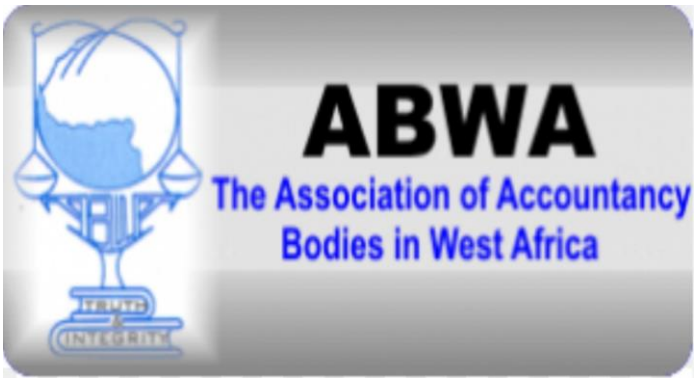

ATSWA

ACCOUNTING TECHNICIANS SCHEME WEST AFRICA

FINANCIAL ACCOUNTING STUDY TEXT

ASSOCIATION OF ACCOUNTANCY BODIES IN WEST AFRICA (ABWA)
ACCOUNTING TECHNICIANS SCHEME WEST AFRICA (ATSWA)

STUDY TEXT FOR

FINANCIAL ACCOUNTING

FIFTH EDITION

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PREFACE

INTRODUCTION

The Council of the Association of Accountancy Bodies in West Africa (ABWA) recognised the difficulty of students when preparing for the Accounting Technicians Scheme West Africa examinations. One of the major difficulties has been the non-availability of study materials purposely written for the scheme. Consequently, students relied on textbooks written in economic and socio-cultural environments quite different from the West African environment.

AIM OF THE STUDY TEXT

In view of the above, the quest for good study materials for the subjects of the examinations and the commitment of the ABWA Council to bridge the gap in technical accounting training in West Africa, led to the production of this Study Text.

The Study Text assumes a minimum prior knowledge and every chapter reappraises basic methods and ideas in line with the syllabus.

READERSHIP

The Study Text is primarily intended to provide comprehensive study materials for students preparing to write the ATSWA examinations.

Other beneficiaries of the Study Text include candidates of other Professional Institutes, students of Universities and Polytechnics pursuing undergraduate and post graduate studies in Accounting, advanced degrees in Accounting as well as Professional Accountants who may use the Study Text as reference material

APPROACH

The Study Text has been designed for independent study by students and as such concepts have been developed methodically or as a text to be used in conjunction with tuition at schools and colleges. The Study Text can be effectively used as a course text and for revision. It is recommended that readers have their own copies.

FOREWORD

The ABWA Council, in order to actualize its desire and ensure the success of students at the examinations of the Accounting Technicians Scheme West Africa (ATSWA), put in place a Harmonisation Committee, to among other things, facilitate the production of Study Texts for students. Hitherto, the major obstacle faced by students was the dearth of Study Texts which they needed to prepare for the examinations.

The Committee took up the challenge and commenced the task in earnest. To start off the process, the existing syllabus in use by some member Institutes were harmonized and reviewed. Renowned professionals in private and public sectors, the academia, as well as eminent scholars who had previously written books on the relevant subjects and distinguished themselves in the profession, were commissioned to produce Study Texts for the twelve subjects of the examination.
A minimum of two Writers and a Reviewer were tasked with the preparation of Study Text for each subject. Their output was subjected to a comprehensive review by experienced imprimaturs. The Study Texts cover the following subjects:

PART I
1 Financial Accounting
2 Economics
3 Business Law
4 Communication Skills

PART II
1 Financial Accounting
2 Public Sector Accounting
3 Quantitative Analysis
4 Information Technology

PART III
1 Principles of Auditing & Assurance
2 Cost Accounting
3 Taxation
4 Management

Although, these Study Texts have been specially designed to assist candidates preparing for the technicians examinations of ABWA, they should be used in conjunction with other materials listed in the bibliography and recommended text.

PRESIDENT, ABWA

STRUCTURE OF THE STUDY TEXT

The layout of the chapters has been standardized so as to present information in a simple form that is easy to assimilate.

The Study Text is organised into chapters. Each chapter deals with a particular area of the subject, starting with learning objective and a summary of sections contained therein.
The introduction also gives specific guidance to the reader based on the contents of the current syllabus and the current trends in examinations. The main body of the chapter is subdivided into sections to make for easy and coherent reading. However, in some chapters, the emphasis is on the principles or applications while others emphasise method and procedures.
At the end of each chapter is found the following:

- Summary;
- Points to note (these are used for purposes of emphasis or clarification);
- Examination type questions; and
- Suggested answers.

HOW TO USE THE STUDY TEXT

Students are advised to read the Study Text, attempt the questions before checking the suggested answers.

ACKNOWLEDGMENTS

The ATSWA Harmonisation and Implementation Committee, on the occasion of the publication of the first edition of the ATSWA Study Texts acknowledge the contributions of the following groups of people. The ABWA Council, for their inspiration which gave birth to the whole idea of having a West African Technicians Programme. Their support and encouragement as well as financial support cannot be overemphasized. We are eternally grateful.

To The Councils of the Institute of Chartered Accountants of Nigeria (ICAN), the Institute of Chartered Accountants, Ghana (ICAG), Institute of Chartered Accountants Sierra Leone (ICASL), Gambia Institute of Chartered Accountants (GICA) and the Liberia Institute of Certified Public Accountants (LICPA) for their financial commitment and the release of staff at various points to work on the programme and for hosting the several meetings of the Committee, we say kudos.

We are grateful to the following copyright holders for permission to use their intellectual properties:

- The Institute of Chartered Accountants of Nigeria (ICAN) for the use of the Institute's examination materials;
- International Federation of Accountants (IFAC) for the use of her various publications;
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We have made every effort to obtain permission for use of intellectual materials in this Study Text from the appropriate sources.

We wish to acknowledge the immense contributions of the writers and reviewers of this manual.
Our sincere appreciation also goes to various imprimaturs and workshop facilitators. Without their input, we would not have had these Study Texts. We salute them.

Chairman
ATSWA Harmonization & Implementation Committee

A new syllabus for the ATSWA Examinations has been approved by ABWA Council and the various PAOs. Following the approval of the new syllabus which becomes effective from the September 2025 diet a team was constituted to undertake a comprehensive review of the Study Texts in line with the syllabus under the supervision of an editorial board.
The Reviewers and Editorial Board members are:

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Contents

ABWA PUBLISHERS ..... **ii**
INTRODUCTION iii
AIM OF THE STUDY TEXT iii
READERSHIP iii
APPROACH iii
FOREWORD iv
STRUCTURE OF THE STUDY TEXT v
ACKNOWLEDGMENTS vi
REVIEWERS vii
EDITORIAL BOARD vii

CHAPTER ONE **14**

INTRODUCTION TO ACCOUNTING **14**
1. 0 Learning Outcomes 14
1.1 Scope of Accounting 14
Accounting Information Systems 14
1.1.1 Definition and Objectives of Accounting 14
1.1.2 Objectives of Accounting 15
1.1.3 Types of Accounting 15
1.2 Difference between Bookkeeping and Accounting 16
1.3 Roles of Accountants in Business 17
1.4 Roles and Duties of those Charged with Governance: 17
Introduction 17
1.4.1 Financial Reporting Participants and Their Interactions 17
1.4.2.1 Responsibilities of Directors in Relation to the Financial Statements 18

1.5 Users of Accounting Information 19
1.6 Bases and Concepts of Accounting 19
1.7 Regulations Governing Accounting and Financial Reporting..... 21
1.8 IAS Standards 23
1.9 IFRS Standards 23
1.1 Financial Reporting Council of Nigeria 24
1.12 Advantages of Accounting Standards 25
1.13 IFRS Foundation..... 25
1.14 IFRS Advisory Council (IFRSAC) 26
1.15 International Financial Reporting Standards Interpretations Committee (IFRSIC)..... 26
1.17 Business Transactions 28
Financial Reporting by Companies..... 30
1.18 Chapter Summary 31
1.19 End of Chapter Questions..... 31

Chapter Two..... 35
Learning Outcomes:..... 35
Content:..... 35
The IASB Conceptual Framework for Financial Reporting..... 35
2.0 Objectives of the Framework 35
2.1 Objective of General-Purpose Financial Statements..... 36
2.2 Users of General-Purpose Financial Statements 36
2.3 Economic Resources and Claims to the Resources..... 36
Changes in Economic Resources and Claims..... 36
2.4 Users of Financial Statements and Their Information Needs 36
Qualitative Characteristics as per the Conceptual Framework..... 37
2.6 The Reporting Entity 39
2.6.1 Types of Reporting Entities 39
2.6.2 Significance of Reporting Entity Structure 39

2.7 Elements of Financial Statements 39
2.7.1 Recognition of the Elements of Financial Statements 41
2.7.2 De-recognition: 41
2.7.4 Measurements of Elements of Financial Statements 42
2.8 Presentation and Disclosure 42
2.10 Other Accounting Concepts 43
2.11 Components of Financial Statements 45
2.12 IFRS 18- Presentation and Disclosure in Financial Statements ... 47
2.13 Aggregation or disaggregation 48
2.14 End of Chapter's Summary 50
2.15 End of Chapter Questions 50

CHAPTER THREE 54
3.0 Learning Objective 54
3.1 Introduction: 54
3,2 ACCOUNTING EQUATION 54
3.2.1 The Entity Concept: 54
Drawings 59
3.3 The Double Entry Bookkeeping 60
3.4 Ledger Accounts: 60
3.5 Source Documents 65
3.6 Books of Prime Entry 72
6.1 The Imprest System and Control Over Petty Cash. 78
3.10 Chart of Accounts 84
3.11 End of Chapter Questions 86

CHAPTER FOUR 88

ACCOUNTING FOR PREPAYMENTS, ACCRUALS, PROVISIONS AND BAD DEBTS 88

CHAPTER CONTENTS 88
4.1 Introduction 88
4.2 Deferred Revenue and Prepayments 89
4.5 Non-current assets and depreciation expenses..... 93

THEORY AND CALCULATION QUESTIONS 110

Straight line method- Motor Vehicles..... 118
CHAPTER SIX 135
INCOMPLETE RECORD AND SINGLE ENTRY 135
Chapter contents..... 135
6.0 Objectives 135
6.1 Introduction 135
6.2 The ascertainment of profit from incomplete records 135
Owner's Capital = Business Net Assets – Business Liabilities 135
Opening capital +profit = opening net assets + increase in net assets... 136
Solution 6.1 137
6.3 Preparation of detailed financial statement from incomplete records..... 138
6.4 Preparation of statement of affairs 138
6.5 Preparation of cash and bank summary 138
6.6 Analysis of unbanked cash sales 138
6.7 Posting from the cash and bank summary 139
6.8 Preparation of trade receivables and trade payables 139
6.9 Extraction of trial balance..... 140
Illustration 6.2 140
Required:..... 141
Solution to 6.2 141
Statement of affairs..... 141
(b) CASH BOOK SUMMARY..... 142

Purchases Ledger Control Account 143
Prepare sales and purchases ledger control accounts 147
Statement of Profit or Loss for the year ended 31/12/2024 149
Statement of Financial Position as at 31/12/2024 150
Non-current assets 150
Current Assets 150
(W2) Telephone & Electricity 151
6.10 Chapter summary 153
6.11 End of chapter questions 153
Use the data below to answer Questions 2 to 5 153
EXAMINATION TYPE QUESTIONS 155
CHAPTER SEVEN 167
Chapter contents 167
7.0 Objectives 167
7.1 INTRODUCTION 167
7.5 CONSISTENCY OF ACCOUNTING POLICIES 168
7.6 Application or treatment of change of accounting policy: 168
7.7 Retrospective Application 168
7.8 Disclosure of Accounting Policies 169
7.9 Changes in Accounting Estimates/Definition of accounting estimates: 169
7.9.1 Examples of accounting estimates 169
7.9.2 Treatment of changes in accounting estimates 169
7.9.3 Disclosure of Accounting Estimates 171
7.11 Accounting for prior year error 171
7.13 End of Chapter Questions 172
7.14 Solution to end of chapter questions 173
CHAPTER EIGHT 174
Chapter contents 174

8.0 Objectives 174
8.1 Introduction 174
8.2 Receipts and Payments Account 175
FEATURES OF RECEIPTS AND PAYMENTS ACCOUNTS 175
8.3 Income and Expenditure Account 175
8.4 Membership Subscription 175
8.5 Bar Trading Account 177
8.6 Life Membership 177
8.7 Accumulated Fund or Equity Reserve Fund. 177
8.10 Solution to end of chapter questions 189
CHAPTER TEN 221
PARTNERSHIP ACCOUNTS 221
10.0 Learning Objectives 221
10.1 Definition of Partnership 221
10.2 Types of Partners in a Partnership 221
10.3 Formation of Partnership 221
10.4 Partnership Agreement 222
10.5 Rules Applicable in the Absence of Partnership Agreement **Error! Bookmark not defined.**
10.6 Accounts That Are Peculiar To the Partnership Business..... **Error! Bookmark not defined.**
10.7 Guaranteed Share of Profit 224
10.8 Recording of Partnership Transactions 224
Drawing of stocks for personal use: 224
Interest on drawings: 225
Interest on Capital Account: 225
Partner's Salary: 225
Share of Profit: 225
Share of Loss: 225
Drawings by a partner: 225

Illustration 10.1 225
Capital Accounts: 225
Current Accounts: 225
Solution10.1 226
You are required to prepare: 229
Recording of Goodwill in Partnership Accounts 231
10.10 Revaluation of Assets 232
Current Accounts: ..... **Error! Bookmark not defined.**
10.11 Chapter Summary 238
CHAPTER ELEVEN ..... **Error! Bookmark not defined.**
PARTNERSHIPACCOUNTS 2 ..... **Error! Bookmark not defined.**
Chapter contents ..... **Error! Bookmark not defined.**
11.0 Objectives ..... **Error! Bookmark not defined.**
11.1 Changes in the Structure of Partnership **Error! Bookmark not defined.**
11.2 Goodwill ..... **Error! Bookmark not defined.**
11.2.1 Accounting for Goodwill ..... **Error! Bookmark not defined.**
Illustration 11.1 ..... **Error! Bookmark not defined.**
SOLUTION TO ILLUSTRATION 11.1 **Error! Bookmark not defined.**
Partners' Capital Account ..... **Error! Bookmark not defined.**
Bookkeeping in Respect of Revaluation. **Error! Bookmark not defined.**
11.5 RETIREMENT AND DEATH OF A PARTNER ..... **Error! Bookmark not defined.**
11.6 AMALGAMATION OF PARTNERSHIPS **Error! Bookmark not defined.**
11.7 Dissolution of Partnership ..... **Error! Bookmark not defined.**
11.8 Conversion of a Partnership to a Limited Company ..... **Error! Bookmark not defined.**
Realization Account ..... **Error! Bookmark not defined.**
Partners' Capital Accounts ..... **Error! Bookmark not defined.**
11.10 Multiple Choice and Short Answer Questions **Error! Bookmark**

not defined.
11.11 SOLUTIONS ..... **Error! Bookmark not defined.**
CHAPTER TWELVE 269
ACCOUNTING FOR INVENTORIES 269
Chapter contents 269
12.0 Objectives 269
12.1 Definition of an Inventory 269
12.2 Cost of Inventories 269
12.3 Cost of Purchase 269
12.5Costs excluded from valuation of inventory 270
12.6 General Principle for Valuation of Inventory 270
12.7 Accounting for write down on inventory 271
12.8 Methods of calculating cost of inventories: 271
12.9 Methods of recording inventory 275
i. Periodic Inventory methods 275
ii Perpetual Inventory methods 275
Entries to link to statement of profit or loss 276
12.10 Accounting for loss of Inventory 277
Inventory Lost= Opening Inventory +Purchases–Cost of Goods Sold. 277
Inventory: 277
SOLUTION TO ILUSTRATION 12.5 278
₦'000 281
12.11 Inventory Adjustment 281
Required: 282
SOLUTIONTOILLUSTRATION 12.6 283
Illustration 12.7 237
Solution to 12.7 237
12.12 Effect of Cut-Off Point on Inventory Valuation 237
12.14 End of chapter questions 237

12.15 Solution to end of chapter questions 239
12.16 Examination type question 239
Required: 240
12.17 Solution to examination type questions 240
CHAPTER FOURTEEN 260
Chapter contents 260
14.0 Objectives: 260
Types of shares 260
Types of preference share capital 261
Nominal Value 261
Share Premium 261
14.1.1 Uses of the balance in the share premium account. 261
14.1.2 Share Capital 261
14.1.3 Accounting for Issue of Shares. 262
Illustration 14.2 263
14.1.4 Bonus Issue 263
14.1.5 Rights Issue 264
Advantages of rights issue 264
14.2 Loan notes 264
14.3 Company Income Tax 264
Adjustment for tax underestimate or overestimate. 265
Income tax expense 265
Treatment of tax in the statement of financial position 265
14.4. Preparation of Financial statements 265
14.4.1 Additional requirements of IAS 1 265
14.4.2 Other requirements of IAS 1 are the disclosure of: 266
14.4.3 Contents of Financial Statements 266
Contents of the Statement of Financial Position 266
Current and non-current assets and liabilities 266

Current Assets 266
Operating Cycle 267
Examples of current assets are 267
Examples of non-current assets..... 267
Examples of current liabilities are 267
14.5.1 Content of Statement of Profit or Loss 268
Illustration 14.3. 270
You are required to prepare: 271
14.7. Statement of Cash Flows 275
14.7.1 Limitations of the Statement of Cash Flows 275
14.7.2 Differences between Statement of Cash Flows and Statement of Profits or loss. 275
14.7.3 CLASSIFICATION OF CASH FLOWS- IAS7 275
14.7.4 Presentation of the Statement of Cash Flows 277
Cash flows are divided into three parts, namely: 277
2. Indirect Method 277
Working capital items. 278
Illustration 14.4 278
Required: 278
Working Receivables Account 279
Indirect method 280
Illustration 14.5 280
Required: 283
Solution illustration 14.5 Alade LTD 283
14.8 End of Chapter Questions and answers 284
14.8.1 Solution to end of chapter questions – multiple choice question. 287
CHAPTER FIFTEEN 293
INTERPRETATION OF FINANCIAL STATEMENTS 293
Chapter content 293

15.0 Objectives 293
15.1 Users of Financial Statements and Their Information Needs..... 293
15.2.1. Tools of Financial Analysis 294
Horizontal Analysis..... 294
Vertical Analysis 295
Intercompany Analysis 295
Ratio Analysis 295
15.2.2 Comparisons and Basis of Comparisons in Financial Analysis 295
15.3 Ratio Analysis as a Tool of Financial Analysis 295
a. Profitability Ratios 296
Gross Profit Margin..... 296
Net Profit Margin 297
Rate of Return on Equity (ROE) 298
Return on Assets..... 298
Return on Capital Employed (ROCE)..... 298
b. Activity or Efficiency Ratios 298
i. Sales to Assets Ratio 298
ii. Sales to Capital Employed 298
iii. Inventory Turnover Ratio/Period 299
Receivables Turnover Ratio/period..... 299
iv. Payable Payment Period 299
c). Liquidity or Short-term financial stability Ratio..... 299
Current Ratio..... 299
Quick Ratio or Acid Test Ratio 300
Inventory Turnover Period 300
Receivables Collection Period 300
Payables Payment Period 300
Cash Operating Cycle/Working Capital Cycle 300
15.4 The Concept of Overtrading 301

15.5 Gearing or Long- term Financial Stability Ratios 301
The Concept of Financial Balance 302
iii. Proprietary Ratio 302
iv. Fixed Interest Cover 303
v. Fixed Dividend Cover 303
Investment or Market Value Ratios 303
The Earnings Per Share (EPS) 303
Dividend Per Share (DPS) 303
Earnings Yield 304
Price Earnings Ratio 304
Dividend Yield 304
Dividend Pay-Out Rate 305
15.6 Calculation of Basic Ratios and Their Interpretation 305
Required 305
Solution 15.1 306
Illustration 15.2 307
Required: 307
Solution 15.2 309
b) Profitability 309
Financial Stability 309
Illustration 15.3 310
Income statement for the year ended 31 December 2016 310
Statement of Financial Positions as at 31 December 2024 310
Short-term Financial Strength 316
15.7 Limitations of Ratio Analysis 316
15.9 Chapter Summary 319
15.10 END OF CHAPTER QUESTION 319
SHORT ANSWER QUESTIONS 320
SOLUTION TO MULTIPLE CHOICE QUESTIONS 320

Profitability 321
Financial Stability 321
CHAPTER SIXTEEN 322
16.0 Objectives 322
16.2 Professional Ethics 322
16.4 Fundamental principles of Professional code of ethics 323
16.5. Threats that may affect professional accountants from compliance with ethical behaviour 324
16.7 Ways by which financial statements information can be compromised 324
16.8 What are the motivations for unethical financial reporting by companies? 325
16.9 How to resolve issues of ethical conflict 325
16.10 Consequences of unethical financial reporting: 326
16.11 How accountancy profession ensure quality financial reporting 326
16.14 Computerised Accounting System 328
Components of Computerised Accounting System 328
Workings of the Computerised Accounting System 328
Basic requirements of computer database application 329
Coding and Grouping of accounts 329
Non-current assets 330
Current assets 330
16.14.1. Type of coding 330
Block-coding: Assigned to 330
Accounting software 330
i. Readymade software (off- the -shelf software) 331
ii. Customised packages 331
Advantages of Computerised Accounting System 331

Examination type questions 339

CHAPTER ONE
INTRODUCTION TO ACCOUNTING

1. 0 Learning Outcomes

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

Define accounting and state the objectives of accounting.
Differentiate between financial accounting and book-keeping.
Identify the users of accounting information and their information needs.
Identify the possible impacts of relevant legislation and regulations governing corporate and non-corporate accounts
Explain the accounting concepts, including:
Going concern
Accruals
Materiality and aggregation
Substance over form
Business entity concept
Fair presentation
Offsetting
Consistency and presentation
Prudence
Identify and discuss the bases of accounting, including:
Accruals
Cash
Break-up bases of accounting
Identify and explain the attributes of different reporting entities.

1.1 Scope of Accounting

Accounting plays a vital role in the financial management and decision-making processes of organizations. The scope of accounting encompasses a broad range of activities, functions and users, making it an essential tool for businesses, non-profit organizations and individuals. It provides stakeholders with financial information to make informed decisions.

Accounting, often regarded as the "language of business," plays a vital role in the financial management and decision-making processes of organizations. The scope of accounting encompasses a broad range of activities, functions, and users, making it an essential tool for businesses, non-profit organizations, and individuals. Financial Planning

Financial planning is a critical aspect of accounting that involves forecasting financial outcomes, identifying funding needs, and developing financial strategies. Financial planning helps organizations achieve their goals and objectives by ensuring that financial resources are allocated effectively.

Accounting Information Systems
Accounting information systems involve designing and implementing systems for financial data collection, processing and reporting. These systems provide stakeholders with timely and accurate financial information, enabling them to make informed decisions.

1.1.1 Definition and Objectives of Accounting

Definition of Accounting
Accounting is the process of identifying, recording, classifying, reporting and analyzing financial information of a business or organization. It involves the systematic and comprehensive recording of financial transactions and events, providing stakeholders with relevant and reliable financial information.

1.1.2 Objectives of Accounting

The primary objectives of accounting are:

1. Recording financial transactions: To record financial transactions and events accurately and systematically in a timely manner.
2. Classifying and reporting financial information: To classify and report financial information in a way that is meaningful and useful to stakeholders.
3. Providing relevant and reliable information: To provide stakeholders with relevant and reliable financial information to support decision-making.
4. Assessing financial performance: To assess the financial performance and position of a business or organization.
5. Compliance with laws and regulations: To ensure compliance with relevant laws, regulations, and standards.

1.1.3 Types of Accounting

Financial Accounting: Financial accounting involves preparing financial statements, such as balance sheets and income statements, to provide stakeholders with a clear picture of a company's financial performance and position. Financial accounting is typically performed in accordance with accounting standards, such as Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS).

Performance Management or Management Accounting: Management accounting involves providing financial information to internal stakeholders, such as managers and executives, to aid in decision-making and strategic planning. Management accounting uses various techniques, including budgeting, forecasting, and performance measurement, to help organizations achieve their goals.

Cost Accounting: Cost accounting involves analyzing and reporting the costs associated with producing goods or services, such as labour, materials and overhead costs. Cost accounting helps businesses determine the profitability of their products or services and make informed decisions about pricing, production and investment.

Tax Accounting: Tax accounting involves preparing and filing tax returns, such as income tax returns and value-added tax (VAT) returns, to comply with tax laws and regulations. Tax accounting also involves planning and advising on tax strategies to minimize tax liabilities and maximize tax benefits.

Auditing: Auditing involves examining financial statements, and records to ensure accuracy, completeness and compliance with laws and regulations. Auditors, who may be internal or external, use various techniques, including testing and verification, to express an opinion on the fairness and reliability of financial statements

Forensic Accounting: Forensic accounting involves using accounting skills to investigate financial crimes, such as embezzlement, fraud and money laundering. Forensic accountants use various techniques, including data analysis and financial modeling, to gather evidence and testify in court.
Sustainability Accounting: Sustainability accounting involves measuring, reporting and analyzing an organization's social, environmental, and economic impacts. Sustainability accounting helps businesses understand their sustainability performance, identify areas for improvement, and make informed decisions about sustainability strategies.

Project Accounting: Project accounting involves tracking and reporting the financial performance of specific projects, such as construction projects or software development projects. Project accounting helps businesses manage project costs, revenues and resources, and make informed decisions about project investments.
Fund Accounting: Fund accounting involves managing and reporting the financial activities of non-profit organizations, such as charities, foundations, and educational institutions. Fund accounting helps non-profits track and report on their financial resources, expenditures, and achievements.
Environmental Accounting: Environmental accounting involves measuring and reporting the environmental impacts of an organization's activities, such as greenhouse gas emissions, water usage and waste generation. Environmental accounting helps businesses understand their environmental footprint, identify areas for improvement and make informed decisions about environmental strategies.

Accounting Systems
Business entities operate a system to record business transactions in accounting records. This system is called a book-keeping system. All large businesses (and many small ones) have a book-keeping system for recording the financial details of their business transactions on a regular basis. The bookkeeping records of a business are often referred to as the accounts of the business.

The content of financial statements might vary depending on whether a business is a sole trader, partnership, or limited liability company. However, the basic process used to record transactions is similar for all types of entities. The technique used is called double-entry bookkeeping and is explained in detail later.

Accounting is one of the key functions for almost any business; it may be handled by a bookkeeper and accountant at small firms or by sizable finance departments with dozens of employees at larger companies.

1.2 Difference between Bookkeeping and Accounting

This might be best explained by comparing the work of a bookkeeper and an accountant.
Bookkeeping is the first step in an accounting process. Bookkeepers are responsible for maintaining a record of all transactions entered into by a business. Bookkeepers enter the

transactions into the accounting system to produce an accurate and complete record of the financial transactions of a business. Bookkeeping is a routine task, so it tends to be repetitive.
Accounting includes not only the keeping of accounting records but also the design of efficient accounting systems, the interpretation of accounts, and development of forecasts. In essence, accountants use the information recorded by the bookkeepers to help them produce financial statements (or other reports as required by management).
Bookkeeping is part of accounting, but accounting is much wider in scope. An accountant could easily perform a bookkeeping function, but a bookkeeper would require a lot more education and training before becoming an accountant.

1.3 Roles of Accountants in Business

Qualified accountants have considerable knowledge and expertise about all aspects of business, with a particular focus on the numbers that reflect the position and performance of the business.
An accountant may fulfill or contribute to a large number of roles and functions. These include:
Financial reporting – Accountants generate financial reports. This involves using information from the accounting system, adding to it, analyzing it, and presenting it in accordance with the accounting rules followed in the jurisdiction in which the business operates.

- Compliance – Accountants are involved in ensuring that a business complies with certain aspects of company law (e.g., a company must prepare financial statements in a given form).
- Strategy – Accountants provide analysis and insight during the formulation of a business's strategy.
- Planning – Accountants are involved in providing information used when businesses plan their future activities.
- Control – Accountants assist in setting targets and monitoring and reporting on performance.
- Decision making – Accountants are involved in providing information used for decision-making purposes.
- Taxation – Accountants might prepare taxation computations or provide relevant information to tax specialists for the preparation of taxation computations.
- Systems – Accountants help to set up and run efficient systems of accounting and internal control.
- Treasury managers – Accountants also often act as treasury managers, overseeing the financial management of an organization

1.4 Roles and Duties of those Charged with Governance:

Introduction

Those charged with governance means the persons with responsibilities for overseeing the strategic direction of the entity and the obligations related to accountability of the entity. This includes financial reporting processes. They have the responsibility of supervising the work done by the entity and the responsibility for approving the financial statements.
Those charged with governance includes board of directors, audit committee and management. Those charged with governance may also include the entity's executive team.
The company's directors are the most prominent group of actors charged with the governance. Management is responsible for the operational processes of the entity while directors are responsible for the strategic oversight of the entity.

1.4.1 Financial Reporting Participants and Their Interactions

The key participants in the financial reporting supply chain and their respective roles are as follows:

i. Management are responsible for the day to day operation of the company and prepares financial statements to reflect the company's financial position and performance;
ii. Audit Committee reviews and oversee the financial reporting process, ensuring the integrity of the financial statements. They may identify issues or ask questions before the financial statements are finalised;
iii. Directors approve financial statements, ensuring they accurately represent the company's financial situation and comply with relevant laws and regulations;
iv. External auditors conduct independent audits of financial statements to ensure their accuracy, completeness, and compliance with accounting standards and regulatory requirements. This provides stakeholders with the confidence in the company's financial reporting, enabling them to make informed decisions ; and
v. Stakeholders, such as investors, creditors and regulators, make decisions based on the financial statements, relying on their accuracy and reliability.

1.4.2 Directors Duties

Directors owe duty of care to the organisation it is governing. This duty of care is written in the Companies Act (Companies and Alllied Act 2020). Directors are required to exercise duties of care, diligence and skill that a responsible director would exercise in the same circumstances. Companies and organisations are not a natural person; therefore directors are accountable on behalf of entity to those who provide the entity with capital to operate. These are the shareholders, investors and creditors.

The requirements of the Companies Act is often supplemented by a former written agreement between the organisation and the directors outlining further specific terms of appointment, including responsibility for financial reporting. Other duties set out in the Companies Act require the directors to;

i. act in good faith and in the best interest of the company,
ii. avoid conflicts of interest,
iii. exercise independent judgment,
iv. maintain confidentiality;
v. not accept benefits from third parties, and
vi. declare interest in a proposed arrangement

1.4.2.1 Responsibilities of Directors in Relation to the Financial Statements

Some of the specific responsibilities of the director in relation to the financial statements are as follows:

i. To ensure that financial statements are prepared in accordance with the applicable framework, regulations and legal requirements;
ii. To make sure those financial statements presents a true and fair view of the state of affairs of the entity. Financial statements should be consistent with the rest of the financial information available to users, so that they are not misleading;
iii. To ensure that appropriate and adequate financial reporting system are in place;
iv. To approve annual budget and ensure adherence to the budget;
v. To liaise with the external auditors and oversee the quality and independence of the external audit process; including approving the audit fees and the scope of the audit;
vi. To establish and review internal control and internal check processes to ensure that the information used to compile the financial statements is accurate, verifiable and timely;
vii. Review the other information presented in the Annual Report to ensure it is consistent with the management information they have received and the information contained in the financial statements. Directors are responsible for internal control necessary to enable the preparation of financial statements that are free from material errors and fraud;
viii. Directors should understand and approve the assumptions adopted by the organisation and the

key areas of judgment and estimation applied in preparing the financial statements. They need to review the validity of the going concern assumption regularly. Furthermore, they should apply professional caution when assessing management's views on areas of significant judgment and estimates; and

ix. Directors should ensure that financial statements are filed with regulators on time timely and regular basis.

1.5 Users of Accounting Information

Accounting plays a vital role in providing stakeholders with relevant and reliable financial information, enabling them to make informed decision. The users are:

Internal Users

- Owners: interested in the financial performance and position of the business to assess the return on their investment and make informed decisions about the business.
- Managers: use financial information to make strategic decisions, monitor performance and control costs.
- Employees: interested in the financial stability and profitability of the business to assess job security and potential for salary increases.

External Users

- Investors (existing and potential): interested in the financial performance and position of the business to assess the risk and potential return on their investment.
- Lenders (banks and other financial institutions): interested in the business's ability to repay loans and interest.
- Suppliers and trade creditors: interested in the business's ability to pay debts on time.
- Customers: interested in the business's stability and ability to continue supplying goods or services.
- Government and government agencies: interested in the business's compliance with laws and regulations, and its contribution to the economy.
- Financial analysts: interested in analyzing financial statements to provide recommendations to investors and other stakeholders.
- General public: interested in the business's contribution to the local economy and its social responsibility.

Information Needs

- Financial performance: users need information about the business's revenue, expenses, profits, and cash flows.
- Financial position: users need information about the business's assets, liabilities, and equity.
- Liquidity and solvency: users need information about the business's ability to pay debts and meet financial obligations.
- Future prospects: users need information about the business's future plans, opportunities and risks

1.6 Bases and Concepts of Accounting

1.6.1 Bases and Concepts of Accounting

There are three bases of accounting:

1. Accrual basis

2. Cash basis
3. Breakup basis

Of these three bases, the accrual basis is the most useful when preparing general-purpose financial statements.

Accrual Basis
The accrual basis of accounting recognises transactions and other events in the accounting period in which they occur, not when the associated cash is received or paid.

- Revenue from sales and other incomes are reported in the period they are earned, not in the period when the cash is received.
- An expense should be charged in the period in which it is incurred, not the period when the payment is made.

The accrual basis and the application of the matching principle:

- The accrual basis is based on the application of the matching principle.
- The accrual basis provides the reason for adjusting for accrued and prepaid expenses when preparing financial statements.
- The application of the matching principle leads to the recognition of:

- Prepaid and accrued expenses, and income receivable or deferred income in the statement of financial position.
- Cost of sales, not purchases, depreciation and amortization in the statement of comprehensive income, rather than cash paid or received for items involved.

Cash Basis
Cash basis accounting recognises transactions, other events and conditions in the periods in which cash receipts and payments occur.

- Revenue from credit sales and other incomes are reported in the period when the cash involved is received, not in the period when the sales were made or the income earned.
- All expenses are recognised and reported in the period when payments were made, rather than in the period when the expenses were incurred.

Set-backs associated with the cash basis of accounting include:

- It does not match costs with revenue, hence profits may be distorted.
- Unearned income and liability accounts are not reported; hence the statement of financial position may not reflect all monies due or owing.
- It does not show income that has not been invoiced or received.
- It does not allow for tracking the actual sales and purchases.
- It does not report the effect of non-current asset utilization made by entities, as it ignores depreciation effect on such assets.

Breakup Basis
The breakup basis of accounting is applied to businesses that have lost their going concern status. In this situation, business assets and liabilities are measured at the amount of cash they can be sold for or settled.

Illustration 1.1 on accrual and cash bases of accounting
Omo Ajii Confectionaries sells ₦1,000,000 worth of confectionaries in December but only ₦800,000 was collected in cash by reporting date. The remaining ₦200,000 will be collected in January of the following year. Omo Ajii also receives ₦300,000 in cash in December for confectionaries sold in November.
How would Omo Ajii Confectionaries account for these transactions under both the accrual basis and cash basis of accounting?
How would the accounting basis used affect financial position?

Solution:
Accrual Basis of Accounting:
Under the accrual basis, revenue is recognised when earned, regardless of when cash is collected. Expenses are recognised when incurred, regardless of when cash is paid.
Sales: ₦1,000,000 (full amount of cakes sold in December is recorded as revenue, even though ₦200,000 has not been collected yet)
Cash received: ₦800,000 (cash collected in December for December sales) + ₦300,000 (cash collected in December for November sales) = ₦110,000
However, for accrual accounting, the ₦300,000 received for November sales would have been recorded as revenue in November. So, in December, the revenue would be ₦1,000,000 (December sales) and the ₦300,000 would be a reduction of Accounts Receivable from November.
Cash Basis of Accounting:
Under the cash basis, revenue is recognised when cash is collected. Expenses are recognised when cash is paid.
Revenue: ₦800,000 (cash collected in December for December sales) + ₦300,000 (cash collected in December for November sales) = ₦110,000
The ₦200,000 not collected yet would not be recorded as revenue until it is collected in January.
Accrual Basis:
Assets: Accounts receivable would be ₦200,000 higher (₦1,000,000 sales - ₦800,000 cash collected) because it records the amount owed to the business.
Revenue: Higher revenue (₦1,000,000) would be reported in the statement of comprehensive income, which would increase retained earnings (Equity).
Overall, the accrual basis provides a more accurate picture of the business's financial position and performance.
Cash Basis:
Assets: Accounts Receivable would not be recorded for the ₦200,000 not collected yet. Cash would be ₦1,100,000 (₦800,000 + ₦300,000).
Revenue: Revenue would be ₦1,100,000, including ₦300,000 from November sales.
Retained Earnings (Equity) would be different due to the different revenue recognition.
The accrual basis generally provides a more accurate representation of a company's financial position and performance, while the cash basis can distort financial reporting, especially for businesses with significant accounts receivable or payable.

1.7 Regulations Governing Accounting and Financial Reporting

Importance of Regulations

Users rely on financial statements to make investment decisions; hence their presentation needs to be regulated to ensure credibility and fairness. For example, banks lend money to companies based on their financial statements, and in the event of a merger of companies, financial statements also form the basis for valuation. While profit reported by a company also forms the basis for charging income tax.

In view of these, there must be appropriate laws and regulations that would guide against creative accounting as much as possible.

Basis of Financial Statement Preparation

The preparation and presentation of financial statements are based on a large number of concepts, principles and detailed rules. Some of these are contained in law, while others are in financial reporting standards and generally accepted accounting principles (GAAP). Generally Accepted Accounting Principles vary from country to country because their legal and regulatory systems are not the same. However many countries all over the world have now accepted a uniform accounting standards, which is known as International Financial Reporting Standards IFRS or IAS. It is this set of standards and use of appropriate local GAAP that are applied when preparing and presenting financial statements.

Accounting Standards

Definition

Accounting standards are common sets of principles and procedures that define the basis of financial accounting policies and practices. They apply to the whole spectrum of an entity's financial transactions and other events, including assets, liabilities, revenue, expenses, and equity.

Adoption

Accounting standards do not have the force of law, but they become effective if they are adopted by a country.

International Accounting Standards Board (IASB)

The IASB is responsible for issuing new International Financial Reporting Standards (IFRSs). The board is made up of 14 members that are highly skilled in accounting and each member contribute to the issue and publications of the following documents issued by the Board.

Outputs of the IASB

The IASB issues several types of documents, including:

Exposure draft of standards

Revised International Accounting Standards (IAS)

International Financial Reporting Standards (IFRSs)

Final interpretation of the IFRS Interpretation Committee (IFRSIC)

Responsibility of the IASB

The IASB has full responsibility for all technical matters. They have issued the IASB Conceptual Framework, which sets out the concepts that underlie the preparation and presentation of financial statements for users.

Further Details

The details of the Conceptual Framework have been dealt with in another chapter.

The International Accounting Standards Board (IASB) is responsible for setting global accounting standards. National accounting standard-setting bodies, such as Nigeria's Financial Reporting Council (FRCON), ensure compliance with International Financial Statement (IFRS). The IASB issues standards, including IFRSs and Interpretations (IFRICs), which are used globally to promote consistency and transparency in financial reporting. Since 2001 IASB has published the following Standards

1.8 IAS Standards

1. 1. IAS 1 - Presentation of Financial Statements –To be replaced by IFRS 18 with effect from January
   1,2027
2. IAS 2 - Inventories
3. IAS 7 – Statement of Cash flows
4. IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors
5. IAS 10 – Events after the Reporting Period
6. IAS 12 – Income Taxes
7. IAS 16 - Property, Plant and Equipment
8. IAS 19 - Employee Benefits
9. IAS 23 – Borrowing Costs
10. IAS 27 – Separate Financial Statements
11. IAS 29 –Financial Statement in Hyperinflationary Economy
12. IAS 28 – Investment in Associates and Joint Venture
13. IAS 32 - Financial Instruments: Presentation
14. IAS 36 - Impairment of Assets
15. IAS 37 - Provisions, Contingent Liabilities and Contingent Assets
16. IAS 38 - Intangible Assets
17. IAS 40- Investment Property
18. IAS 41 - Agriculture

1.9 IFRS Standards

1. IFRS 1 - First-time Adoption of IFRS
2. IFRS 2 - Share-based Payment
3. IFRS 3 - Business Combinations
4. IFRS 4 - Insurance Contracts
5. IFRS 5 - Non-current Assets Held for Sale and Discontinued Operations
6. IFRS 6 - Exploration for and Evaluation of Mineral Resources
7. IFRS 7 - Financial Instruments: Disclosures
8. IFRS 8 - Operating Segments
9. IFRS 9 - Financial Instruments
10. IFRS 10 - Consolidated Financial Statements
11. IFRS 11 - Joint Arrangements
12. IFRS 12 - Disclosure of Interests in Other Entities
13. IFRS 13 - Fair Value Measurement
14. IFRS 14 - Regulatory Deferral Accounts
15. IFRS 15 - Revenue from Contracts with Customers
16. IFRS 16 - Leases

17. IFRS 17 - Insurance Contracts (replacement for IFRS 4)
18. IFRS for SMEs - International Financial Reporting Standard for Small and Medium-sized Entities
19. IFRS 19 – Subsidiaries without Public Disclosures

1.10 Relevant IFRSs

The following IFRSs are relevant at this level of the ATSWA examination:

1. IAS 1 - Presentation of Financial Statements
2. IAS 2 - Inventories
3. IAS 7 - Statement of cash flows
4. IAS 8 - Accounting Policies, Changes in Accounting Estimates, and Errors
5. IAS 16 - Property, Plant, and Equipment

1.1 Financial Reporting Council of Nigeria

The Financial Reporting Council of Nigeria (FRCoN) is the national accounting standards setting body in Nigeria, replacing the Nigerian Accounting Standards Board (NASB) in June 2011.

Establishment

The FRCN was established by the Financial Reporting Council of Nigeria Act, No. 6, 2011, which repealed the Nigerian Accounting Standards Board Act No. 22 of 2003.

Supervision

The FRCN is an agency (Parastatal) of the Federal Government, directly supervised by the Federal Ministry of Industry, Trade and Investment.

Objectives

According to the Act, the main objects of FRCN are:

a.) To protect investors and other stakeholders' interests;
b. To give guidance on issues relating to financial reporting and corporate governance to professional, institutional and regulatory bodies in Nigeria;

c. To ensure good corporate governance practices in the public and private sectors of the Nigerian economy;

d. To ensure accuracy and reliability of financial reports and corporate disclosures, pursuant to various laws and regulations currently in existence in Nigeria;

e. To harmonise activities of relevant professional and regulatory bodies as relating to corporate governance and financial reporting;

f. To promote the highest standards among auditors and other professionals engaged in the financial reporting process;

Structure

For effective operations, the FRCON is structured into seven directorates:

1. Directorate of Accounting Standards - Private Sector
2. Directorate of Accounting Standards - Public Sector
3. Directorate of Auditing Practice Standards
4. Directorate of Actuarial Standards
5. Directorate of Valuation Standards
6. Directorate of Inspection and Monitoring
7. Directorate of Corporate Governance

Responsibilities of the Directorate of Accounting Standards
To achieve its purpose of developing and publishing accounting standards in Nigeria, the FRCON Directorate of Accounting Standards is assigned the following responsibilities:

(a) To develop accounting and financial reporting standards to be observed in the preparation of financial statements in the private sector and small and medium-scale enterprises;
(b) To promote the general acceptance and adoption of such standards by preparers and users of financial statements;
(c) To promote compliance with the accounting standards developed or reviewed by the Directorate;
(d) To review from time to time the accounting standards developed in line with the prevalent social, economic, and political environment;
(e) To promote compliance with accounting and financial reporting standards adopted by the Council;
(f) To promote, in the public interest, accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities; and
(g) To perform such other duties which, in the opinion of the Board, are necessary or expedient to ensure the efficient performance of the functions of the Council.

It should be noted that international accounting standards cannot be used or applied in any country without the involvement and approval of the national regulators in that country. Every country has its peculiar approval process or road map which must be followed before IFRS can be applied in such country. In Nigeria, the FRCON constructed a plan, called a road map, which was used in driving the convergence of Nigerian GAAP to IFRS from January 2012 to 2014. Effectively Nigeria adopted IFRS from January 1, 2012.

Scope
Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are not intended to be applied to immaterial items, nor are they retrospective.

1.12 Advantages of Accounting Standards

1. Improve the reliability of financial statements because their reliability can be tested against the prescriptions of the relevant standards.
2. Allow for inter-firm and intra-firm comparisons, which allow users of financial statements to check the progress of the firm and its position in the market effectively.
3. Allow interpretations of financial statements by users.
4. Ensure uniformity in the preparation of financial statements of entities within the same industry.
5. Ensure that financial statements of entities are prepared in a consistent manner every year.

6. Ensure that financial statements are prepared in a transparent manner, based on rules and principles.

1.13 IFRS Foundation

The International Accounting Standards Committee Foundation (IASC) is the parent entity of the IASB. In July 2010, it changed its name to IFRS Foundation.

Duties of the IFRS Foundation
1. Responsible for raising funds needed to finance standard setting.
2. Responsible for the appointment of members to the IASB, IFRS Interpretation Committee, and IFRS Advisory Council.
3. Oversees and supervises the standard-setting work.
4. Oversees and supervises the IFRS structure and strategy.
5. Responsible for reviewing the constitution.
6. In charge of governance of standard setting and IFRS strategy.

1.14 IFRS Advisory Council (IFRSAC)

The IFRS Advisory Council is a formal advisory body to the IASB and the Trustees of the IFRS Foundation. It consists of a group of organizations and individuals with interest and relevant knowledge in international financial reporting.

Membership
The members of the IFRS Advisory Council are drawn from different geographic locations and have a wide variety of backgrounds, including:

- User groups
- Preparers of financial statements
- Financial analysts
- Academics
- Auditors
- Regulators
- Professional accounting bodies
- Investor groups

Role
The major role of the IFRS Advisory Council is to advise the Trustees of the IFRS Foundation and the IASB on financial reporting issues, especially on:

- Prioritization of its work
- Implications of proposed standards for users and preparers of financial statements

The IASB is required to consult with the IFRS Advisory Council in advance of any board decisions on major projects that it wishes to add to its agenda.

1.15 International Financial Reporting Standards Interpretations Committee (IFRSIC)

The IFRSIC assists the IASB by improving existing standards.

Membership

The IFRSIC comprises mostly technical partners in audit firms, as well as preparers of financial statements and user groups.

Functions and Responsibilities
The IFRSIC has the following functions and responsibilities:

1. To interpret the accounting standards (IFRSs and IASs) issued by the IASB.
2. To review, on a timely basis, newly identified financial reporting issues not specifically addressed in IFRSs.
3. To clarify issues where unsatisfactory or conflicting interpretations have developed, or are likely to have developed.
4. To provide timely guidance on the application and interpretation of IFRSs.
5. To answer queries from constituencies about how to interpret IFRSs.
6. To liaise with the US Emerging Issues Task Force and similar bodies and standard setters to try to preserve convergence.
7. To establish working relationships with local or national standards setters who have adopted or converged, or are about to adopt or converge to IFRSs.

Company Laws
Company laws set out rules for determining profits available for distribution, issuing and redeeming share capital, the reserves a company must have, and the uses to which they can be put. Company law establishes the accounting requirements for financial reporting and contains the general requirements to prepare financial statements.
Key Provisions
- Places a duty on directors to prepare annual statements each year
- Prescribes the form and content of financial statements

Variations
Company law varies from country to country. In Nigeria, the relevant company law is the Companies and Allied Matters Act 2020.

Listing Rules
These rules set out the information that entities must supply when their shares are traded on the stock market. They must comply with these rules to maintain their listing.

Requirements
The rules include financial information, which comprises financial reports that entities must prepare and provide to the stock market while they are listed.

Further Regulations
Further regulations are often issued by banks and other insurance regulators. These rules apply to relevant entities in the financial service sector.

1.16 Types of Business Entities

1. **Sole Trader**: Owned and managed by one person, personally liable for debts, and profits belong to the owner.
2. **Partnership**: Owned by two or more people, partners share profits and losses, and are personally liable for debts.
3. **Company/Limited Liability Company**: A separate legal entity from its owners, with limited liability, and ownership represented by shares.

4. **Not-for-Profit Entities**: Established for social and welfare services, not for profit, and often rely on subscriptions and donations.

Entities Sole Trader:
Owned and managed by one person, personally liable for debts, and profits belong to the owner.

1.17 Business Transactions

Business
The term "business" means different things to different persons. It can be used to describe an economic process and to describe entities that participate in that process.
Business can be defined as an economic system where goods and services are exchanged for one another or for money. A business entity is a commercial organization that aims to make a profit from its operations.

Characteristics of Business
The following characteristics are applicable to all businesses:
(i) Businesses are formed with a profit motive. That is, all businesses exist to make a profit.
(ii) Business makes a profit by supplying goods or rendering services to others, called customers.
(iii) Businesses might make the goods they supply or buy the goods from other outside parties.
(iv) Business takes risks to survive. So, profit is the reward for accepting risk.
(v) The profit made by a business belongs to its owners. A share of the profit might be paid to the owners periodically as dividend or share of profit.

Types of Business Entity
Ordinarily, there are three main types of business entity:

- A sole trader or sole proprietorship
- A partnership business
- A company or limited liability company

Sole Trader or Sole Proprietor
Any business owned and managed by one person is referred to as a sole trader or sole proprietor. Any individual who sets up a business on their own without forming a company is a sole trader.
Important Features of a Sole Trading Business
a. There is no legal distinction between the proprietor and the business. Thus, he is personally liable for an unpaid debt and other obligations of the business, and also when a sole trader dies, the business ceases to exist.
b. The profits of the business belong to the sole proprietor.
c. The assets of the business belong to the sole proprietor.
d. The sole trader can extract cash and other assets from the business for personal use, and this is called drawings when preparing financial reports.
e. The business may be financed by the owner's capital as well as by personal and business loans.
f. A sole proprietorship business can be sold as a going concern by its owner.

Partnership

A partnership business is an enterprise in which two or more persons, called partners, share the ownership of a business. Each partner will be expected to contribute an agreed sum of money to set up the business.
A partnership is defined as the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all.

Important Features of a Partnership
(i) It must be an association of two or more persons to carry on a business.
(ii) The partners are the owners of the business and are personally liable as individuals for the unpaid debts and other obligations of the business.
(iii) When a partner dies, the partnership comes to an end and is dissolved. That is, there is no perpetual succession.
(iv) The profits of the business belong to the partners in an agreed ratio.
(v) The assets of the business belong to the partners in an agreed ratio.
(vi) The partners, if allowed by the partnership deed, can extract cash and other assets from the business as drawings.
(vii) The business may be financed by both the partners' capital and loans.
(viii) A partnership can be sold as a going concern by its owners.

Company/Limited Liability Company
A company is a special form of business entity. Almost all the companies in business are limited liability companies with liability limited by shares.

Important Features of Limited Liability Company
a) Ownership of the company is represented by ownership of shares. A company might issue any number of shares, depending largely on its size. Large companies usually have a large number of shares in issue and consequently a large number of shareholders. The number of shares acquired by a shareholder determines his stake or ownership interest in the company.
b) Unlike a sole trader or partnership, a company has the status of a "legal person" in the eyes of the law. Thus:
i. A company can be the legal owner of business assets and can sue and be sued in its own right in the law.
ii. A company is taxed separately from its owners for the profits made by the company. This is not so with sole traders and partnerships, as the business profit is taxed in the hands of the partners or the sole proprietor.
iii. A company is liable for its own debts, and not the shareholders. When the shareholders are not the managers of their company, it becomes essential that information about the position and performance of the company should be reported regularly by the management to the shareholders. This is the main purpose of financial reporting.

Not-for-Profit Entities
These are entities that are established with the aim of providing social and welfare services and not necessarily for profit motive. Such entities include clubs, societies, and voluntary associations, benevolent and similar institutions.

Some Important Features of Not-for-Profit Entities
(i) Members pay subscriptions to maintain their membership.
(ii) They sometimes carry out activities that yield profit, like running a bar or organizing fee-paying competitions.

(iii) The entities do not prepare a statement of profit or loss; rather, an income and expenditure account is prepared.

Advantages and Disadvantages of Different Types of Business Entities
The advantages and disadvantages of operating as each type of business entity may be summarized briefly as follows:

Subject Matter	Sole Trader	Partnership	Company
1. Ownership	Owned by one person	Several individuals working together	Shareholders
2. Liability for unpaid debts and other obligations	Personal liability of owner	Personal liability of partners	Limited
3. Management	Business managed by its owner	Business managed by its owners (partners)	Larger companies managed by professional managers
4. Raising Capital	Capital provided by sole owner, often limited	Capital provided by owners, likely limited	Capital provided by shareholders; public companies can raise new capital from investors in the stock market
5. Financial Accounting and Auditing	Some financial accounts needed for tax purposes	Financial accounts needed for partners and tax purposes	Fairly strict regulation of financial reporting; legal requirements for audit

Financial Reporting by Sole Traders and Partnerships
The financial statements of a sole trader are private and do not have to be disclosed, except to tax authorities and possibly to a lending bank. These must be prepared according to accepted accounting principles and practices but need not conform to all the requirements of accounting standards.
Similarly, the financial statements of a partnership business are private and do not have to be disclosed.

Financial Reporting by Companies
The financial statements of a company are prepared for the shareholders and are usually subject to audit. Audit is the examination of financial statements by an independent expert who expresses an opinion on whether they are fairly presented.

Company law requires financial statements to be filed with a government agency, where they can be accessed and read by any member of the general public. Companies whose shares are traded on a major stock market make their financial statements generally available to the public, often on the company's website.
The financial statements of a company are subject to more regulation than those of a sole trader or partnership. Financial accounting may also be important to company management, providing historical information needs for persons not involved in running the business.

1.18 Chapter Summary

This chapter provides an introduction to accounting, covering its definition, objectives and scope. It discusses the different types of accounting, including financial accounting, management accounting, and other specialized areas. The chapter also identifies the various users of accounting information, including investors, creditors and regulatory bodies, and explains their information needs.

The chapter further explores key accounting concepts, such as going concern, accruals, materiality and aggregation, substance over form, business entity concept, fair presentation, offsetting, consistency of presentation and prudence. These concepts form the foundation of accounting and are essential for preparing financial statements that accurately reflect an entity's financial position and performance.

Additionally, the chapter discusses the different bases of accounting, including accruals, cash and break-up bases. It also explains the attributes of different reporting entities and how they impact financial reporting. Finally, the chapter touches on the relevant legislation and regulations governing corporate and non-corporate accounts, highlighting their potential impact on financial reporting.

By covering these topics, this chapter provides a comprehensive overview of the fundamentals of accounting, setting the stage for further exploration of accounting principles and practices.

1.19 End of Chapter Questions

MCQs

1. . What is the primary objective of financial accounting?

A. To provide financial information to external users
B. To record financial transactions
C. To prepare budgets
D. To provide financial information to management
E. To audit financial statements

2. What is the basis of accounting that recognises revenues and expenses when earned or incurred?

A. Cash basis
B. Historical cost basis
C. Break-up basis
D. Fair value basis
E. Accrual basis

3. Who are the primary users of financial accounting information?
A. Management
B. Regulatory bodies
C. Creditors
D. Investors
E. Customers

4. What is the accounting concept that requires entities to account for transactions based on their economic reality?
A. Substance over form
B. Fair presentation
C. Accruals
D. Materiality
E. Prudence

5. What is the purpose of the business entity concept?
A. To combine the entity's financial transactions with those of its owners
B. To record financial transactions
C. To separate the entity's financial transactions from those of its owners
D. To prepare financial statements
E. To audit financial statements
6. Which of the following is an attribute of a reporting entity?
A. Size
B. Type of business
C. Location
D. Ownership structure
E. Industry trends
7. What is the accounting concept that requires entities to present financial information in a consistent manner?
A. Accruals
B. Consistency of presentation
C. Materiality
D. Fair presentation
E. Going concern

8. What is the basis of accounting that recognises revenues and expenses when cash is received or paid?
A. Accrual basis
B. Fair value basis
C. Historical cost basis
D. Break-up basis
E. Cash basis

9. What is the impact of relevant legislation and regulations on financial reporting?

A. To increase the complexity of financial reporting
B. To ensure compliance with accounting standard
C. To reduce the cost of financial reporting
D. To provide flexibility in financial reporting
E. To decrease transparency in financial reporting

Question 1

What are the primary responsibilities of directors in relation to the preparation and presentation of financial statements?

Answer
The primary responsibilities of directors in relation to financial statements include:

- Ensuring that the financial statements are prepared in accordance with the applicable financial reporting framework (e.g. IFRS)
- Ensuring that the financial statements present a true and fair view of the company's financial position and performance
- Approving the financial statements before they are issued to shareholders and other stakeholders
- Ensuring that the financial statements are free from material misstatements and are presented in a transparent and consistent manner
- Overseeing the company's financial reporting process and ensuring that adequate controls are in place to ensure the accuracy and reliability of financial information.

Directors have a fiduciary duty to act in the best interests of the company and its stakeholders, and their responsibilities in relation to financial statements are critical to maintaining investor confidence and ensuring the integrity of the financial markets.

Question 2
What is the role of regulatory bodies in overseeing financial reporting, and provide examples of such bodies?

Answer
Regulatory bodies play a crucial role in overseeing financial reporting by setting and enforcing standards, monitoring compliance, and ensuring the integrity of financial markets. Their roles include:

- Setting accounting standards and regulations
- Reviewing and approving financial statements
- Enforcing compliance with accounting standards and regulations
- Investigating and penalizing non-compliance

Examples of regulatory bodies in Nigeria include:

- Nigerian Exchange Limited (NGX)
- Securities and Exchange Commission (SEC) Nigeria
- Financial Reporting Council of Nigeria (FRCN)

- Central Bank of Nigeria (CBN) for banks and financial institutions

These bodies help to maintain investor confidence, promote transparency, and ensure the stability of financial markets in Nigeria.

Answer to MCQs

1. A
2. E
3. D
4. A
5. C
6. B
7. B
8. E
9. B

Chapter Two
Financial Reporting Framework and Structure of Financial Statements

Learning Outcomes:

end of the chapter, learners should be able to:
Explain the IASB Conceptual Framework for Financial Reporting
Identify the components of financial statements
Explain the characteristics of current assets and liabilities
State the minimum line items in the statement of profit or loss and other comprehensive income (OCI)
State the minimum line items in the statement of financial position
Explain the requirements of IFRS 18

Content:

Overview of IASB Conceptual Framework
Components of Financial Statements
Characteristics of Current Assets and Liabilities
Minimum Line Items in Statement of Profit or Loss and OCI
IFRS 18: Presentation and Disclosure
Objective
Three requirements:
Subtotals for profits
Management-defined performance measurement; and
Aggregation and disaggregation

The IASB Conceptual Framework for Financial Reporting

Status and Purpose of the Conceptual Framework

Status

It provides concepts and guidance that underpin the decisions made when the IASB is developing a standard. It is not a standard; hence it does not override any requirement of any standard.

2.0 Objectives of the Framework

The objective of the Framework is set out to:

i. Guide standard setters in the development of future standards and reviewing the existing standards, so that there is a rational basis for reducing the number of alternatives in existing standards.

ii. Guide preparers in applying standards and in applying principle-based rather than rule-based approaches to the treatment of matters not covered by the standards.
iii. Assist auditors in satisfying themselves that financial statements being audited are in conformity with the framework principles.
iv. Provide stakeholders with the basis for interpreting the information contained in the financial statements.

2.1 Objective of General-Purpose Financial Statements

The objective of general-purpose financial statements is to provide information about the financial position, performance, and changes in financial position of an entity.

2.2 Users of General-Purpose Financial Statements

The primary users of general-purpose financial reporting are present and potential investors, lenders, and other creditors. They use the information to make decisions about:

- Buying, selling, or holding equity or debt instruments,
- Providing or settling loans or other forms of credit,
- Exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's resources

2.3 Economic Resources and Claims to the Resources

A reporting entity's economic resources and claims are reported in the statement of financial position.

Information about the nature and amounts of a reporting entity's economic resources and claims assists users:

- To assess that entity's financial strengths and weaknesses,
- To assess liquidity and solvency, and its need and ability to obtain financing, and
- To predict how future cash flows will be distributed among those with a claim on the reporting entity.

Changes in Economic Resources and Claims

Changes to economic resources and claims could be due to changes resulting from financial performance or changes not resulting from financial performance.

Changes in economic resources and claims resulting from financial performance are reported in the statement of comprehensive income. Information about a reporting entity's financial performance during a period is useful in assessing the entity's past and future ability to generate net cash inflows.

Changes not resulting from financial performance are presented in the statement of changes in equity.

Financial performance reflected by past cash flows is presented in the statement of cash flows.

2.4 Users of Financial Statements and Their Information Needs

Apart from the primary users of general-purpose Information, the Framework also identifies other users of financial information.

There are various users of financial statements, each with different information needs. Users of financial statements can be categorized into:

- Internal users and
- External users

Internal users are people within a business organization who use financial information. Examples of internal users are owners, managers, and employees.

External users are people outside the business entity (organization) who use accounting information. Examples of external users are suppliers, banks, customers, investors, potential investors, and tax authorities.

Primary users of financial statements and their information needs are:

- Investors – who supply risk capital in the form of funding, this group is concerned with the risk inherent in, and the return provided by their investments;
- Lenders – want information that will enable them to decide whether their loans will be paid when due, and whether or not to issue new loans to the entity.
- Suppliers and trade creditors are interested in information that will help them determine whether the amounts owing to them will be paid on time.
- Customers will be interested in the continuance of the entity, especially if they depend on it themselves.
- Employees – wish to know about the stability and profitability of their employers. This may give them confidence about their jobs and could be used to discuss salary and conditions of employment.
- The government and government agencies are interested in the allocation of resources and the activities of the entities in general.
- The general public and financial analysts are interested in how an entity may contribute to the local economy that will affect their purchasing power.
- Investor information has relevance when it influences the economic decisions of users by helping them evaluate past, present, or future events or confirming (or correcting) their past evaluations.

Qualitative Characteristics as per the Conceptual Framework

i. Fundamental Characteristics

- Relevance, and
- Faithful representation

ii. Enhancing Characteristics

- Comparability,
- Understandability,
- Verifiability, and
- Timeliness

Relevance:

To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance if it can be used for predictive and confirmatory purposes.

- It has predictive value if it can help users to evaluate present or future events.
- It has confirmatory value if it helps users to confirm the assessments and predictions they have made in the past or correcting their past evaluations.

The relevance of information is affected by its materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Faithful Representation:

To be useful, information must represent faithfully that which it either purports to represent or could reasonably be expected to represent. Information has the quality of faithful representation

when it is neutral, complete, and free from material error and bias. Another key element of faithful representation is substance over form.

A perfect faithful representation would have three characteristics:

- Complete: The financial statement must include all information necessary for a user to understand the phenomenon being depicted, including all necessary descriptions and explanations;
- Neutral: The depiction is without bias in the selection or presentation of financial information; and
- Free from error: There should be no error or omissions in the description of the phenomenon, and the process used to produce the information has been selected and applied with no errors.

Prudence: A neutral depiction is supported by the exercise of caution. Prudence involves allowing for some caution in preparing financial statements by making reasonable allowances in order not to overstate assets or income or to avoid understating expenses or liabilities.

The value of an asset is written down when the amount expected to realize from their sale or continued use is less than its carrying amount. Accounting standards usually prescribe how to write down assets in such circumstances.

Comparability:

Users must be able to compare the financial statements of an entity through time to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.

Verifiability:

When information can be verified, it gives assurance that the information faithfully represents the economic phenomena being represented. For information to be verifiable, it means that different knowledgeable and independent parties could reach consensus (although not necessarily complete agreement) that a particular depiction is a faithful representation.

Understandability:

Users must be able to understand financial statements. They are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information properly. Complex matters, if relevant for decision-making, should not be left out of financial statements simply due to their difficulty in being understood.

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Timeliness

It refers to the availability of financial information in time to influence the decisions of users

Users need to obtain reliable, relevant and **timely** information in order to react to changes in the entity's financial position or performance and make informed decisions based on current information. The longer the period between the financial report and the financial year end, the more negative the effect on timeliness of corporate financial information.

Timing can pose a challenge to faithful representation in financial reporting, as it may be difficult to accurately measure certain transactions or events by the reporting date.

The constraint of timeliness often requires management to make estimates and judgments in financial reporting. These estimates and judgments must be made in accordance with the requirements of the Conceptual Framework and relevant IFRS standards, ensuring that the financial statements provide a faithful representation of the entity's financial position and performance. This balance between timeliness and accuracy is crucial in maintaining the reliability and usefulness of financial information.

Enhancing qualitative characteristics can only provide useful information if that information is relevant and is faithfully represented

2.6 The Reporting Entity

The reporting entity is the business or organization for which financial statements are prepared. The reporting entity can be a single company, a group of companies, or even a segment of a company.

2.6.1 Types of Reporting Entities

i. **Single Company**: a single entity that prepares its own financial statements.
ii. **Group of Companies**: a parent company and its subsidiaries that prepare consolidated financial statements.
iii. **Segment Reporting**: a company reports financial information for specific business segments.

2.6.2 Significance of Reporting Entity Structure

The reporting entity structure is significant because it:

i. The structure of financial statements depends on the reporting entity.
- A single company or organization that prepares its own financial statements.
- A parent company and its subsidiaries that prepare consolidated financial statements.
- A component of a larger entity, such as a division or segment, that prepares separate financial statements

ii. Analysts need to understand the reporting entity structure to accurately analyze financial statements.
iii. Stakeholders use financial statements to make informed decisions, and the reporting entity structure can impact those decisions.

Impact on Financial Statement Structure

i. The reporting entity's accounting policies and procedures determine the accounting treatment for transactions and events.
ii. The reporting entity's structure determines the level of disclosure required in the financial statements.

2.7 Elements of Financial Statements

Transactions and other events are grouped together in broad classes and in this way, their financial effects are shown in the financial statements. These broad classes are the five elements of financial statements, discussed under the Framework.

The elements of financial statements are assets, liabilities, equity, income and expenses.

Assets:

A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. The potential economic benefits need not be expected to flow to the entity; they do not need to be certain or most likely.

However, a low probability of an inflow of economic benefits may indicate that recognition of an item meeting the definition of an asset may not provide relevant information.

i. The rights may include the following:
i. Rights to receive cash;
ii. Rights to receive goods and services;
iii. Rights to exchange economic resources on favorable terms;
iv. Rights to use intellectual property; and
v. Rights to benefit from the use of physical objects such as the lease of property, plant, and equipment.
The existence of an asset, particularly in terms of control, is not reliant on physical form.

Liabilities

A present obligation of the entity to transfer an economic resource as a result of past events. An obligation is a duty or responsibility that the entity has no practical ability to avoid. A liability is the obligation to transfer an economic resource, and not the ultimate outflow of economic benefits. Obligation is a duty or responsibility to act or perform in a certain way.

- Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement.
- Obligations may be constructive obligations, which are the result of expected practice.

Equity

Equity is the residual interest in the assets of the entity after deducting all its liabilities. Equity comprises those that arise from owners' contributions and those that arise from increases in income. Examples of equity are equity share capital, share premium, revaluation reserves, and retained earnings.
It is the residual interest of the owners or shareholders in the business as at the reporting date. It is calculated as total assets less total liabilities or share capital plus all reserves.
Equity interest confers on the holders the right to receive dividends and proceeds from satisfying the equity claims, either in full on liquidation or in part at other times.

Income

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
The definition of income encompasses both revenue and gains.
i. Revenue
Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names, including sales, fees, interest, dividends, royalties, and rent.
ii. Gains
Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. For instance, when non-current assets are sold above their carrying amount, the difference is a gain.
Contributions (e.g., issue of equity shares) from owners in their capacity as owners are not income.

Expenses

Expenses are decreases in economic benefits during the accounting period in the form of

outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity.

- Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, salary and wages, rent and depreciation.
- Losses represent other items that meet the definition of expenses and may or may not, arise in the course of the ordinary activities of the entity. Examples are loss on disposal of non-current assets and impairment losses on assets.

Distributions to owners in their capacity as owners (i.e., dividend distribution to shareholders) are not expenses.

2.7.1 Recognition of the Elements of Financial Statements

Recognition is the process of incorporating in the statement of financial position or income statement an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is probable that any future economic benefit associated with the item will flow to or from the entity; and
- The item's cost or value can be measured reliably.

Based on these general criteria:

- An asset is recognized in the statement of financial position when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
- A liability is recognized in the statement of financial position when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably.
- Income is recognized in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.

Expenses are recognized when decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).

2.7.2 De-recognition:

De-recognition occurs when an item is removed from financial statements as an asset, liability or equity. This should happen when an item no longer meets any one of the recognition criteria. De-recognition often involves transfer of risks and rewards associated with the assets or liabilities.

2.7.3 Key Principles of De-recognition.

a. An asset is de-recognised when the entity loses control over the assets. This occurs when the entity no longer has the ability to direct the use of the asset and obtain benefits from it.

b. A liability is de-recognised when the obligation is discharged, cancelled or expires.

These principles are crucial in determining whether an item should be removed from the financial statements

Examples:
Entity A purchased a piece of equipment for ₦10,000,000. The equipment meets the definition of an asset, its cost is measurable and it can be faithfully represented in the financial statements.

Recognition:

Definitions: Meets the definition of an asset.
Measurable: Cost of ₦10,000,000 is measurable.
Faithful Representation: Accurately reflects the economic phenomenon.

De-recognition:

If Entity A sells the equipment, it would be de-recognised as an asset because it no longer meets the recognition criteria (it is no longer an asset of the entity). IASB Conceptual framework

2.7.4 Measurements of Elements of Financial Statements

Measurement relates to the basis on which elements of financial statements will be included in the financial statements. The selection of a measurement basis should take into account the fundamental characteristics of useful financial information, that is, relevance and faithful representation, and measurement uncertainty and cost constraint.

The following measurement bases are discussed:
i. Historical cost: This is the cost at which transactions and other events are acquired.
ii. Non-financial assets held at historical cost should be adjusted over time to reflect usage through depreciation and amortization; or when the carrying amount of the asset is greater than the recoverable amount, impairment loss should be written off.

- Financial assets held at historical costs should reflect subsequent changes such as interest and payments in the process of amortized cost.

iii. Fair value: This is defined as the price at which items are exchanged in an orderly transaction between market participants.
iv. Current cost: This is the value at which the entity would acquire the asset or transfer the liability at the current market price.

- Assets are carried at the amount which is required to acquire them currently.
- Liabilities are carried at the undiscounted amount currently required to repay them.

v. Value in use: This is defined as the present value of cash flows that an entity expects to derive from the continuing use of an asset and its ultimate disposal.

2.8 Presentation and Disclosure

A reporting entity communicates information about its assets, liabilities, equity, income, and expenses by presenting and disclosing information in its financial statements. Presentation and disclosure relate to the following:

- Determining where an item should be presented in the financial statements;
- Sorting assets, liabilities, equity, income, or expenses on the basis of shared characteristics; and
- Adding together assets, liabilities, equity, income, or expenses that have shared characteristics.

2.9 Capital Maintenance Concepts:

Concepts of capital maintenance are important as only income earned in excess of amounts needed to maintain capital may be regarded as profit.

IASB Conceptual Framework discussed two capital maintenance concepts, which are the financial capital and the physical capital maintenance concepts.

i. Financial Capital Maintenance Concept:

Under this concept, a profit is earned only if the financial (or nominal) amount of the net assets at the end of the period exceeds the financial (or nominal) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from owners during the period.

ii. Physical Capital Maintenance:

Under this concept, a profit is earned only if the physical productive capacity (or operating capacity) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of the period

2.10 Other Accounting Concepts

i. Going Concern

IAS 1 assumes that an entity is a going concern.The going concern is a fundamental assumption of financial reporting. An entity is considered a going concern if the business entity is capable of earning a reasonable net income and there is no intention or threat from any source to curtail significantly its line of business in the near future.

The going concern assumption is critical because it affects the valuation of assets and liabilities. If an entity is not considered a going concern, it may need to value its assets at liquidation values, which could significantly impact its financial position. Entities must assess their ability to continue as a going concern and disclose any material uncertainties that may impact their future operations.

ii. Consistency of Presentation

IAS 1 requires that entities maintain consistency in the presentation and classification of items in the financial statements from one period to another. The concept of consistency holds that when an entity selects an accounting policy, it should continue to use that policy in subsequent periods.

Consistency of presentation enables users to compare an entity's financial performance and position over time, identifying trends and patterns. By maintaining consistency, entities can provide users with reliable and relevant information, enabling them to make informed decisions. Consistency also helps entities to avoid arbitrary changes in accounting policies or presentation, which could
impact the comparability of financial statements

iii. Fair Presentation

IAS 1 requires that financial statements present fairly the financial position, financial performance and cash flows of an entity. Financial statements should present information that is complete, neutral and free from error about the financial position, financial performance and cash flows of an entity.

Fair presentation is critical because it enables users to trust the financial information presented and make informed decisions. Entities must ensure that their financial statements are transparent, complete, and free from material errors. Fair presentation also requires entities to

provide additional disclosures when necessary to enable users to understand the financial statements.

v. **Materiality and Aggregation**: IAS 1 requires that financial statements should present fairly the financial position, financial performance, and cash flows of an entity. Materiality and aggregation are essential in achieving this objective. Materiality refers to the threshold at which information becomes relevant and influential to users' decisions. Aggregation, on the other hand, refers to the process of combining similar items to present a comprehensive picture .Information is material if its omission from or misstatement in the financial statements could influence the economic decisions of users.

Materiality and aggregation are critical in financial reporting because they enable users to focus on relevant information and avoid unnecessary details. By aggregating similar items, entities can present a clear picture of their financial performance and position. However, entities must ensure that aggregation does not obscure material information, which could lead to users making incorrect decisions.

vi. Offsetting: IAS 1 prohibits offsetting assets and liabilities or revenues and expenses unless required or permitted by a Standard or Interpretation.

Offsetting can distort the financial position and performance of an entity, making it difficult for users to understand the underlying financial transactions.

By prohibiting offsetting, IAS 1 ensures that entities present a transparent and faithful representation of their financial transactions.

Entities must carefully assess their transactions and ensure that they do not offset assets and liabilities or revenues and expenses, unless offsetting is expressly permitted by the specific standard. However, if the specified criteria in the relevant standard are met, offsetting is mandatory.

Offsetting is permitted only where both of the following criteria are satisfied:

- The entity currently has a legally enforceable right to offset the recognised amounts.
- The entity intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously

Additionally, where an entity offset in accordance with these requirements, disclosure of additional quantitative information is required according to the relevant standard.

Not all net presentation of items is considered to be offsetting. For example, the following are not offsetting: presenting property, plant and equipment (PP&E) and intangible assets net of accumulated depreciation and amortisation; provisions against inventory; or measuring receivables net of an expected credit loss or allowances for doubtful receivables

The following are specific examples where offsetting is permitted:

- Gain or losses on disposal of non-current assets; and
- Gains or losses arising from group of similar transactions, such as, gains or losses arising foreign from exchange transactions.

ix. Accruals

IAS 1 requires entities to prepare financial statements using the accrual basis of accounting. Accrual accounting recognises revenues and expenses when earned or incurred, regardless of when cash is received or paid.

Accrual accounting provides a more accurate picture of an entity's financial performance because it matches revenues with the expenses incurred to generate those revenues. This approach helps users understand an entity's underlying financial performance and make informed decisions. Accrual accounting also enables entities to recognise liabilities and assets that may not be reflected in cash flows.

vii. Prudence
IAS 1 requires entities to exercise prudence in preparing financial statements, which involves a degree of caution in making judgments and estimates.

Prudence is essential in financial reporting because it helps entities avoid overstating assets or revenues and understating liabilities or expenses. By exercising prudence, entities can provide users with a more realistic picture of their financial performance and position. Prudence also enables entities to account for uncertainties and risks in a way that reflects their potential impact on the financial statements.

viii. Substance over Form:
Substance over Form
IAS 1 requires entities to account for transactions and events in accordance with their substance and economic reality, rather than just their legal form.

Substance over form is critical because it ensures that financial statements reflect the underlying economic reality of transactions and events. By accounting for transactions based on their substance, entities can provide users with a more accurate picture of their financial performance and position. This approach helps users understand the underlying drivers of an entity's financial results and make informed decisions.

2.11 Components of Financial Statements

A full set of financial statements would include the following:

1. A statement of profit or loss and other comprehensive income or a statement of profit or loss followed by a statement of other comprehensive income;
2. A statement of financial position;
3. A statement of changes in equity;
4. A statement of cash flows; and
5. Notes to the financial statements (not in this syllabus).

Statement of Financial Position
The statement of financial position is a structured presentation of the assets and liabilities of the business. The difference between assets and liabilities is capital (equity). Assets are resources controlled by the business, and liabilities are amounts owed by the business.
IAS 1 requires entities to present current and non-current assets and liabilities separately on the statement of financial position

Characteristics of current assets and current liabilities are as follows:

i. Expected to be realized or consumed within the entity's normal operating cycle
ii. Held primarily for trading purposes
iii. Expected to be realized within 12 months from the reporting date
iv. Cash or cash equivalents, unless restricted Examples of current assets include Inventories ,Trade and other receivables - Cash and cash equivalents

Current Liabilities:

i. Expected to be settled within the entity's normal operating cycle
ii. Held primarily for trading purposes
iii. Due to be settled within 12 months from the reporting date
iv. No unconditional right to defer settlement for at least 12 months after the reporting date

Examples of current liabilities include trade and other payables and current tax liabilities

The minimum line items in the statement of financial position under IAS 1:

i. Assets

- Property, plant and equipment
- Investment property
- Intangible assets
- Financial assets
- Investments accounted for using the equity method
- Biological assets
- Inventories
- Trade and other receivables
- Cash and cash equivalents
- Assets classified as held for sale

ii. Liabilities and Equity

- Trade and other payables
- Provisions
- Financial liabilities
- Liabilities included in disposal groups classified as held for sale
- Current tax liabilities and assets
- Deferred tax liabilities and assets
- Issued capital and reserves
- Non-controlling interest

Statement of Profit or Loss

This statement provides information about the performance of an entity in a period. It consists of two parts:

- A statement of profit or loss – a list of income and expenses which result in a profit or loss for the period; and
- A statement of other comprehensive income – a list of other gains and losses that have arisen in the period.

Note that the statement of other comprehensive income will include only gain on revaluation of non-current assets at this level.

The statement of profit or loss shows the performance of the business in terms of its main activities. It is a structured presentation of all revenue, other income earned in a period, and the costs of earning those revenues.

The minimum line items in the statement of profit or loss and other comprehensive income under IAS 1:

Statement of Profit or Loss:

- Revenue
- Cost of sales
- Gross profit
- Other income
- Distribution costs
- Administrative expenses
- Other expenses
- Finance costs
- Share of profit/(loss) of associates and joint ventures
- Profit/(loss) before tax
- Income tax expense
- Profit/(loss) for the period
- Other comprehensive income:
- Revaluation gain on non-current assets
- Total comprehensive income:
- Profit/(loss) for the period + other comprehensive income

iii. Structure of Changes in Equity

- Total comprehensive income showing separately;
  - Amount attributable to equity owners of the parent; and
  - Non-controlling interest group
- Effect of retrospective application of changes in accounting policies and prior period errors.
- Recording separately the changes due from;
  - Profit or loss
  - Other comprehensive income
  - Distribution to owners as dividends
  - Contribution from owners in form of issue of additional shares
- Reconciling the amount of equity at the beginning and at the end of the period.

2.12 **IFRS 18-** Presentation and Disclosure in Financial Statements

In January 2024, the International Accounting Standards Board (IASB) introduced IFRS 18 **Presentation and Disclosure in Financial Statements**, a major update that replaces IAS 1.

Objectives of the Standard:

The objectives of the Standard are to provide relevant information about an entity's assets, liabilities, equity, income and expenses and sets out the general requirements for financial statements.

FRS 18 aims to standardize the structure of the income statement, enhance the comparability of financial data, and improve disclosure requirements to better reflect a company's financial performance.
IFRS 18 aims to improve how companies communicate their financial performance in the statement of profit or loss to investors, enhance the comparability of financial data, and improve disclosure requirements to better reflect a company's financial performance.

IFRS 18 introduces three sets of requirements to achieve these goals.

The three requirements are:

1) Presentation of new defined subtotals in the statement of profit or loss IFRS 18 requires companies to report:

- Operating profit; and
- Profit before financing and income taxes.

These subtotals provide a consistent structure for the statement of profit or loss, thereby improving comparability, though it will not affect how companies measure their financial performance and the overall profit figure.

2) Disclosure of management-defined performance measures (MPMs).

IFRS 18 requires companies to disclose reconciliations between management-defined performance measures and subtotals listed in IFRS 18 or totals or subtotals required by IFRS Accounting Standards. Entities must now disclose, unusual income or expenses and explain why they are not expected to recur judgments applied in classification and subtotals not required by IFRS (if presented)

MPMs are subtotals of income and expenses used in public communications to communicate management's view of an aspect of the financial performance for the company as a whole. Public communications include management commentary, press releases and investor presentations but exclude oral communications, written transcripts of oral communications or social media post. The official publication must point out that the measures are management performance measures.

They are not common income and expenses listed in IFRS 18.

Investors use MPMs to get insight into how management views the company's financial performance, how the company is managed and how its financial performance is developing

2.13 Aggregation or disaggregation

Companies are required to aggregate or disaggregate items to present line-items in the primary financial statements to provide useful structured summaries. Furthermore, in the notes to the financial statements, companies are required to aggregate or disaggregate items to provide material information, but in doing so, must not obscure material information

Classification of income and expenses and the inclusion of sub-totals in the statement of profit or loss

The Standard requires a company:

- To classify income and expenses into operating, investing and financing categories in the statement of profit or loss; plus income taxes and discontinued operations; and

- To present two new defined subtotals; operating profit and profit before financing and income taxes.

  The standard requires entities to present subtotals for operating profit or loss:
- Profit or loss before financing activities and income tax and;
- Profit or loss resulting from all income and expenses. There is no requirement to present sub-totals for investing category or financing category like in the statement of cash flows

Nature or Function

The Standard permits the implementation of expenses by its nature or function. Nature of expenses means classification by the economic resources consumed to accomplish the company's activities, for example, raw materials, labour, lighting and heating salaries, advertising cost. Function of expenses refers to the activity to which the consumed resource relates, for example, cost of sales, distribution costs and administrative expenses.

For example in a manufacturing company the line items that provide most useful information for their activities are raw material, labour and production overheads. Such companies may present their profit or loss according to the nature of expenses; or use nature of expenses on some situation and function of expenses in other situations. Furthermore, the IFRS 18 structure and content enable banks, insurance and property investment companies to present their statement of profit or loss, according to their main specific activities, differently from other businesses.

Classifications:

IFRS 18 classifies income and expenses into five categories in the statement of profit or loss. They are

i. Operating Category
ii. Investing category
iii. Financing category
iv. Income taxes category; and
v. Discontinued operations category

This new format enhances clarity and **forces consistent classification** of income and expenses across companies.

Classification in operating category:

The operating category consists of all income and expenses that are not classified in the investing, financing, income taxes or discontinued operations categories. It is the default category. IFRS 18 defines operating category as all income and expenses arising from a company's operations. It is not meant to measure only recurring operating performance

.

Operating activity is defined to include:

i. Income from the main activities of the business; and
ii. . Income and expenses from other business activities, such as income and expenses do not meet the requirements to be classified in any of the other categories.

Classification in investing category:

Income and expenses in the investing categories are those that y enables investors to analyse returns from stand-alone investments separately from a company's operations.

The investing category includes:

i. Income and expenses from assets that generate returns separately from a company's business

activities, such as rentals from an investment property or dividends from shares in other companies and income from bonds

ii. Income and expenses from cash and cash equivalents and investments in associates and joint ventures and unconsolidated subsidiary, such as, a company share of profits from an associate

Classification in financing category:
The financing category includes:

i. Income and expenses on liabilities such as bank loans and bonds and other liabilities arising from pure financing transactions; and
ii. Interest expenses on any other liability, for example, lease and pension liabilities.

The financing category and the subtotal for profit before financing and income taxes enable investors to analyse companies' performance before the effects of its financing

The income tax category:
The income taxes category consists of income tax expense (or tax income) that is included in profit or loss in accordance with IAS 12 Income Taxes, and any related foreign exchange differences

The discontinued operations category:
The discontinued operations category consists of income and expenses from discontinued operations recognised in accordance with IFRS 5 Non-current Assets Held for Sale and Discontinued Operations.

IFRS 18 Structure and Content for Banks, Insurance and Property investment Companies
Furthermore, the IFRS 18 structure and content enable banks, insurance and property investment companies to present their statement of profit or loss, according to their main specific activities, differently from other businesses.

Issues that Remains Unchanged from IAS 1
IFRS 18 carries forward the following from IAS 1

- How to recognise or measure revenue, expenses, assets liabilities or equity.
- The following principles remain unchanged from IAS 1:
  - Accrual basis;
  - Going concern assumption;
  - Materiality;
  - Consistency;
  - Offsetting; and
  - Fair presentation.
- Structure and contents of statement of financial position and statement of changes in equity.
- Statement of cash flows except for minor changes made to presentation of dividends and interest paid, and dividends and interest received, in IAS 7- Statement of cash flows.
  - Dividends and interest paid are generally required to be classified in cash flows from financing activities; while
  - Dividends and interest received are generally required to be classified in cash flows from investing activities

The previous classifications of under IAS 7, which allowed them to be classified as operating activities has been discontinued.

2.14 End of Chapter's Summary

This chapter covers the IASB Conceptual Framework for Financial Reporting, components of financial statements, and characteristics of current assets and liabilities. It also discusses the minimum line items required in the statement of profit or loss and other comprehensive income (OCI) and the requirements of IFRS 18. The chapter provides a comprehensive overview of financial reporting framework and standards for presenting financial statements.

2.15 End of Chapter Questions

MCQs

1. What is the primary objective of the IASB Conceptual Framework for Financial Reporting?*

A. To specify the format of financial statements
B. To provide a framework for financial reporting
C. To determine the accounting treatment for specific transactions
D. To ensure compliance with regulatory requirements
E. To prepare financial statements for listed companies

2. Which of the following is a component of financial statements?

A. Notes to the financial statements
B. Management commentary
C. Auditor's report
D. Corporate governance report
E. Press release

3. Which of the following is a characteristic of current assets?

A. Expected to be realized within reasonable time
B. Held for long-term investment
C. Expected to be realized within the entity's normal operating cycle
D. Not expected to be realized within 12 months
E. Restricted for use

4. Which of the following is a current liability?

A. Trade payables
B. Share premium
C. Retained earnings
D. Property, plant and equipment
E. Long-term loan

5. Which of the following statements is true about IFRS 18?

A. It deals with accounting for income taxes
B. It requires entities to present a statement of cash flows
C. It provides a framework for presenting and disclosing information in financial statements
D. It specifies the format of the statement of financial position
E. It deals with accounting for leases

6. Which of the following is or are current asset(s)?

I. PPE
II. Inventory

III. Cash

A. I only
B. II only
C. I and III
D. II and III
E. I, II and III

7. What is one of the requirements of IFRS 18 regarding the statement of profit or loss?*

A. To present only one performance measure
B. To disclose all transactions in the notes
C. To account for income taxes
D. To classify all expenses as operating expenses
E. To present subtotals for profits

8. Which accounting concept assumes that an entity will continue to operate for the foreseeable future?

A. Materiality
B. Accruals
C. Fair presentation
D. Substance over form
E. Going concern

Question 1

Explain the concept of materiality in accounting and its importance in financial reporting.

Question 2

Explain the going concern assumption in accounting, including its significance and implications for financial statement preparation.

Answers- MCQ

1. B
2. A
3. C
4. A
5. C
6. D
7. E
8. E

Answer to theory questions

Materiality is an accounting concept that refers to the threshold at which information becomes relevant and influential to users' decisions. In financial reporting, materiality is important because it helps entities determine what information to disclose and what can be omitted. Material information is that which could influence the decisions of investors, creditors or other stakeholders. By applying the materiality concept, entities can ensure that their financial statements provide a faithful representation of their financial position and performance, without

overwhelming users with unnecessary details

Question 2
Explain the going concern assumption in accounting, including its significance and implications for financial statement preparation.

The going concern assumption is an accounting concept that assumes an entity will continue to operate for the foreseeable future. This assumption is significant because it allows entities to value assets and liabilities based on their expected future use, rather than their liquidation values. The going concern assumption also enables entities to defer certain expenses and revenues, matching them with the periods in which they are expected to benefit or be incurred.

The implications of the going concern assumption for financial statement preparation are:
- Assets and liabilities are valued based on expected future use
- Expenses and revenues are matched with the periods they benefit or are incurred
- Entities can prepare financial statements that reflect their long-term operations and strategies.

If an entity is not considered a going concern, its financial statements would need to be prepared on a different basis, such as a liquidation basis, which could significantly impact its financial position and performance

CHAPTER THREE

Accounting Equation, Double Bookkeeping and Books of Prime Entry

3.0 Learning Objective

Apply the accounting equation to analyze the impact of transactions.
Understand the double-entry system and apply it to record transactions.
Balance ledger accounts
Extract the trial balance
Identify the purpose of the trial balance
Identify the purpose of source documents
Explain the purpose of different types of source documents
Describe the different types of books of prime entry
Record transactions in the sales day book, purchases day book and the returns day books
Explain the use of the petty cash book and the imprest system
List the internal controls over the petty cash book
Explain the uses of the journal
Post in the journal and explain the narrations
State how to post from the journal to the ledger

3.1 Introduction:

nderstanding the Foundation of Accounting

The accounting equation, books of prime entry, and double-entry principles form the bedrock of financial record-keeping. This chapter will explore the accounting equation's components, the role of books of prime entry in transaction recording and the principles of double-entry bookkeeping.

The bookkeeping involve several steps:

- Transactions take place
- Source documents are obtained showing evidence of transactions
- Details of each transaction are recorded in the books of prime entry
- Detail of each transaction are recorded in the ledger accounts

3,2 ACCOUNTING EQUATION

Understanding the fundamental principles of accounting is crucial for accurately recording and reporting financial transactions.

3.2.1 The Entity Concept:

One of the cornerstone concepts in accounting is the entity concept, which distinguishes a business from its owners. This concept is applied universally to all types of business entities, including sole traders, partnerships, companies, governments and not-for-profit organisations.

The entity concept has significant implications for accounting, particularly in the separation of business transactions from personal transactions. When an owner invests cash in their business,

it is considered capital. If an owner borrows money for business purposes, the borrowed amount is recorded as a liability.
This chapter delves into the accounting equation and the double-entry principles that underpin it.

3.2.2 The Accounting Equation
The accounting equation is expressed as:

Assets = Capital + Liabilities

.
If you recall, these are the three elements of the statement of financial position, discussed in Chapter 1. Assets are resources while capital and liabilities are claims to the resources.
Assets are classified as non-current and current.
Non-current assets are those held for use in the operations of the business; that is, they are not held for resale.
Example of non-current assets are; property, machinery and patent rights
Examples of current assets are:

- Inventory- goods manufactured or purchases for resale;
- Trade receivables -money owed by customers who have purchased goods or services on credit; and
- cash.

Liabilities are also classified as non-current and current.

Non-current liabilities: They are liabilities payable more than 12 months after the reporting date.
Example of non-current liabilities are- loan and long-term bonds
Current liabilities are those payable within 12 months of the reporting date
Examples of current liabilities are; trade payables, tax payables, bank overdraft
Equity is the residual interest in the entity's assets after deducting its liabilities
Example of equity is capital, which is a form of liability due to the owner of the business, (entity concept). The amount will increase with additional profit earned during each year and retained.
The Accounting Equation

The Accounting Equation: Assets = Capital +Liabilities

.
In accounting every transaction that takes place affect the financial statement in two ways, therefore at any point in time the assets of the business will be equal to the capital and liabilities of the business. This is called dual effect.

Mastering these fundamental concepts is essential for preparing accurate financial reports.
You will appreciate the implications of applying the entity concept in accounting when dealing with more complex accounting situations involving companies and other corporate entities.

Illustration 3.1

Transaction 1:Omoaji sets up a business to be selling Cosmetic. He begins by putting ₦6,000,000 into the bank account for the business

.

Solution

Assets		=	Equity (Capital)		+	Liabilities	
	₦'000			₦'000			₦'000
Cash	6,000		Original	6,000	+		0
Cash increased by ₦6,000,000 and capital increased by ₦6,000,000							

Transaction 2: Omoaji borrows ₦8,000,000 from his brother for the business.

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Solution

Assets		=	Capital		+	Liabilities	
	₦'000			₦'000			₦'000
Cash	6,000		Original	6,000	+		0
Cash	8,000					Loan	8,000
	14,000			6,000	+		8,000
The cash borrowed also has a dual effect; cash increased by ₦8,000,000 and liabilities increased by ₦8,000,000							

Transaction 3: Omoaji purchased motor van with the money borrowed from his brother.

Solution

Assets		=	Capital		+	Liabilities	
	₦'000			₦'000			₦'000
Cash	6,000		Original	6,000	+		0
Cash	8,000					Loan	8,000
Motor van	8,000						
Cash	(8,000)						
	14,000			6,000	+		8,000
The motor van purchased increased asset by ₦8,000,000 but it reduced another asset, cash by ₦8,000,000.							

In addition to the above two transactions, the following additional transaction during the 6-months ended 30 June 2025.

Transaction 4: Omoaji buys a market stall and pays ₦1,000,000 in cash.
Transaction 5: Omoaji now buys some Cosmetics for ₦3,600,000. He buys these on credit, and does not have to pay for them immediately.
Transaction 6: Omoaji pays ₦2,000,000 to his suppliers for some of the Cosmetics he purchased.
Transaction 7 : Omoaji sells 50% of the Cosmetics (cost = ₦180,000) for ₦2,400,000 in cash

Transaction 8: Omoaji sells Cosmetics for ₦1,800,000, to a shop owner in another town. These Cosmetics originally cost ₦100,000. He sells the Cosmetics on credit, giving the purchaser one month to pay.
Transaction 9: Omoaji repays ₦2,000,000 of the loan.
Transaction 10: Omoaji pays his trade suppliers ₦1,200,000.
Transaction 11: Omoaji receives ₦1,600,000 of the money owed to him by the customer (trade receivable).
Transaction12: Omoaji purchases another ₦500,000 of Cosmetics, on credit.
Transaction13: Omoaji decides to take ₦800,000 in cash out of his business, and he also takes inventory with a value of ₦400,000.

Explanations:

Now let us consider the effects of these transactions on the accounting equation:
Transaction 4: The business has used one asset (cash) to acquire a different asset (a stall). There is no change in the total assets, simply a change in the make-up of the assets. **Cash reduces by ₦1,000,000, while stall (non-current asset) increases by ₦1,000,000.**
Transaction 5: The business has acquired more assets (Cosmetics = inventory). In doing so, it has created another liability, because it now owes money to its supplier, who is recorded as a 'trade payable'**. Both assets and liabilities have increased by the same amount.**
Transaction 6: The payment reduces the liabilities of the business, but also reduces its assets (cash) by the same amount.
Transaction 7: The business has sold assets that cost ₦1,800,000. It has received ₦2,400,000 in cash, and the difference is the profit on the sales. **Cash is increased by ₦2,400,000; the business will recognise cost of sales of ₦1,800000 and profit of ₦600,000 shall be added to the owners capital**
Transaction 8: The business has sold for ₦1,800,000 assets that cost ₦1,000,000 on credit. The difference is the profit of ₦800,000 on the sale. Profit adds to the owner's capital. With this transaction, however, the business is still owed the ₦1,800,000 from the customer for the sale. Money owed by a customer for a sale on credit is called a 'trade receivable'. A trade receivable is an asset.
Transaction 9: The payment of loan reduces both assets and loan by ₦2,000,000
Transaction 10: The payment of trade suppliers reduces assets and liabilities by ₦1,200,000
Transaction 11: The cash received from customer increases assets by ₦1,600,000 and reduces another asset (receivables), by ₦1,600,000
Transaction 12: The business has acquired more assets (Cosmetics = inventory) on credit. An **asset (inventory) increases by ₦500,000 and payables increases by ₦500,000**
Transaction 13: The owner has withdrawn ₦800,000 cash and ₦400,000 inventory from the business. **Assets (cash and inventory) decrease by ₦1,300,000 and equity decreases by ₦1,300,000.**

Assets			Capital			Liabilities	
	₦'000			₦'000			₦'000
Cash	600 (1)		Original	600 (1)			
Cash	800 (2)					Loan	800 (2)
Car	800 (3)						
Cash	(800) (3)					Payables	(200) (6)
Stall	100 (4)		Profit	60(7)			
Cash	(100) (4)		Profit	80(8)			
Inventory	360 (5)					Loan	(200) (9)
Cash	(200)(6					Payable	20) (10)
Cash	240 (7)					Payable	0 (12)
Inventory	(180) (7)						
Receivable	180(8)						
Inventory	(100) (8)						
Cash	(200) (9)						
Cash	(120) (10)						
Cash	160 (11)						
Receivable	(160) (11)						
Inventory	50 (12)						

At the end of the 12th transaction, the summary of the accounting equation will be as follows

Assets			Capital			Liabilities	
	₦'000			₦'000			₦'000
Cash			Original				
Motor van			Profit				
						Loan	
Inventory						Payables	
Receivables							
Assets							

Drawings

The owner or owners of a business can draw out the profits that the business makes. If they wish to do so, they can draw out all their profits. In practice, however, owners usually draw some profits and retain the rest in the business, to finance the growth of the business.

- Profits that are kept in the business are called retained earnings.
- Profits that are drawn out of the business are called **drawings**, in the case of businesses owned by sole traders or partnerships. Profits paid out to the shareholders of companies are called **dividends**.

Drawings are usually in cash. However, an owner might take out some inventory from the business for his own personal use, or even a larger asset such as a motor vehicle. Taking inventory or other assets is a form of drawing, as well as cash.

Transaction13: Omoaji decides to take ₦80,000 in cash out of his business, and he also takes inventory with a value of ₦40,000. The assets of the business are reduced by ₦120,000 (cash + inventory), and capital is reduced by the same amount.
The assets of the business are reduced by ₦120,000 (cash + inventory), and capital is reduced by the same amount.

Note: The original capital can only increase with retained earnings (profit minus drawings) plus additional capital brought in by the owner. Furthermore, from the accounting equation missing figures can be derived.

When additional capital in introduced the accounting equation becomes:
Assets = Capital + Additional Capital + profit –Drawings

Practice Question

Olayode operates a business as a sole trader.

On July 1, 2024 the net assets of the business were ₦670,000.

During the year to June 30, 2025, the business made a profit of ₦250,000 and Olayode took out ₦220,000 in drawings.

Due to a shortage of cash in the business, he paid in additional capital of ₦40,000 in early June 2025.

The net assets of the business at June 30, 2025 can be calculated as follows:

3.3 The Double Entry Bookkeeping

The Dual Effect

As previously discussed, the accounting equation (Assets = Liabilities + Equity) forms the foundation of financial record-keeping. Double-entry bookkeeping is a method that maintains the balance of this equation by ensuring that every transaction affects at least two accounts. When a transaction occurs, one account is debited and another is credited, keeping the equation in balance.

For example, if a business purchases equipment (asset) on credit (liability), the asset account is debited (increased), and the liability account is credited (increased), keeping the equation balanced. This dual recording enables businesses to generate accurate financial statements that reflect their financial position and performance.

Accounts are kept in a ledger. A ledger is a term meaning collection of related accounts.
All transactions are classified into different types and then recorded in the accounts. The accounts that record the double entries for each transaction are kept in the general ledger, which is also known as the nominal ledger or the main ledger.

3.4 Ledger Accounts:

Transactions are recorded in the ledger accounts. There is a ledger account for each asset, liability, income and expense item.

- Each transaction at least two ledger accounts
- One account will be debited while the other account will be credited
- Whether an entry should be debited depends on whether the transaction is an asset, a liability, equity, income or an expense

nts >		ties		e	ses
s:					
Increase					
Decrease					

Recording cash transactions

- When cash is received, cash increases. Being an increase in asset, cash account is debited and the corresponding account is credited, with equal amounts

- When cash is paid, cash reduces. Being a reduction in asset, cash account is credited and the corresponding account is debited, with equal amounts

Illustration 3.2
The following transactions relate to Morayo, A trader in Oshodi Market for the month of January, 2025
January 1: Morayo started business with an initial cash of ₦500,000.
January 3: Purchased goods for cash ₦82,000
January 5: Cash sales of ₦150,000.
January 10: Paid rent of ₦50,000 by cash.
January 15: Received ₦80,000 cash as loan from Mr. Bello to support his business
January 20: Purchased goods for ₦70,000 cash.
January 25: Buys ₦30,000 electricity for office use.
Record the transaction in the cash book and the corresponding entries in the relevant ledgers

Solution

Cash

2025	₦		₦
Jan. 1 Capital	500,000	Jan. 3 Purchases	82,000
Jan.5 Sales	150,000	Jan. 10 Rent	50,000
Jan. 15 Loan	80,000	Jan. 20 Purchases	70,000
		January 25. Electricity	30,000

Capital

	₦		₦
		Jan. 1 Cash	500,000

Purchases

	₦		₦
Jan. 3 Cash	82,000		
Jan. 20 Cash	70,000		

Sales

	₦		₦
		Jan. 5 Cash	150,000

Rent

	₦		₦
Jan. 10 Cash	50,000		

Loan

	₦		₦
		Jan. 15 Cash	80,000

Electricity

	₦		₦
Jan. 25 Cash	30,000		

3. 4.1 Purchases and sales of goods on credit

Where goods are purchased or sold on credit, rather that debit cash for goods sold, the customer's account or receivables account will be debited and for goods purchased on credit, the supplier's or payables account.

Illustration 3.3

Mensa Joe Enterprises started a retail business, selling cement on retail basis. On 1st of March 2025, he introduced the following into the business:

i] Motor van valued at ₦4,800,000
ii] Cash from his salary account: ₦3,300,000
iii] Money borrowed from a friend: ₦660,000

The following transactions took place in March:

		₦
March 3	Purchased cement on credit from Fola Ltd.	1,890,000
March 3	Paid carriage on cement to warehouse	164,560
March 6	Sold goods on credit to Aburi & Co	1,900,000
March 8	Sold cement for cash	262,800
March 11	Paid sundry expenses	162,780
March 15	Purchased Cement on credit from Fola Ltd.	600,000
March 17	Bought some Dunlop tyres from Okechukwu Enterprises On credit	108,520
March 20	Paid cash to Fola Ltd on account	1,675,000
March 22	Aburi & Co paid cash on account	1,250,000
March 25	Paid salaries and wages	779,580
March 25	Paid electricity bill	60,000
March 27	Sold cement on credit to K. Opobo	680,000

i] Open the ledger accounts and post the above transactions
ii] Balance the ledger accounts

Solution to Illustration 3.3
Akufor Joe Enterprises
Capital account

2025		₦	2025		₦
March 31	Bal c/d	8,100,000	March 1	Cash	3,330,000
		----------	March 1	Motor vehicle	4,800,000
		8,100,000			8,100,000
			April 1	Bal b/d	8,100,000

Loan Account

2025		₦	2025		₦
March 31	Bal c/d	660,000	March 1	Cash Account	
				660,000	
			April 1	Bal b/d	
				660,000	

Cash Account

2025		₦	2025		₦
March 1	Capital	330,000	March 3	Carriage inward	164,560
March 1	Loan	660,000	March 11	Sundry	expenses
March 8	Sales	262,800	162,780		
March 22	Aburi & Co	1,250,000	March 20	Fola Ltd	
		_____	1,675,000		
			March 25	Electricity bill	
		5,472,800	60,000		
April	Bal b/d	2,630,880	March 28	Salaries & wages	779,580
			March 31	Bal c/d	2,630,800
			5,472,800		

Motor Vehicle Account

2025		₦	2025		₦
March 1	Capital	4,800,000	March 31	Bal c/d	4,800,000
April	Bal b/d	4,800,000			

Carriage Inwards

2025		₦	2025		₦
March 3	Cash	164,560	March 31	Bal c/d	164,560
April 1	Bal b/d	164,560			

Aburi & Co-Debtor

2025		₦	2025		₦
March 6	Sales	1,900,000	March 22	Cash	1,250,000
		_____	March 31	Bal c/d	650,000
		1,900,000			1,900,000
April 1	Bal b/d	650,000			

Fola Ltd – Creditor

2025		₦	2025		₦
March 20	Cash	1,675,000	March 3	Purchases	1,890,000
March 31	Bal c/d	815,000	March 15	Purchases	600,000
		2,490,000			2,490,000
			April 1	Bal b/d	815,000

Sundry Expenses Account

2025		₦	2025		₦
March 11	Cash	162,780	March 31	Bal c/d	162,780
March 31	Bal b/d	162,780			

Motor Van Expenses

2025		₦	2025		₦
March 17	Okechukwu	108,520	March 31	Bal c/d	108,520
April 1	Bal b/d	108,520			

Salaries & Wages Account

2025		₦	2025		₦
March 25	Cash	779,580	March 31	Bal c/d	779,580
April 1	Bal b/d	779,580			

Electricity Bill Account

2025		₦	2025		₦
March 25	Cash	60,000	March 31	Bal c/d	60,000
April 1	Bal b/d	60,000			

Purchases Account

2025		₦	2025		₦
March 3	Fola Ltd	1,890,000			
March 15	Fola	600,000	March 31	Bal c/d	2,490,000
		2,490,000			
April 1	Bal b/d	2,490,000			

Sales Account

2025		₦	2025		₦
March 31	Bal b/d	2,842,800	March 6	Aburi & Co	1,900,000
March 27	K. Opobo	680,000	March 8	Cash	262,800
		2,842,800			2,842,800
			April 1	Bal b/d	2,842,800

Okechukwu Enterprises – Accounts Payable

2025		₦	2025		₦
March 31	Bal c/d	108,520	March 17	M/V expenses	108,520
			April 1	Bal b/d	108,520

K. Opobo Account – Debtor

2025		₦	2025		₦
March 27	Sales	680,000	March 31	Bal c/d	680,000
April 1	Bal b/d	680,000			

Notes

i] The balance carried down on 31[t] March 2006, the end of March became the balance brought down on 1 April, the beginning of the next period.

ii] a) All assets' accounts, i.e. cash account, motor vehicle account, and debtors account have debit balances.

b) All liabilities' accounts, i.e. loan account and creditors account have credit balances.

c) Capital accounts have credit balances.

iii] In this illustration, the transactions are posted directly to the ledger accounts. In real practice, the transactions would first pass through the books of original entry.

Illustration 3.4

We can now draw up the trial balance to illustration 3.4

Akufor Joe Enterprises

Trial Balance at 31 March 2025

	Dr	Cr
Capital		8,100,000
Loan		660,000
Cash	2,630,880	
Motor Vehicle	4,800,000	
Carriage Inwards	164,560	
Debtor – Aburi & Co	650,000	
Creditors		815,000
Sundry Expenses	162,780	
Motor Van Expenses	108,520	
Salaries and Wages	779,580	
Electricity Bill	60,000	
Purchases	2,490,000	
Sales		2,842,800
Account Payable		108,520
Debtor – Opobo	680,000	
	12,526,320	12,526,320

3.5 Source Documents

Source documents perform the following functions:

1. They serve as evidence of financial transactions, thereby guarding against fraud.
2. They provide a basis for recording transactions in the accounting records.
3. They facilitate auditing and verification of transactions.

4. They support financial statements and tax returns.
5. When there are more than one source documents for a transaction, they complement each other thereby
6. They are usually signed by the parties to the transaction; therefore it is almost difficult to alter or defaced them.

3.5.1 Types of Source Documents

i. Purchases Invoice

A Purchases Invoice is a document received from a supplier requesting for payments.

Key Details

- Supplier information
- Invoice date and number
- Description of goods/services
- Quantity and unit price
- Total cost
- Payment terms

Typically distributed to:

- Accounting department
- Procurement department
- Inventory management department
- Finance department

The purchases invoice is crucial for recording purchases, tracking liabilities and facilitating payment. It is normally cross-checked with the delivery note and the purchase order.

ii. Sales Invoice

A sales invoice is a document sent to customers requesting payment for goods sold

Key Details

- Customer information
- Invoice date and number
- Description of goods/services sold
- Quantity and unit price
- Total amount due
- Payment terms

Typically distributed to:

- Customer
- Accounting department
- Sales team
- Finance department

The sales invoice serves as a request for payment and helps with revenue recognition, accounts receivable management and cash flow tracking. It is normally checked against purchases order and delivery note

iii. Purchase Order

A purchase order is a document issued by a buyer authorising a supplier to deliver certain quantities of goods of specified quantity.

Key Details

- Goods or services to be purchased
- Quantity and description
- Unit price and total cost
- Delivery terms
- Payment terms

Distribution

Typically distributed to:

- Supplier
- Procurement department
- Accounting department
- Inventory management

The purchase order serves as a formal agreement between the buyer and supplier, helping to ensure accurate ordering and proper inventory management. They are checked to the invoice and quotation

iv. Quotation

A Quotation is a document provided by a supplier or vendor that outlines prices and terms of goods

Key Details

- Description of goods or services
- Price and pricing details
- Terms and conditions
- Validity period

Typically distributed to:

- Potential customer
- Procurement department
- Sales team

The quotation helps with providing price information, outlining terms and conditions and facilitating purchasing decisions. It is checked against the purchased requisition or order.

v. Delivery Note

A delivery note is a document that accompanies goods being delivered to a customer. It typically includes:

Key Details

- Description of goods delivered
- Quantity delivered
- Delivery address
- Order numbers or reference numbers

Distribution

Typically distributed to:

- Customer
- Delivery team
- Warehouse/Inventory management
- Accounting department (for verification)

The delivery note serves as proof of delivery and helps with verifying shipment contents, confirming delivery and managing inventory. It is checked with the goods received and the purchases order.

vi. Goods Received Note (GRN)

A goods received note is a document with serves as proof of the receipt of goods from a supplier.

Key Details

- Description of goods received
- Quantity received
- Date and time of receipt
- Supplier information
- Order numbers or reference numbers

Typically distributed to:

- Procurement department
- Inventory management
- Accounting department
- Warehouse/Inventory management

The goods received note helps with verifying shipment contents, updating inventory records and processing payments to suppliers

vii. Supplier's Statement

A supplier's statement is a document sent by a supplier to a buyer, typically on a regular basis (e.g., monthly), to reconcile the amount owing to its records.

Key Details

- Outstanding invoices
- Payments made
- Credits or debits applied
- Current balance owed

Typically distributed to:

- Accounting department
- Procurement department
- Finance department

The supplier's statement helps with reconciling accounts, verifying transactions and managing supplier relationships. It is checked to the records of the supplier with the buyer.

viii. Credit Note

A credit note is a document issued by a supplier to a buyer, indicating that the buyer's account has being credited for goods returned or for being overcharged.

Key Details

- Amount credited to the buyer's account
- Reason for the credit (e.g., returns, refunds or errors)
- Original invoice details

Typically distributed to:

- Buyer/accounting department
- Procurement department
- Finance department

The credit note serves to adjust accounts payable, reflect changes in transactions and provide a paper trail for audits. It is checked with documents relating to goods returned

.

ix. Debit Note

A debit note is a document issued by a supplier to a buyer indicating that the amount due from the customer has been increased.

Key Details

- Amount debited to the buyer's account
- Reason for the debit (e.g., additional charges, fees or corrections)

Typically distributed to:

- Buyer/accounting department
- Procurement department
- Finance department

The debit note serves to adjust accounts payable, reflect additional charges or fees and update financial records.

x. Remittance Advice

A remittance advice is a document sent by a buyer to a supplier as notification for payment.

Key Details

- Payment details (amount, date, method)
- Invoice numbers or reference numbers being paid
- Any deductions or adjustments made

Typically distributed to:

- Supplier/accounts receivable
- Buyer's accounting department

The remittance advice helps with reconciling payments, updating accounts and confirming payment details. It is checked against invoice.

xi. Receipt

A receipt is a document issued to a buyer that confirms amount received for goods sold or service rendered. Key Details

- Amount received
- Date and method of payment
- Description of goods/services paid for

Typically distributed to:

- Customer
- Accounting department
- Sales team

The receipt serves as proof of payment and helps with confirming transactions, updating financial records and providing customer documentation. It is compared with the invoice

xii. Payment Voucher

A payment voucher is a document that supports a payment transaction.

Key Details

- Payment amount
- Payee information
- Payment method
- Date and description of payment
- Details of authorising officer

Typically distributed to:

- Accounting department
- Finance department
- Accounts payable

The payment voucher helps with verifying transactions, recording payments and maintaining financial records.

xiii. Bank Pay-in-slips

Bank pay-in-slips are documents used to deposit funds into a bank account.

Key Details

- Account holder's information
- Deposit amount
- Date
- Description of deposit (e.g., cash, cheque)

Typically used by:

- Businesses
- Individuals
- Accounting/finance departments

Bank pay-in-slips help with depositing funds, recording transactions and maintaining financial records.

xiv. Cheque Counterfoils

Cheque counterfoils are the stub or duplicate portion of a cheque that remains in the cheque book after a cheque is written.

Key Details

- Cheque number
- Date
- Payee information
- Amount
- Balance (in some cases)

Cheque counterfoils help with recording transactions, tracking cheque payments and reconciling accounts.

xv. Bank Statement

A bank statement is a source document that provides a record of all transactions that have taken place within a specific period, typically a month. It serves as proof of financial transactions and can be used for various purposes, such as reconciliations, auditing, loan applications and financial analysis.

Bank statements usually include details like:

- Transaction dates
- Transaction descriptions
- Debit and credit amounts
- Running balance

A bank statement is typically distributed to or accessed by:

- Account holders: Individuals or businesses with the account.

- Accountants or bookkeepers: For financial record-keeping and reconciliation.
- Auditors: During financial audits.

The bank statement is checked against:
- Cash book or general ledger: To reconcile transactions and identify discrepancies.
- Company records: To verify accuracy and completeness of financial transactions.
- Cheques and payment records: To confirm transactions match internal records.
- This process helps identify errors, unauthorized transactions, or missing entries.

xvi. Bin Card

A bin card is a document used to track inventory levels in a warehouse or storage area.

Key Details
- Item description
- Quantity received
- Quantity issued
- Balance quantity
- Date and transaction details

Bin cards help with tracking inventory levels, monitoring inventory movements, identifying inventory discrepancies and inventory management.

The source documents that impact the double entry bookkeeping are:
i. Invoice
ii. Receipt
iii. Pay-in-slips
iv. Cheque counterfoils
v. Credit notes
vi. Debit notes
vii. Bank statement

3.6 Books of Prime Entry
Books of prime entry book in which transactions are first recorded

3. 6.1 Features
Books of prime entry have several key features. Firstly, transactions are recorded in chronological order, meaning they are documented as they occur.
These books serve as the point of original entry, where transactions are first recorded before being posted to the ledger accounts.

Each transaction is recorded in detail, including relevant information such as the date, amount, and parties involved.

The books also follow a specific format, with columns and headings tailored to the type of transactions being recorded.

Furthermore, each book of prime entry is designed to record specific types of transactions, such as sales, purchases, cash receipts, or cash payments, allowing for organized and efficient recording of financial date

3.6.2 Types of books of prime entry

1. Sales Day Book
Sales day book records credit sales of goods or services and helps to track sales transactions and update trade receivables

A typical Sales Day Book contains the following information:

Date	Invoice No.	Customer	Amount Invoiced (₦)
20 Jan 2024	340	Jaredada	250,000
23 Jan 2024	341	Taiwo Kehinde	155,000
25 Jan 2024	342	Janet Paul	140,000
2 Feb 2024	343	Samson Ajayi	165,000
Total			710,000

In a situation where the entity maintains the control account, it will form part of the double entry principle.

Debit Receivables ledger control account ₦710,000
Credit sales ₦710,000

Then update the individual accounts of the customers. For example:

Debit Jaredada ₦250,000
Debit Taiwo Kehinde ₦155,000
Debit Paul ₦140,000
Debit Samson Ajayi ₦165,000

Credit Sales ₦710,000

This Sales Day Book provides a clear and organised record of credit sales, making it easier to track and manage sales transactions.

Sales Day Book (with VAT)- VAT rate is 7.5%

Date	Invoice No.	Customer	Sales Amount (₦)	VAT (₦)	Total (₦)
Feb 1	001	John & Co	1,000,000	75,000	1,150,000
Feb 5	002	Jane Ventures	800,000	60,000	920,000
Feb 10	003	Uzairu Ltd	1,200,000	90.000	1,380,000
Feb 15	004	Alhaji Nig. Ltd	900,000	67.500	1,035,000
Total			3,900,000	292,500	4,192,500

Debit Receivables ledger control ₦4,192,500
Credit Vat ₦292,000
Credit sales ₦3,900,000

Then updated the individual accounts of the customers

2. Purchases Day Book
Purchases day book records credit purchases of goods or services and helps to track purchases transactions and update accounts payable. It keeps a list of invoices received from suppliers.

Date	Supplier	Amount (₦)
30 Jan 2024	Kofi & Co	50,000
31 Jan 2024	Ahamed Nig. Ltd	175,000
4 Feb 2024	Maxi Ltd	155,000
5 Feb 2024	Wike & Co	205,000
Total		585,000

Debit Purchases ₦585,000
Credit Payable ledger control account ₦585,000
Then updated the individual accounts of the suppliers

There is no invoice number column in the purchase day book because it records invoices from various suppliers, each with their own unique invoice number.

Purchases Day Book (with VAT)- VAT rate is 7.5%

Date	Invoice No.	Supplier	Amount (₦)	VAT (₦)	Total (₦)
Feb 3	INV001	ABC Suppliers	500,000	37,500	537,500

Date	Invoice No.	Supplier	Amount (₦)	VAT (₦)	Total (₦)
Feb 8	INV002	XYZ Enterprises	800,000	60,000	860,000
Feb 12	INV003	DEF Industries	1,000,000	75,000	1,075,000
Feb 18	INV004	GHI Ventures	600,000	45,000	645,000
Total			2,900,000	217,500	3,117,500

Exercise: Post the double entry of the purchases day book.

3. Sales Returns Day Book
The sales returns day book or the returns inwards book records returns of goods sold on credit and helps to track sales returns and update trade receivables and sales accounts

Sales Returns Day Book

Date	Customer	Credit Note No.	Amount (₦)
Feb 10, 2024	Alaba Martins	CN001	50,000
Feb 12, 2024	Femi Adebayo	CN002	20,000
Feb 15, 2024	Nneoma Okoro	CN003	30,000
Feb 18, 2024	Bola Olaitan	CN004	45,000
Feb 22, 2024	Chinedu Eze	CN005	18,000
Feb 25, 2024	Adaobi Okonkwo	CN006	25,000
Total			

Exercise: Calculate the total amount and post the double entry.

4. Purchases Returns Day Book
The purchases returns day book or returns outwards records, returns of goods purchased on credit and helps to track purchases returns and update trade payables and purchases accounts

Purchases Returns Day Book

Date	Supplier	Credit Note No.	Amount (₦)
Feb 3, 2024	Ebony Ventures	CN001	120,000
Feb 5, 2024	Akwa Ltd	CN002	80,000
Feb 8, 2024	Enugu Industries	CN003	250,000
Feb 12, 2024	Lagos Traders	CN004	90,000
Feb 18, 2024	Port Harcourt Supplies	CN005	60,000
Feb 22, 2024	Abuja Distributors	CN006	200,000
Total			800,000

Exercise: Post the double entry

5. Cash Book

The cash book is both a book of prime entry and a ledger. Cash book records all cash receipts and cash payments. Where an entity maintains the imprest system the cash book records only bank transactions, such as; receipts from customers deposited into the bank, payments to suppliers or creditors via cheque or electronic transfer, bank charges and interest and other bank-related transactions.

In this case, the cash book helps businesses to; track bank transactions and balances and reconcile bank statements with the cash book balance. By using a cash book to record bank transactions, businesses can maintain a clear and accurate picture of their bank balances and transactions.

Cash discount given and received is recorded as a memorandum record in the cash book. The double entry would then be completed in the general ledger and the payable or receivable ledgers.

Some entities keep cash receipts book and cash payments book separately.

a. Cash receipts book records cash sales, cash received from credit customers and other cash income, and it helps to track cash inflows and update cash and back balances.

Cash Receipts Book

Date	Particulars	Cash	Bank	Discount	Total
		₦	₦	₦	₦
Feb 1	Cash Sales	10,000			10,000
Feb 3	Received cheque from John		50,000	1,000	51,000

Date	Particulars	Cash	Bank	Discount	Total
Feb 5	Cash received from Jane	8,000		200	8,200
Feb 10	Received cheque from Uzairu Ltd		100,000		100,000
Feb 15	Cash sales	12,000			12,000

In this example, the cash column records cash received, the bank column records cheques or other bank transactions and the discount column records any discounts allowed to customers.

b. Cash payment book records cash purchases and other cash payments, and it helps to track cash outflows , and to update cash and bank balances.

Cash Payments Book

Date	Particulars	Cash	Bank	Discount	Total
		₦	₦	₦	₦
Feb 1	Paid rent	50,000			50,000
Feb 5	Paid supplier by cheque		100,000	2,000	102,000
Feb 10	Paid wages in cash	20,000			20,000
Feb 15	Paid utility bills by cheque		30,000		30,000
Feb 20	Paid cash to creditor	15,000		500	15,500

In this example, the cash column records cash payments, the bank column records cheque payments or other bank transactions and the discount column records any discounts received from suppliers

6. Petty Cash Book

The petty cash book is another important book of prime entry that records small cash transactions, typically for miscellaneous expenses, such as; office supplies, postage, travel expenses and entertainment expenses

The petty cash book is used to track and control small cash expenditures, and is usually maintained by a designated person, known as the petty cashier.

The Petty Cash Book typically records the date, description of transaction, amount and analysis of expenses.

The Petty Cash Book helps businesses to control and manage petty cash, replenish petty cash funds as needed and ensure accurate financial recording and accounting

Some businesses may use an imprest system for petty cash, where a fixed amount is allocated for petty cash expenses, and the petty cashier is responsible for accounting for the expenditures and replenishing the fund when necessary.

6.1 The Imprest System and Control Over Petty Cash.

The imprest system is a method of managing petty cash in an organization. It operates by allocating a fixed amount of cash, known as the imprest amount, which is entrusted to a designated person, the petty cashier. This petty cashier is responsible for making payments for petty expenses, ensuring that receipts and records are kept for each transaction.

All cash payments made by the petty cashier are supported by an approved petty cash voucher. The petty cash voucher is a document that shows the evidence of payment made by the petty cashier.

All payments made are recorded on the credit side of the book, which each expense extended to its related expense column, while the imprest and the regular re-imbursements are recorded on the debit side of the petty cash book.

When the fund is depleted or at regular intervals, the petty cashier submits the receipts and records to request reimbursement. The imprest fund is then replenished to its original amount, based on the receipts and records submitted. This process ensures that the fund is always maintained at the same level, hence the term "imprest".

The imprest system provides a convenient way to manage petty expenses, while also helping to control and monitor expenditures. The Petty cashier is accountable for managing the fund and ensuring that transactions are properly recorded. This system is beneficial for organizations as it allows for efficient management of petty cash, while maintaining transparency and accountability.

There must be effective supervision of the recordings made by in the petty cash book. In relation to the approved petty cash voucher and the cash received, by a superior officer. The petty cash voucher must be signed by the claimant and the petty-cashier. Generally, re-imbursement can only be made after confirming that the petty cash book balance is with the cash balance.

Illustration 3.5

Enter the following transactions in the Petty Cash Book of Emzor Ventures, assuming the company operates on an imprest system with a float of ₦50,000.

Feb 1 Received cash to establish the petty cash fund
Feb 3 Paid for office supplies ₦10,000
Feb 5 Paid for postage ₦5,000
Feb 8 Reimbursed bus fare to staff ₦2,000
Feb 10 Purchased stationery ₦8,000
Feb 15 Bought refreshments for meeting ₦3,000
Feb 18 Paid for courier services ₦4,000

Feb 20 Bought tea and snacks for office ₦1,500
Feb 22 Paid for printing services ₦6,000
Feb 25 Reimbursed mileage to staff ₦3,500
Feb 28 Paid for newspaper subscription ₦1,000

Emzor Ventures- Petty cash book

Debit	Date		Voucher	Total	Office expenses	Transport	Refreshment	postage
₦	Feb			₦	₦	₦	₦	₦
50,000	1	Cash						
	3	Office supplies	01	10,000	10,000			
	5	Postage	02	5,000				5,000
	8	Bus fare	03	2,000		2,000		
	10	Stationery	04	8,000	8,000			
	15	Refreshments	05	3,000			3,000	
	18	Courier	06	4,000	4,000			
	20	Tea and snacks	07	1,500			1,500	
	22	Printing	08	6,000	6,000			
	25	Transport fare	09	3,100		3,100		
	28	Newspaper	10	1,000	1,000			
				43,600	29,000	5,100	4,500	5,000
43,600	28	Cash						
		Balance c/f		50,000				
83,500				83,600				
50,000	Mar 1	Balance b/f						

The Journal

7. The Journal

The journal records non-routine transactions that do not fit into the other day books, including:

I. Adjustments and corrections
II. Opening and closing entries
III. Transfer from one account to another
IV. Purchases and sales of non-current assets
V. Other non-cash transactions

On every entry made, narration or explanation must be made to show why the journal is raised

Illustrations 3.6 Adjustment and correction

An error has been detected in the books of Varlee & Sons. F. Zizi's account a customer has been debited instead of J. Zizi with goods sold for L$20000.

Varlee & Son
Journal

	Debit	Credit
	L$	L$
J. Zizi	20,000	
F. Zizi		20,000
Being correction of the wrong entry in F.Zizi's account		

Illustration 3.7- Closing entries

Akua Enterprises, a Ghanaian company, has the following information:
- Opening inventory: GHC 15,000
- Purchases: GHC 80,000
- Cost of Goods Sold: GHC 60,000
- Closing inventory: GHC 35,000
Show the journal entry to record the closing inventory

.

Solution

Akua Enterprises

Journal

	Debit	Credit
	₵	₵
Inventory	35,000	
Cost of sales		35,000
Being adjustment for closing inventory. for Akua Enterprises		

The amount will be deducted from cost of sales while preparing the statement of profit or loss and recognized as current assets at the reporting date

Illustration 3.8 – Opening Entries

The following are the assets and liabilities of Fatu Ventures

	L$
Fixtures	450,000
Motor vehicles	600,000
Inventory	700,000
Trade receivables	200,000
Cash	250,000
Trade payables	240,000

Required: Prepare the opening journal of Fatu Ventures.

Solution

Fatu Ventures

	Debit	Credit
	L$	L$
Fixtures	450,000	
Motor vehicles	600,000	
Inventory	700,000	
Trade receivables	200,000	
Cash	250,000	
Payables		240,000
Capital		1,960,000
Being opening assets and liabilities of Fati Ventures	2,200,000	2,200,000
This is an example of a compound journal		

Illustration 3.9 – Transfer from one account to another
Suba Ltd transferred ₦125,000 from their payables ledger control account in the sales ledger control account to offset purchases against sales.

Solution
Zuba Ltd
Journal

	Debit	Credit
	₦	₦
Payables ledger control account	125,000	
Receivables ledger control account		125,000
Being transfer of the balance in the payables ledger control account to sales ledger control account		

3.7 Typical Worksheet or Extended Trial Balance Format

Opening Trial Balance	Adjustments	Adjusted Trial Balance	Final Trial Balance	Statement of Profit or Loss	Statement of Financial Position
DR	CR	DR	CR	DR	CR
₦	₦	₦	₦	₦	₦

Procedure for Setting up a Worksheet or Extended Trial Balance
Step 1: Extract Opening Trial Balance
Extract the opening trial balance from the ledger of the firm, including unadjusted balances.
Step 2: Enter Adjustments
Enter each adjustment necessary in the appropriate column (debit/credit entries) against the relevant account affected.
Step 3: Calculate Adjusted Trial Balance
Extend the amounts in the trial balance and adjustment columns into the adjusted trial balance column, adding together credit or debit balances as necessary. Ensure both debit and credit sub-columns agree to confirm arithmetical accuracy.
Step 4: Prepare Income Statement
Extend the adjusted trial balance column into the income statement column for items related to trading activities, operational income, and expenses. Calculate net profit or loss and insert the difference into the short column, extending it to the opposite side in the statement of financial position column.
Step 5: Prepare Statement of Financial Position
Extend all outstanding balances in the adjusted trial balance into the statement of financial position column. Ensure both sub-columns agree if all preceding steps have been correctly followed.
By following these steps, you can prepare a worksheet or extended trial balance that helps in financial statement preparation and analysis

3.8 Correction of Errors and Suspense Account

Categories of Errors

1. Errors that are revealed by trial balance.
2. Errors that are not revealed by trial balance.

Correction of Errors

Errors are normally corrected when identified by the use of journal entries. The journal indicates the account(s) to be debited and the account(s) to be credited. It also contains a narration which describes the error.

Key Point

Errors that are not revealed by trial balance do not pass through the suspense account. However, errors that are revealed by trial balance are corrected through the suspense account.

By using journal entries to correct errors, financial statements can be accurately prepared and presented. The suspense account plays a crucial role in correcting errors that affect the trial balance.

Illustration 3.9

The trial balance of Kwame Ankra Enterprise extracted on April 30, 2025 agreed, but the bookkeeper later discovered the following errors committed during the financial year.

i. Cash purchase of ¢560,000 spent for the purchase of new equipment was debited to the office equipment repairs account.

ii. The sum of ¢198,000 paid for insurance expenses was debited to rent account during posting.

Required:

Make necessary journal entries to correct the above errors.

Kwame Ankra Enterprise

Journal Entries

	¢	¢
Dr. Office equipment	560,000	
Cr. Office repairs account		560,000
Being correction of principle committed by debiting office equipment repair instead of office equipment		
Dr. Insurance account	198,000	
Cr. Rent account		198,000
Being correction of wrong debit of ¢198,000 to rent account instead of rent account		

3.8.1 Suspense Account

When the trial balance cannot balance due to the effect of some yet-to-be-identified error(s), the difference is transferred or recorded in a suspense account, and this would make the trial balance totals agree. The suspense account can have a debit or credit balance, depending on which column of the trial balance had a higher total. A suspense account with a debit balance in the trial balance is an indication that some assets or expenses are unidentified or there might be an unidentified liability if it has a credit balance.

The correction of those errors which are revealed by the trial balance must pass through the suspense account. When all the errors have been corrected, the suspense account will show a zero or nil balance.

Illustration 3.10
The trial balance of Malam Bako Enterprise at December 31, 2024, did not balance, and a credit balance of ₦1,717,000 was entered in the suspense account to agree with the trial balance. A detailed check of the books disclosed the following errors.
(a) Purchases return for December 2024, ₦400,000, was posted to the debit of the purchase account.
(b) The sales day book for June was undercast by ₦40,000.
(c) Discount received in September, ₦480,000, was posted to the wrong side of the discount account.
(d) A sales of ₦41,000 to B. Adamu was correctly entered in the sales book but was posted to the credit of B. Adamu in the sales ledger as ₦22,000.
(e) ₦20,000 paid for repairs to vehicles was not entered in the relevant repairs account.
Required
Show the relevant journal entries to effect the correction and the suspense account after the corrections.
In the books of Malam Bako
Journal

		Debit	Credit
		₦	₦
A	Suspense	400,000	
	Purchases account		400,000
	Being cancellation of purchases return debited in purchases account.		
	Suspense	400,000	
	Purchases return		400,000
	Being correction of purchases return wrongly debited to purchase account		
B	Suspense account	40,000	
	Sales account		40,000
	Being correction of sales day book under-cast		
C	Suspense	480,000	
	Discount received		480,000
	Being cancellation of discount received posted to wrong side of the account		
	Suspense	480,000	
	Discount received		480,000
	Being correction of discount received, now recorded correctly		
D	B. Adamu's account	22,000	
	Suspense account		22,000
	Being cancellation of incorrect sales amount to the wrong side B. Adamu's account.		
	B. Adamu's account	41,000	
	Suspense account		41,000

	Being the entry of the correct sales amount to B. Adamu's account.		
e.	Vehicles repairs account	20,000	
	Suspense Account		20,000
	Being correction of vehicle repairs omitted		

Suspense account

	₦		₦
Purchases	400,000	Balance b/f	1,717,000
Purchases returns	400,000	B. Adamu	63,000
Sales	40,000	Motor vehicle	20,000
Discount receivable	960,000		
	1,800,000		1,800,000

3.9 Relationship of Books of Prime Entry to Control Accounts

Control accounts are accounts in the general ledger that summarise the balances of related subsidiary accounts. Books of prime entry are essential in maintaining control accounts because:

i. Books of prime entry help ensure that transactions are accurately recorded and posted to subsidiary ledgers, which are then reconciled with the control accounts in the general ledger.
ii. Books of prime entry facilitate the identification of errors and discrepancies between the subsidiary ledgers and control accounts, enabling prompt correction and reconciliation.

3.9.1 Relationships between Source Documents, Books of Prime Entry and Accounts

Source Documents: Source documents are original records that provide evidence of transactions, such as; invoices, receipts, bank statements and contract documents

Books of Prime Entry: Books of prime entry are where transactions are first recorded in chronological order, based on source documents.

Ledger Accounts
Ledger accounts or the general ledger are where transactions are classified and summarised by account.

In summary, source documents provide evidence of transactions, which are recorded in books of prime entry and then posted to ledger accounts, and the extraction of the trial balance, ultimately leading to the preparation of financial statements.

The relationships can be expressed diagrammatically as:
Source Documents ➞ Books of Prime Entry ➞ Ledger Accounts ➞ Trial Balance ➞ Financial Statements

3.10 Chart of Accounts

Definition and Purpose

A chart of accounts is a systematic listing of all accounts used by a business to record financial transactions. Its primary purpose is to provide a framework for organizing and classifying financial data, enabling accurate financial reporting and analysis.

Components of a Chart of Accounts

i. **Account numbers**: Unique codes assigned to each account.
ii. **Account names**: Descriptive names for each account.
iii. **Account types**: Classification of accounts into asset, liability, equity, revenue, and expense categories.

Account Codes

Account codes, also known as account numbers, are unique codes assigned to each account in a chart of accounts. These codes help to:

i. Distinguish between accounts with similar names or purposes.
ii. Efficiently record and retrieve financial data.
iii. Support automated financial reporting and analysis.

Derivation Methods

Account codes can be derived using various methods, including:

i. **Sequential numbering**: Assigning consecutive numbers to accounts (e.g., 1000, 1001, and 1002).
ii. **Hierarchical numbering**: Using a hierarchical structure to reflect account relationships (e.g., 1000-1999 for assets, 2000-2999 for liabilities).
iii. **Alpha-numeric coding**: Combining letters and numbers to create unique codes (e.g., ASH101 for Cash).

Account Types

i. **Assets**: Resources owned or controlled by the business (e.g., cash, accounts receivable, inventory).
ii. **Liabilities**: Debts or obligations owed by the business (e.g., accounts payable, loans payable).
iii. **Equity**: Ownership interests in the business (e.g., common stock, retained earnings).
iv. **Revenue**: Income earned by the business (e.g., sales, service revenue).
v. **Expenses**: Costs incurred by the business (e.g., salaries expense, rent expense).

Benefits of a Chart of Accounts

i. Enables preparation of accurate financial statements.
ii. Facilitates analysis of financial performance and trends.
iii. Streamlines financial recording and reporting processes.
iv. Provides informed basis for decision-making.

Best Practices for Designing a Chart of Accounts

i. **Consistency**: Use a consistent numbering system and account structure.
ii. **Logical structure**: Design a logical and intuitive account hierarchy.
iii. **Flexibility**: Allow for future expansion and changes to the chart of accounts.
iv. **Industry-specific considerations**: Consider industry-specific requirements and regulations.

Implementing a Chart of Accounts

i. **Identify Business Needs**: Determine the specific needs of the business.

ii. **Design the chart**: Create a chart of accounts that meets business needs.
iii. **Assign account numbers**: Assign unique codes to each account.
iv. **Set up accounting system**: Configure accounting system to use the chart of accounts.

Maintaining a Chart of Accounts

i. **Regular review**: Periodically review and update the chart of accounts.
ii. **Account maintenance**: Add or remove accounts as needed
iii. **Consistency**: Ensure consistent application of account classifications and numbering.

3.11 End of Chapter Questions

1. What is the purpose of a ledger account?
   A) To record all transactions in chronological order
   B) To classify and summarize transactions
   C) To prepare financial statements
   D) To calculate profit or loss
   E) To reconcile bank statements
2. Which account is used to correct errors that affect the trial balance?
   A) Suspense account
   B) Profit and loss account
   C) Capital account
   D) Drawings account
   E) Sales account
3. What type of error occurs when a transaction is recorded in the wrong account?
   A) Error of omission
   B) Error of commission
   C) Error of principle
   D) Error of original entry
   E) Compensating error
4. Which book of prime entry records all purchases of goods on credit?
   A) Purchases day book
   B) Sales day book
   C) Returns inward book
   D) Returns outward book
   E) Cash book
5. What is the effect of debiting an asset account?
   A) Increase in liability
   B) Decrease in asset
   C) Increase in asset
   D) Decrease in equity
   E) Increase in revenue
6. Which account is debited when goods are purchased on credit?
   A) Purchases account
   B) Sales account
   C) Cash account
   D) Accounts payable
   E) Accounts receivable

7. What is the purpose of correcting errors in accounting?
   A) To avoid penalties
   B) To ensure accurate financial reporting
   C) To increase profits
   D) To reduce tax liability
   E) To conceal fraud
8. Which type of error is not revealed by a trial balance?
   A) Error of omission
   B) Error of commission
   C) Error of principle
   D) Compensating error
   E) All of the above
9. What is the final step in correcting an error that affects the trial balance?
   A) Prepare journal entry
   B) Post to ledger account
   C) Close suspense account
   D) Prepare financial statements
   E) None of the above
10. Which book of prime entry records all credit sales?
   A) Sales day book
   B) Purchases day book
   C) Cash book
   D) Returns outward book
   E) Journal

Answers

1. B
2. A
3. C
4. A
5. C
6. A
7. B
8. D
9. C
10. A

.

CHAPTER FOUR
ACCOUNTING FOR PREPAYMENTS, ACCRUALS, PROVISIONS AND BAD DEBTS

CHAPTER CONTENTS

a. Introduction
b. Deferred Revenue and Prepayments
c. Accrued expenses
d. Accrued revenue
e. Depreciation expense
f. Bad debts
g. Provision for doubtful and irrecoverable debts
h. Bad debts recovered
i. Provision for discount on trade receivables

4.0 Objectives

At the end of this chapter, the reader must be able to:

a) Explain prepayments and accruals
b) Pass adjusting entries in respect of prepayment and accruals
c) Explain and pass entries in respect of bad debts and provision for doubtful debts
d) Record increases and decreases in the provision for doubtful debts
e) Calculate and make entries with respect to provisions for discount on receivables and payables
f) Prepare profit or loss account and statement of financial position extract showing the treatment of bad debt, provision for doubtful debts, depreciation and provision for discount on receivables and payables.

4.1 Introduction

Adjustments occur in final accounts whenever certain events do not properly fit into the financial year. This will arise either because income has been earned, but not received or expenditure has been incurred, but not yet paid for.

In conformity with matching concept, all income and expenses must be accounted for in the accounting year they belong. Therefore, income and expenses can either be carried forward or provided for in the current year.

In a financial year, from day-to-day financial transactions, many changes occur in the management of an entity's economic resources. These changes bring about financial obligations from customers to pay up outstanding trade receivables, commitment to pay certain current liabilities as and when due. Example of these financial obligations and commitment include interests that accrue daily on debts, as does rent expense payable/outstanding for use of an office building, prepaid stationery expense, income receivable and other related financial items in day-to-day management of a business entity. Similarly, other resources and obligations such as employee salaries originate as service is rendered, customers buy goods on credit, and supplier supply goods for sale on credit, lenders give loan to a business entity with payment to follow at specified dates. In most cases, the end of the accounting period generally does not coincide with the receipt or payment of cash associated with all the types of resource changes indicated in the preceding paragraphs.

Consequently, adjusting entries are, therefore, used to record such resource changes (expenses accrued, prepaid, incomes receivables and provisions for doubtful debts are made where necessary) to ensure the accuracy and truthful representations of the economic phenomena

reported in the financial statements. This chapter will consider some of the adjustments most commonly used in the preparation of the final accounts as well as discussing why such adjustments are required; their treatment in both the profit or loss account and in the statement of financial position will be treated in detail in the chapter.

Accountants rely on two principles in the adjusting process – revenue recognition and matching principles. The revenue recognition concept requires that revenue be reported when earned, not before or after. Revenue is earned for most entities at the time when services and products are delivered to customers and not when cash is eventually paid. If an entity sells goods on 31 December, 2024 to a customer, despite the fact that the customer has not paid as at this date, the revenue was earned in the year 2024 and this should be reported as revenue in the 2024 statement of profit or loss for the year ended 2024, even if the customer paid for the goods later in the year 2025. The value of the good bought by the customer will be recorded as trade receivable in the statement of financial position as at 31 December, 2024. Besides, where there is a likelihood of default on the credit sales to the customer in 2024, the entity will make a provision for doubtful debts as an expense in the statement of profit or loss for the year ended 2024 and this will reduce the total value of the trade receivable in the statement of financial position as at 31 December, 2024.

Furthermore, the matching principle aims to report expenses in the same accounting period as the revenue that are earned as a result of incurring these expenses. The matching of expenses with revenue is a major part of the adjusting process. As an example, if a business earns monthly revenue while operating out of rented store place, the matching concept stipulates that the rent must be reported on the statement of profit or loss for a particular period, December even if rent is paid in a period earlier than or after December. This ensures that the rent expense for December is matched with the revenue of the particular month. At the end of an accounting period, it is likely that any entity will find that some expenses have been paid which relate to the next accounting period, whilst other amounts, which relate to the current period remain outstanding. In order that the accounts show a true and fair view of the entity's financial performance, adjustments for such are necessary. The simple adjustment affecting the statement of profit or loss for the year ended and the statement of financial position as at a given date are classified as follows into different categories:

1) Allowances for irrecoverable and doubtful trade receivables;
2) Allowance for discounts on trade receivables;
3) Deferrals and prepayments;
4) Accrued expenses and revenue;

4.2 Deferred Revenue and Prepayments

Deferrals or prepayments refer to transactions where cash is paid or received before a related expense or revenue is recognized. These transactions are recorded when cash is paid for expenses that apply to more than one accounting period or when cash is received for revenue that relates to more than one accounting period. The portion of the expense or revenue that applies to the future periods is deferred as a prepaid expense (assets) or unearned revenue (liability). If we do not make adjustments for prepayments and unearned revenues, profit for the current period will be understated or overstated respectively. Items which normally need to be prepaid include rates, rent, interest, insurance and road licensing fee.

In some cases, when preparing the final accounts, it will be necessary to consider the question of the period in respect of which an expense has been incurred. Some payments such as rates,

interest, insurance, rent etc must have been paid in advance. In that case, the account will reveal that more expenses have been made in that period than is due. This will eventually have effect on the account, as such amount prepaid expenses will decrease the expenditure for the period. For this reason, there is the need to amend the books in order for it to show the true figure for that period.

The accounting entry requires the prepayment to reduce the relevant expense in the Statement of Profit or Loss thereby increasing profit. The same applies to the unearned revenue, where the adjusting entry reduces the relevant revenue in the Statement of Profit or Loss thereby decreasing profit. Since conceptually the prepayment represents an amount owned by an entity from a third party and unearned revenue represents amounts owed by the business to third party, they are included under current assets and current liabilities respectively in the statement of financial position. The accounting entries are as follows:

Debit: Prepayments (Statement of financial position)
Credit: Expenses (Statement of profit or loss)
Debit: Revenue (Statement of profit or loss)
Credit: Unearned revenue (Statement of financial position)

Illustration 4.1

Assume that Santo Ltd. paid ¢2,400,000 for two years insurance protection beginning on December 1, 2023.

The cash payment of ¢2,400,000 will be debited to the insurance account. With the passage of time, the benefit of the insurance protection gradually expires and apportion of the unexpired insurance is transferred to the next accounting period as a prepaid expense. For instance, one month's insurance coverage expires by December 31, 2023. This expense is ¢100,000 = 2,400,000 x $^{1}/_{24}$. The insurance account will be as follows:

Insurance Account

		¢			¢
1/12/2023	Cash	2,400,000	31/12/2023	Profit or loss	100,000
				Prepaid c/f	2,300,000
		2,400,000			2,400,000
1/1/2024	Prepaid b/f	2,300,000	31/12/2024	Profit or loss (12/24x2,400,000)	1,200,000
			31/12/2024	Prepaid c/f	1,100,000
		2,300,000			2,300,000
		1,100,000			

The balances carried forward of ¢2,300,000, and ¢1,100,000 represents insurance prepaid to be shown under current assets in the Statement of Financial Position for the years 2023 and

2024 respectively.
The adjusting entries will be journalised as follows:

2023	Dr	Cr
	¢	¢
Insurance Prepaid	2,300,000	
Insurance expense		2,300,000
2024		
Insurance Prepaid	1,100,000	
Insurance expense		1,100,000

Let us now illustrate the treatment of deferred revenue as follows: Illustration 4.2
Assume that Santo Ltd rented a small office in its building to a customer on January 1, 2023. The rental agreement required the payment of ¢1.800,000 cash in advance for 18 month's rent. This transaction is recorded as:

Dr: Cash.
Cr: Rent Received.

On December 31, 2023, the unadjusted Trial Balance will report ¢1,800,000 as rent received, which is overstated by ¢600,000 (6/18 x ¢1,800,000) relating to 2024. The rent received account will be as follows:

		¢'000			¢'000
31/12/2023	Profit or loss	1,200,000	1/1/2023	Cash	1,800,000
31/12/2023	Balance c/f	600,000			
		1,800,000			1,800,000
			1/1/2024	Balance b/f	600,000

Rent receivable account

The balance carried forward of ¢600,000 in 2023 represent unearned revenue which will be recorded under current liabilities in the Statement of Financial Position for the year 2023. The adjusting entry will be journalised as follows:

	Dr.	Cr.
	¢	¢
Rent receivable A/c	600,000	
Deferred Rent Revenue		600,000

4.3 Accrued Expenses

Accrued expenses and accrued revenues reflect transactions where cash is paid or received after

a related expense or revenue is recognized. It represents an item, the use of which the firm has already benefited from during the current accounting period, but which will not be paid for until the next accounting period. If we do not make an adjustment the profit for the current period will be overstated. Examples of items that need to be accrued for include electricity, since it is not likely that these bills will exactly coincide with the entity's accounting year-end. The accounting entry for accrued expense is:

	Dr.	Cr.
Expense (Statement of Profit or loss)	x	
To: Accrued expense (Statement of financial position)		x

In this case, the relevant expense in the Statement of Profit or Loss is increased by the accrued amount whilst in the Statement of Financial Position, accruals appear under current liabilities, reflecting an amount owing by the business entity.

Illustration 4.2

Assume Santo Ltd's Trial Balance recorded electricity expenses of ¢6,000,000 which cover the period Jan 1 to 31 October 2023. A careful examination of the previous electricity bills of Santo Ltd shows that the company's consumption of energy is even throughout the period.

The above example tells us that the electricity charge in the Trial Balance does not cover the entire year which means that an accrual is required for the period of November 1 to 31 2023. Since electricity is used evenly throughout the year, we can estimate the outstanding amount based on the bills received to date. The ¢6,000,000 recorded in the Trial Balance represents 10 months of electricity charge, therefore, the accrual is estimated as follows:
Accrual=¢6,000,000 x2/10 =¢1,200,000

The electricity expense recorded as follows:

Electricity Expenses Account

		¢'000			¢'000
1/1/2023	Cash	6,000,000	31/1/2023	Profit or Loss	7,200,000
31/12/2023	Balance c/f	1,200,000			
		7,200,000			7,200,000
			1/1/2024	Balance b/f	1,200,000

The balance carried forward of ¢1,200,000 in 2023 represents accrued expense and will be recognized as current liabilities in the Statement of Financial Position. The adjusting entry will be as follows:

		,¢	¢
Dr	Electricity expense A/c	1,200,000	
Cr	Accrued Expense A/c		1,200,000

4.4 Accrued Revenue

Accrued revenue refers to transactions where cash is received after related revenue is recognised. It represents an item, the use of which the entity has already dispensed with during the current accounting period, but which will not be received until the next accounting period. If we do not make an adjustment the profit for the current period will be understated. Examples of items that need to be accrued for include interest earned on treasury bills of which payment has not been received, since it is not likely that the maturity of these bills will exactly coincide

with the entity's accounting year-end. The accounting entry for accrued revenue is:

	₦	₦
Dr. Accrued income (Statement of Financial Position)	x	
Cr. Interest Receivable (Statement of Profit or Loss)		x

In this case the relevant income in the Income statement is increased by the accrued amount. In the statement of financial position the accrued income will appear under current assets, reflecting an amount owned by the business entity.

Illustration 4.3

Assume that the Trial Balance of Sky Ltd. shows interest receivable of ¢855,000. Excluded from the Trial Balance is a 182 days Bank of Ghana Bond purchased on August, 1 2024 at an interest rate of 15% per annum at a cost of ¢12,000,000. Sky Ltd prepares account to December, 31 each year.

From the illustration above, Sky Ltd. will receive a total of ¢900,000 (15% x ¢12,000,000 x 6/12) representing interest that will be earned on the bond for the period August, 1 2024 to January, 31 2025. Since five months interest amounting to ¢750,000 (5/6 x ¢900,000) relates to 2024 financial year, it must be accrued in the Statement of Profit or Loss for 2024 though the amount will be received after 2024. The interest receivable account will be recorded as follows:

Interest Receivable Account

		¢			¢
31/12/2024	Profit and loss	1,605.000	31/12/2024	Cash	855,000
			31/12/2024	Balance c/f	750,000
		1,605,000			1,605,000
1/1/2025	Balance b/f	750,000			

The adjusting entry will be as follows:	Dr. ¢	Cr. ¢
Interest accrued A/c	750,000	
Interest receivable A/c		750,000

4.5 Non-current assets and depreciation expenses

As stated earlier, the non-current assets (both tangible and intangible) reduce in value of their expected useful life due to some factors. The reduction in value is accounted for using depreciation. The depreciable values of the non-current assets are spread over its useful life. The accounting treatment is as follows:

	Dr. ¢	Cr. ¢
Depreciation expense (Statement of Profit or Loss)	X	
Accumulated Depreciation (Statement of financial position)		X

The effect of the entry is to show depreciation as a business expense in the Statement of Profit or Loss, thereby reflecting the proportion of cost or valuation attributable to the current period. The fact must not be forgotten that depreciation is a non-cash item. This means it is a book adjustment only, which does not involve the physical movement of cash.

Illustration 4.4

Given below is the record of depreciation extracted from the books of Santos Ltd at the end of 2024 under the straight-line method.

Asset	Cost	Residual Value	Estimated Useful Live	Proportionate use by function	
	¢	¢		Selling Function	Administrative Function
Building	1,600,000	100,000	15 yrs	46%	54%
Equipment	910,000	10,000	10 yrs	40%	60%

Computation:

		Selling	Administration
		¢	¢
Building [(¢1,600,000 - ¢100,000) ÷15yrs]	100,000	46,000	54,000
Equipment [(910,000 - 10,000) ÷10yrs]	90,000	36,000	54,000
Totals	190,000	82,000	108,000

The adjusting entry for the set two assets is:

		Dr	Cr
		¢	¢
Depreciation:	Selling Expense	82,000	
	Administration Expense	108,000	
Provision for Depreciation:	Building		100,000
	Equipment		90,000

The adjusting entry reduces the carrying amount of the building and equipment accounts. The accumulated depreciation account is a contra account that has a stated balance against that of the assets account to which it relates. Thus, the accumulated depreciation account is deducted from the gross building and equipment accounts, leaving the carrying amounts of ¢1,500,000 (¢1,600,000-¢100,000) and ¢820,000 (¢910,000-¢90,000) for building and equipment respectively in the Statement of Financial Position.

4.6 Bad Debts

An entity that sells its goods on purely cash basis, does not have to worry about customers not

paying for such goods. This is not always the case in reality. Goods and services are usually sold or rendered on credit, giving rise to trade receivables. The business entity is therefore taking the risk of some customers defaulting in the payment of their debts. Trade receivables that cannot be collected are called bad debts or irrecoverable debts, which is the risk of doing business on credit terms. Where a customer's debt is found to be irrecoverable, steps must be taken to remove such debts from the list of customers owing the business entity. This is done by completely writing off the debt from the receivables account. Writing off of a particular debt from the list of receivables accounts means that the value of the assets (receivables) of the business has reduced or diminished. This has the effect that the business entity has incurred losses that must be accounted for by increasing the expense account of irrecoverable debt, which will eventually reduce profit and also reduce assets of receivables. This also translates to a reduction of the net assets of the business. Where an account containing a debt is declared 'irrecoverable' a journal entry must be passed as follows:

	Dr.	Cr.
	N	N
Bad /Irrecoverable debts expense account (Statement of Profit or Loss)	x	
Trade receivables account (Statement of financial position)		X

It is important for entities to review their receivables periodically and identify those debts that are unlikely to be collected in full. These irrecoverable debts may then be written-off in the statement of profit or loss. This practice prevents overstatement of both profit and assets and is always required if irrecoverable debts are probable and can be estimated. At the end of the accounting period, the total debt written off is transferred from the irrecoverable debts account to the Statement of profit or loss as follows:

Dr.	Cr.
x	
Statement of Profit or Loss	Irrecoverable debts account

Illustration 4.5
Kumasi Venture extracted Trial Balance

	Debit	Credit
	¢	¢
Trade Receivables	500,000	
Allowances for doubtful debt		50,000
Trade Payable		100,000
Gross Profit		150,000
Capital		200,000
	500,000	500,000

Assume the following situations that there are:

i. Increase in allowances for doubtful receivables to 15%
ii. Increase in allowances for doubtful receivables by 2 ½ %
iii. Allowances for doubtful receivables increase to ¢62,000
iv. Allowances for doubtful receivables reduce by ¢10,000
v. Allowances for doubtful debt reduce to 7 ½ % of Trade Receivables
vi. Decrease in allowances for doubtful debt by 3% of Trade Receivables

vii. Allowances for doubtful receivables are no longer required

viii. A customer with outstanding of ₵80,000 in the above trial balance is declared bankrupt by a competent court of jurisdiction

Required:

With appropriate ledger entries, post items i-viii and under each assumption; prepare the extracts of Statement of Profit or Loss Account and Statement of Financial Position.

Situation I:

Increase in allowance for doubtful debt to 15%: 15% of ₵500,000 = ₵75,000 Original provisions allowance for doubtful debt (trial balance) = ₵50,000

Allowance/Provision for Doubtful Trade Receivables' Account

₵		₵	
Bal c/d (SOFP)	125,000	Bal b/f	50,000
		P or L	75,000
	125,000		125,000
		Bal b/d	125,000

Statement of Profit or Loss Extract	₵
Gross Profit from trial balance	150,000
Less Expenses:	
Increase in Allowance for doubtful debt	(75,000)
Profit for the year	75,000

Statement of Financial Position Extract	₵
Current Assets:	
Net Trade Receivables (₵500,000- ₵125,000)	375,000
Capital	200,000
Profit for the year	75,000
Total Capital	275,000
Current Liability:	
Trade Payable	100,000
Total Capital and Liability	375,000

Situation II: Increase in allowances for doubtful receivables by 2½%

Increase in allowance for doubtful debt to **2½%**: **2½%** of ₵500,000 = ₵12,500

Original provisions allowance for doubtful debt (trial balance) = ₵50,000

Increase in provision = ₵62,500

Allowance/Provision for Doubtful Trade Receivables' Account

₵		₵	

Bal. c/d (SOFP)	62,500	Bal. b/f	50,000
	-	P or L	12,500
	62,500	Bal. b/d	62,500

Statement of Profit or Loss Extract	¢
Gross Profit from trial balance	150,000
Less Expenses:	
Increase in Allowance for doubtful debt	(12,500)
Profit for the year	137,500

Statement of Financial Position Extract	¢
Current Assets:	
Net Trade Receivables (¢500,000- ¢62,500)	437,500
Capital	200,000
Profit for the year	137,500
Total Capital	337,500
Current Liability:	
Trade Payable	100,000
Total Capital and Liability	437,500

Situation III: Allowances for doubtful receivables increase to ¢62,000

¢ Bal c/d (SOFP)	¢
112,000 112,000	Bal b/f 50,000
	P or L 62,000
	112,000
	Bal b/d 112,000

Statement of Profit or Loss Extract	¢
Gross Profit from trial balance	150,000
Less Expenses:	
Increase in Allowance for doubtful debt	(62,000)
Profit for the year	88,000

Statement of Financial Position Extract	¢

Current Assets:		
Net Trade Receivables (¢500,000- ¢112,000)	338,000	
Capital	200,000	
Profit for the year	88,000	
Total Capital	288,000	
Current Liability:		
Trade Payable	100,000	Increase in allowance for doubtful debt to
Total Capital and Liability	338,000	

¢62,000 = ¢62,000

Original provisions allowance for doubtful debt (trial balance) = ¢50,000
Increase in provision = ¢112,000

Allowance/Provision for Doubtful Trade Receivables' Account

Situation IV: Allowances for doubtful receivables reduce by ¢10,000
Reduction in allowance for doubtful debt by ¢10,000 (debit) = (¢10,000)
Original provisions allowance for doubtful debt (trial balance) = ¢50,000
Increase in provision = ¢40,000

Allowance/Provision for Doubtful Trade Receivables' Account

¢		¢	
Gross Profit	10,000	Bal b/f	50,000
Bal c/d	40,000		
50,000		50,000	
		Bal b/d (SOFP)	40,000

Statement of Profit or Loss Extract	¢
Gross Profit from trial balance	150,000
Add:	
Decrease in Allowance for doubtful debt	10,000
Profit for the year	160,000

Statement of Financial Position Extract	¢
Current Assets:	
Net Trade Receivables (¢500,000- ¢40,000)	460,000
Capital	200,000
Profit for the year	160,000
Total Capital	360,000
Current Liability:	
Trade Payable	100,000
Total Capital and Liability	460,000

Situation V: Allowances for doubtful debt reduce to 7 ½ %

7 ½ % of ¢500,000 = ¢37,000, ¢50,000-¢37,500 = ¢12,500

Reduction in allowance for doubtful debt by ¢10,000 =(¢12,500) (debit)

Original provisions allowance for doubtful debt (trial balance) = ¢50,000

Decrease in provision = ¢37,500

Allowance/Provision for Doubtful Trade Receivables' Account

	¢		¢
Gross Profit	12,500	Bal b/f	50,000
Bal c/d	37,500		
	50,000		50,000
		Bal b/d (SOFP)	37,500

Statement of Profit or Loss Extract	¢	
Gross Profit from trial balance		150,000
Add:		
Decrease in Allowance for doubtful debt	12,500	
Profit for the year	162,500	

Statement of Financial Position Extract	¢
Current Assets:	
Net Trade Receivables (¢500,000- ¢37,500)	462,500
Capital	200,000

Profit for the year	162,500
Total Capital	362,500
Current Liability:	
Trade Payable	100,000
Total Capital and Liability	462,500

Allowance/Provision for Doubtful Trade Receivables' Account

	¢		¢
Gross Profit	15,000	Bal. b/f	50,000
Bal. c/d	35,000		
50,000		50,000	
		Bal. b/d (SOFP)	35,000

Statement of Profit or Loss Extract	¢
Gross Profit from trial balance	150,000
Add:	
Decrease in Allowance for doubtful debt	15,000
Profit for the year	165,000

Statement of Financial Position Extract	¢
Current Assets:	
Net Trade Receivables (¢500,000- ¢35,000)	465,000
Capital	200,000
Profit for the year	165,000
Total Capital	365,000
Current Liability:	
Trade Payable	100,000
Total Capital and Liability	465,500

Allowance/Provision for Doubtful Trade Receivables' Account

¢		¢	
Gross Profit	50,000	Bal b/f	50,000
Bal c/d	0.000		
50,000		50,000	
		Bal b/d (SOFP)	0.000

Statement of Profit or Loss Extract	¢
Gross Profit from trial balance	150,000
Add:	
Decrease in Allowance for doubtful debt	50,000
Profit for the year	200,000
Statement of Financial Position Extract	¢
Current Assets:	
Net Trade Receivables (¢500,000- ¢0.000)	500,000
Capital	200,000
Profit for the year	200,000
Total Capital	400,000
Current Liability:	
Trade Payable	100,000
Total Capital and Liability	500,500

Situation VIII: A customer with outstanding of ¢80,000 in the above trial balance is declared bankrupt by a competent court of jurisdiction.

Trade Receivables' Account

¢		¢	
Bal b/d	500,000	Bad Debt	82,000
		Bal c/d	418,000
	500,000		500,000
Bal. b/d (SOFP)	418,000		

Statement of Profit or Loss Extract	¢
Gross Profit from trial balance	150,000
Add:	
Bad Debt	82,000
Profit for the year	68,000
Statement of Financial Position Extract Current Assets:	¢
Net Trade Receivables (¢500,000-¢50,000-¢82,000)	368,000
Capital	200,000
Profit for the year	68,000

Total Capital Current Liability:	268,000
Trade Payable	100,000
Total Capital and Liability	368,000

Illustration 4.6

Jack Terror has been in business for several years dealing in the sale of second hand clothes. During the three years ended October 31, 2024, he presented the following

	Credit sales	Irrecoverable Debts
	¢	¢
October 31, 2022	4,500,000	1,200,000
October 31, 2023	8,750,000	3,850,000
October 31, 2024	12,200,000	6,300,000

You are required to show the above information for the year ended October 31, 2022, 2023 and 2024 in the following accounts:

a) Trade receivables account
b) Irrecoverable debts account
c) Statement of Profit or Loss

Solution to Illustration 4.6

(a) Trade Receivable Account

	¢		¢
31/10/2022 Sales	4,500,000	31/10/2022 Irrecoverable debts	1,200,000
		31/10/2022 Balance c/f	3,300,000
	4,500,000		4,500,000
1/11/2022 Balance b/f	3,300,000		

Trade Receivable Account

	¢		¢
31/10/2023 Sales	8,750,000	31/10/2023 Irrecoverable debts	3,850,000
		31/10/2023 Balance c/f	4,900,000
	8,750,000		8,750,000
1/11/2023 Balance b/f	4,900,000		

Trade Receivables Account

	¢		¢
31/10/2024 Sales	12,200,000	31/10/2024 Irrecoverable debts	6,300,000
		31/10/2024 Balance c/f	5,900,000
	12,200,000		12,200,000
1/11/2024 Balance b/f	5,900,000		

(b) Irrecoverable debt Account

	¢		¢
31/10/2003 Trade debtors	1,200,000	31/10/2003 Profit and loss	1,200,000
31/10/2004 Trade debtors	3,850,000	31/10/2004 Profit and loss	3,850,000
31/10/2005 Trade debtors	6,300,000	31/10/2005 Profit and loss	6,300,000

a. Statement of Profit or Loss (extract) ended October 31, xxxxxx

	¢	¢
2022 Gross profit	xxxxxx	
Less Irrecoverable debts	1,200,000	X
2023 Gross profit	xxxxxx 3,850,000	
Less Irrecoverable debts		X
2024 Gross profit Less: Irrecoverable debts	xxxxxx 6,300,000	
		X

4.7 Allowance for discounts on Trade Receivables

In certain businesses allowance is made for cash discount that is expected to be offered to customers on the trade receivables balance at the reporting period end. Proponents of this concept argue that since entities allow discounts on credit sale for prompt payment, recording gross realizable value of receivables as the balance on receivables account less allowance for doubtful debts alone will not give the best estimate of the amount expected to be collected from trade receivables. They argue that the best estimate of the value of receivable is that one that gives effect to cash discounts. Hence, making the determination of allowance for discounts on receivables.

The account treatment necessary to make a provision for doubtful debts is:

1. When a provision is made for the first time:

Debit: Statement of Profit or Loss
Credit: Allowance for doubtful debts Account } With the initial allowance made

In this way the current year's profit is reduced, whilst in the statement of financial position the allowance is clearly shown and deducted from trade receivables. In subsequent accounting period's new estimate must be made in respect of debts that may be considered doubtful. The new allowance should be compared with the existing one and where the current allowance is greater than the previous one, the difference representing increase in allowance for doubtful debts should be accounted for as follows:
Debit: Statement of Profit or Loss with the increase
Credit: Allowance for doubtful debts (current allowance less previous allowance)

However, if the current allowance is less than the previous one, the difference representing a decrease in allowance for doubtful debts should be accounted for as follows:
Debit: Allowance for doubtful debts account with the reduction in allowance made
Credit: Statement of Profit or Loss(Previous allowance less current allowance)

Illustration 4.7

Viscosity Ltd. has been in business since 2022 dealing in the sale of mobile phones. During the three-years period ended December 31, 2024 the company presented the following information relating to receivables:

	Receivables (excluding irrecoverable debts)	Irrecoverable Debts
	¢	¢
31 December, 2022	7,000,000	1,000,000
31 December, 2023	18,250,000	2,500,000
31 December, 2024	10,000,000	4,300,000

Viscosity Ltd. makes provision for a doubtful debt at the rate of 6% on receivables. There was no balance on the provision for doubtful debt at the beginning of 2022 financial year.

You are required to show the above information for the year ended December, 31, 2022, 2023 and 2024in the following accounts:

(a) Irrecoverable debt
Allowance for doubtful debts account
(b) Statements of Profit or Loss (extracts)
(c) Statements of financial position (extracts)

Solution to Illustration 4.7

Irrecoverable debts account

		¢			¢
31/12/2022	Trade Receivables	1,000,00 0	31/12/2014	Statement of Profit or Loss	1,000,000
31/12/2023	Trade Receivables	2,500,00 0	31/12/2015	Statement of Profit or Loss	2,500,000
31/12/2024	Trade Receivables	4,300,00 0	31/12/2016	Statement of Profit or Loss	4,300,000

Allowance for doubtful debts account

2003 Balance c/f	420,000	2003 Statement of Profit or loss	420,000
2004 Balance c/f	1,095,000	2004 Balance b/f	20,000
		2004 Statement of Profit or loss	75,000
	1,095,000		,095,000
2005 Profit or loss	495,000	2005 Balance b/f	.,095,000
2005 Balance c/f	600,000	2005	
	1,095,000		1,095,000
		2006 Balance b/f	600,000

Statement of Profit or Loss (extract) for the year ended 31 December xxxxxxx

	¢	
2022 Gross profit		xxxxxx
Less Irrecoverable debts	1,000,000	
Increase in allowance for doubtful debt	420,000	(1,420,000)

2023 Gross profit Less Irrecoverable debts			xxxxxx
	2,500,000		
Increase in allowance for doubtful debt	675,000		3,175,000
2024 Gross profit			
			xxxxxx
Add Decrease in Provision for doubtful debt	495,000		
Less bad debts	(4,300,000)		(3,805,000)

Statement of Financial Position (extract) at 31 December xxxxxxx

	¢		
2022 Trade Receivables	7,000,000		
Less allowance for doubtful debts	420,000		6,580,000
Increase in allowance for doubtful debt			
2023 Trade Receivables	18,250,000		
Less allowance for doubtful debts	1,095,000		17,155,000
2024 Trade Receivables		10,000,000	
Less allowance for doubtful debts		600,000	9,400,000

4.8 Allowance for doubtful debts and irrecoverable debts

The way in which allowance for discount on receivables is calculated is almost the same as when calculating allowance for doubtful debts alone. You must however remember to apply the same rate or percentage to the net amount of trade receivables less allowance for doubtful debts. This is so because discounts are allowed on debts expected to be paid and not irrecoverable debts.

It is the process of making allowance for the possibility of a debt becoming irrecoverable in the future but by what amount cannot be calculated with substantial accuracy. In the case of doubtful debts, the amount or its estimate still remains in the list of receivables and is not cancelled from the receivables account unlike the case of debts that have actually become irrecoverable. Doubtful debt does not relate to any specific debtor, but the business entity recognizes the fact that not all the existing debts will be collected and as such, it is prudent that such uncertainty is reflected in the statement of profit or loss account and the statement of financial position.

Illustration 4.8

Mahatma Ltd. has been in business since 2022 dealing in the sale of Italian executive shoes. During the three years ended 31 December 2024 the company presented the following information relating to receivables:

	Trade Receivables	Allowance for Doubtful debts	Allowance for Cash discount Allowed
	¢	¢	%
31 December 2022	17,000,000	1,000,000	4
31 December 2023	28,550,000	4,500,000	4
31 December 2024	22,000,000	2,800,000	4

You are required to show the above information for the years ended 31 December, 2022, 2023, and 2024 in the following accounts:

a. Allowance for discounts on receivables
Statements of Profit or Loss (extracts)
b. Statements of financial position (extracts)

Solution to Illustration 4.8

(a) Allowance for discounts on receivables account

2003 Balance c/f	640,000	2003 Statement of Profit or loss	640,000
2004 Balance c/f	962,000	2004 Balance b/f	640,000
		2004 Statement of Profit or loss	322,000
	962,000		962,000
2005 Profit or loss	194,000	2005 Balance b/f	962,000
2005 Balance c/f	768,000	2005	
	962,000		962,000
		2006 Balance b/f	768,000

Statement of Profit or Loss (extract) for the year ended 31 December xxxxxxx

		¢
2022 Gross profit		xxxxxx
Less allowance for doubtful debt	1,000,000	
Allowance for discount on receivables	640,000	(1,640,000)
2023 Gross profit		xxxxxx
Less allowance for doubtful debts (Note 4)	4,500,000	
Allowance for discount on receivables	322,000	4,822,000
2024 Gross profit		Xxxxxx
Less: Allowance for doubtful debts.	2,800,000	
Decrease in allowance for discounts on receivables (Note 6)	(194,000)	2,606,000

(c) Statement of Financial Position (extract) as at 31 December xxxxxxxx

		¢	¢	¢
2002	Debtors		17,000,000	
	Less Provision for doubtful debt	1,000,000		
	Provision for discount on debtors	640,000	1,640,000	
				15,360,000
2003	Debtors		28,550,000	
	Less Provision for doubtful debt	4,500,000		
	Provision for discount on debtors	962,000	5,462,000	
				23,088,000
2004	Debtors		22,000,000	
	Less Provision for doubtful debt	2,800,000		
		768,000	3,568,000	
				18,432,000

Note 1: ¢(1,7000,000–1,000,000) x 4%=¢640,000
Note 2: ¢(28,550,000–4,500,000) x 4%=¢962,000
Note 3: ¢(22,000,000–2,800,000) x 4%=¢768,000
Note 4: ¢(4,500,000–1,000,000) = ¢3,500,000 (Increase in allowance)
Note 5: ¢(4,500,000–1,000,000) = ¢3,500,000 (Increase in allowance)
Note 6: ¢(768,000–962,000) =194,000 (decrease in allowance)

4.9 Irrecoverable Debts Recovered

It is a common occurrence that a debt, which has previously been written off in previous accounting periods, may be paid or recovered. In such a situation, the recovered debt should be reinstated. The debt is reinstated in the sale ledger account to ensure that a detailed and concise history of the customer is available as a guide for granting credit to the same customer in future. It will also assist the entity in its credit rating of all customers that buy goods from them on credit.

The accounting entries when a debt is recovered are:

Debit: Trade Receivables account with the amount of debt reinstated Credit: Irrecoverable debts recovered account

Debit: Cash or bank account with the amount recovered from the customer Credit: Trade Receivables account in full or part settlement of all of debt owed

At the end of the accounting period the balance in the irrecoverable debts recovered account will either be transferred directly to the Statement of Profit or Loss or to the main irrecoverable debts account. Whichever way the transfer will produce the same result.

4.10 Chapter Summary

In this chapter we have considered some of the adjustments that are often made to improve the quality of the year-end accounts used to prepare the financial statements. We should also understand that these adjustments are needed in order to record the actual expenses incurred, and the actual revenue earned for the accounting year. It must also be remembered that each of the adjustments considered will impact upon the statement of profit or loss and the statement of financial position. We have learnt that depreciation is a business expense that must be charged in the statement of profit or loss of any period that a non-current asset has been in use. In addition, we learnt that any business debt that an entity is unable to collect is called an irrecoverable debt and that there is the need to also record allowance for irrecoverable debts so that the receivable figures in the statement of financial position will reflect the amount that the business is likely to collect from receivables. Finally we have also learnt how to record irrecoverable debts, allowance for doubtful debts, allowance for cash discounts in the ledger, statement of profit or loss and the statement of financial position. It is hoped that, readers will have better understanding of the purpose and accounting treatment for depreciation, irrecoverable debts allowance and accruals and prepayments.

4.11End of Chapter Questions

Multiple Choice Questions (MCQ)

1. Which of the following would result from an increase in the allowance for doubtful debts?

a. A decrease in gross profit
b. An increase in gross profit
c. A decrease in net profit
d. An increase in net profit
e. An increase in asset

Use the following details to answer Question 2.
Trade receivables control account balance ¢500,000.00
Allowance for doubtful debts ¢50,000.00 Allowance for discount allowed on receivables 5%

2. The receivables figure to be shown under current assets in the statement of financial position is

a. ¢425,000.00
b. ¢427,500.00
c. ¢447,500.00
d. ¢450,000.00
e. ¢475,000.00

3. During year 2024, Victor paid rent amounting to ¢500,000. He owed ¢50,000 at the beginning of the year and by 31 December 2024, he had paid rent in advance of ¢100,000. His rent charge for 2024 was?

a. ¢350,000
b. ¢450,000
c. ¢500,000
d. ¢550,000
e. ¢650,000

4. At the end of the first year of trading, a trader's receivables amounted to ¢5,000. This excludes ¢180 debts found to be irrecoverable. At the same date, it was estimated that ¢70 of the ¢5,000 would still turn out to be irrecoverable debts. Determine the net realizable value of receivables at the end of the first year of trading.

a. ¢4,750
b. ¢4,820
c. ¢4,930
d. ¢5,000
e. ¢45,030

5. A trader had trade receivables of ¢50,000 at the end of his accounting period. Trade receivables at the beginning of the period was ¢60,000. His policy is to make allowance for doubtful debts at the rate of 5%. State the change in value of the allowance for doubtful debts at the end of the current accounting period.

a. ¢500 decrease in allowance
b. ¢500 increase in allowance
c. ¢2,500 decrease in allowance
d. ¢2,500 increase in allowance
e. ¢3,000 decrease in allowance

6. When a debt thought to be irrecoverable and written off is subsequently recovered, which additional entry is required to complete the two entries given below?

i. Debit Personal Account/Credit Irrecoverable Debts Recovered Account
ii. Debit Cash/Bank Account/Credit Personal Account

a) Debit Income statement/Credit irrecoverable debts recovered account
b) Debit Statement of Profit or Loss/Credit Cash/Bank account
c) Debit irrecoverable debts recovered account/Credit Statement of Profit or Loss account
d) Debit irrecoverable debts recovered account/Credit personal account
e) Debit cash/credit Statement of Profit or Loss

7. From the following information, calculate the cash paid by trade receivables during the year. Receivables at the beginning of the year was ¢350,000 and receivables at close of the year was ¢500,000, Credit sales for the year was ¢510,000.

a. ¢340,000
b. ¢360,000
c. ¢380,000
d. ¢520,000
e. ¢660,000

8. The fact that allowances are made against doubtful debts upholds the concept of

a. Consistency
b. Prudence
c. Materiality
d. Business entity
e. Realisation

9. Which accounting concept does not agree with making allowance for discount receivable?

a. Prudence
b. Business entity
c. Accruals
d. Consistency
e. Materiality

10. A customer owing ¢200,000 was allowed to pay ¢180,000 in full settlement of his indebtedness. This results in a

a) Decrease in liability, increase in asset and increase in capital
b) Decrease in asset, decrease in capital and decrease in liability Receivables/Cash/Capital
c) Decrease Receivables, increase cash and decrease capital'
d) Decrease in capital, decrease in asset and increase in liability
e) Increase in capital, decrease in asset and decrease in liability

11. When provision for doubtful trade receivable in the trial balance is no longer required, the accounting entry is:

a. Debit P or L & Credit Trade Receivable Account
b. Debit Trade Receivable & Credit P or L
c. Debit Provision for doubtful Trade Receivable Account & Credit P or L
d. Credit P or L & Debit Provision for doubtful Trade Receivable Account
e. Debit Bad Debt Account and Credit P or L

12. Annual rent payable is ¢500,000. Rent prepaid at 1 January, 2024 was ¢80,000 and rent accrued at 31 December 2024 was ¢60,000. How much was paid in respect of rent in 2024?

a. ¢360,000
b. ¢420,000
c. ¢480,000
d. ¢500,000
e. ¢520,000

Short Answer Questions

1. State the journal entries for allowances for bad and doubtful receivable that is no longer required in the trial balance.
2. An entity, which prepares account to December every year paid ¢150,000 as insurance for the period ended 31 March 2025. Calculate the amount of insurance prepared for the year ended 31 December, 2024.
3. State the journal entries for decrease in allowances for doubtful receivables.
4. An entity's allowance for doubtful receivable rose from ¢105,000 to ¢200,000. Raise the appropriate journal to record the transactions.
5. Which accounting concept allows for delay in payment for an expense, which has been supplied and used in the accounting period?
6. Prepaid expense is a ___in the statement of financial position.
7. An expenses, which is outstanding during the year is a __ in the statement of financial position.
8. An allowance to a credit customer to encourage prompt payment of cash is called____
9. A form of discount deducted from selling price of a product is called_
10. State the journal entries to record discount received from a supplier.

THEORY AND CALCULATION QUESTIONS

1. On 1 January, 2024 the following balances among others stood in the books of Menntua Enterprise.
   Electricity and Water ¢15,000,000 Cr.
   Insurance ¢50,000,000 Dr.
   During the year ended 31 December 2024, the following information relating to the above accounts have been provided:

a. Motor insurance of ¢870,000,000 was paid on 1 June 2024 for a one year period.
b. Marine insurance of ¢190,000,000 covering the year ended 31 March 2025 was paid on 1st April 2024.
   The Entity had not insured one of its buildings in respect of fire after the insurance premium expired on 31 December 2023. The Building was insured for ¢60,000,000 last year and the insurance company does not intend to renew the premium.

c. Electricity bill amounting to ¢750,000,000 was paid on 1 March 2024 and also electricity bill amounting to ¢250,000,000 in respect of November and December 2024 had not been paid by the end of the accounting period. On June 1, 2024 ¢15,000,000 was paid in respect of an old building that is being used as warehouse by the entity.

This payment was made at a time when there was no meter in the building. The electricity bill for the building was arrived at by charging the entity ¢13,500,000 for total consumption in 2024.

You are required to record the above transactions in the appropriate ledger accounts.

2. The following balances were extracted from the ledgers of Victor osky Ltd.

	01/04/2015	31/03/2016
	¢'000	¢'000
Rent receivable–Prepayments	108,000	215,000
Rates and insurance-Prepayment	450,000	385,000
Accruals	103,000	185,000
Trade receivables	798,000	985,000
Stationery: inventories in hand	235,000	275,000
Owing to suppliers	109,000	97,500

During the year ended 31 March 2024, the following transactions took place:

	¢'000
Rent received by cheque	418,000
Rates paid to AMA by cash	950,000
Payment to suppliers for stationery	205,000
Irrecoverable debts written off on a customer who has been declared bankrupt	50,000
Insurance paid by cheque	550,000
Discount allowed	65,000
Cheque received from customers	8,525,000

You are required to post and balance the above transactions in the appropriate ledger accounts.

3. The Trial Balance of Santo Ltd. At 31 December 2022 reported an amount of ¢750,000 by way of trade receivables. At the time of preparing the Trial Balance, the accounts clerk discovered that a customer owing ¢150,000 would not be able to settle such debts. It is the policy of Santo Ltd. to make allowance for doubtful debts of 5% of all outstanding trade receivables at the end of each accounting period. During the accounting year ended 31 December 2023, the company made a total credit sale of ¢980,000 out of which an amount of ¢550,000 was collected from trade receivables. A court in Accra declared a customer who owes the company an amount of ¢85,000 bankrupt in August 2023. The company recorded three cheques amounting to ¢175,000 that were dishonored.

   The company recorded ¢1,500,000 and ¢850,000 in connection with cash sales and credit sales respectively in the year 2024. The company received ¢1,250,000 from trade receivables and also showed ¢670,000 as the outstanding balance on the sales ledger account. A cheque was received from the customer whose debt was written off in 2022 in full settlement of his debt.

   You are required to post and balance the following accounts:

a. Trade receivables account
b. Irrecoverable debts account
c. Allowance for doubtful debts account

4. The net profit of Kumasa Ltd. For years ended 31 December 2021, 2022, 2023 and 2024 were ¢450,000,000, ¢598,000,000, ¢515,000,000 and ¢798,000,000 respectively. It has now been found that the wrong method of depreciation has been used over the years for motor vehicles and Plant and Machinery.

   Details on the assets are as follows:

	Date	Cost	Scrap value	Depreciation
		¢'000	¢'000	Rate
Plant and Machinery	1/1/2021	980,000	40,000	10%
Motor vehicles	1/1/2021	670,000	20,000	25%

   The straight line method of depreciation was used with an estimated useful life of ten (10) years and four (4) years for Plant and Machinery and Motor vehicles respectively. The directors of the company have now decided to adopt the diminishing balance method of providing for depreciation as follows:

   Plant and Machinery 15%
   Motor vehicles 20%

   You are required to re-compute the net profit of Kumasa Ltd. for the years ended December 31 2021, 2022, 2023 and 2024

5. (a) Distinguish between provision for bad receivables and provision for doubtful receivables.
   (b) State the accounting entries for bad receivables and doubtful receivables.

4.12 Solution to End of Chapter Questions

1. C.
2. B.
3. A.
4. C.
5. A.
6. C.
7. B.
8. B.
9. A.
10. C.

11. C
12. A.

Solutions to Short Answer Questions (SAQ)

1. A credit entry to the Gross Profit in the income statement.
2. ¢30,000
   3/15 x 150,000
   ¢30,000
3. DR allowances for doubtful receivable account CR Gross profit in the income statement.
   Being amount of decrease in allowance for doubtful receivable.
4. DR CR

   DR Statement of P or L ¢95,000

   CR Allowance for doubtful receivable ¢95,000
   Being amount of increase in trade receivable in allowance for doubtful debt
5. Accrual
6. Current Assets
7. Current Liability
8. Discount Allowed
9. Quantity Discount

		DR ¢	CR ¢
10.	DR Supplier's Account	XX	
	CR Discount Received Account		XX
	Being amount of discount received from a supplier.		

Solution to some Questions	15,000
Menntua Enterprise	998,500
Question 1	1,500
Water and Electricity Account	1,015,000

2024		¢'000	2024		
March 1	Bank	750,000	Jan 1	Balance b/f	15,000
June 1	Bank	15,000	Dec 31	Statement of Profit or Loss	998,500
Dec 31	Balance c/d	250,000	Dec 31	Balance c/d(15000-13,500)	1,500
		1,015,000			**1,015,000**
Jan 1	Prepaid b/f	1,500	Dec 31	Owing b/f	250,000

Insurance Account

2024		¢'000	2024		¢'000
				Statement of Profit or	
Jan 1	Balance b/d		Dec 31	Loss	760,000
		50,000			
April 1	Bank	190,000	Dec 31	Balance c/d	
				Marine	47,500
		870,000		Motor	362,500
June 1	Bank				
Dec 31	Balance				
		60,000			
		1,170,000			1,170,000

2025

2025

Jan1	Balance b/d: Marine Motor	47,500	
		262,500	
Jan1	Balance b/f	60,000	

Solution to question 2 Victorosky Ltd.

Rent Receivable Account

		¢'000	2015		¢'000
	Statement of				
31/3/2023	Profit or loss	311,000	1/4/2023	Prepaid b/f	108,000
		215,000		Bank	418,000
31/3/2023	Prepaid c/f	526,000			
					526,050
2025			1/4/2024	Prepaid b/f	215,000

Rates and Insurance Account

2023		¢'000	2023		¢'000
April 1	Balance b/f	450,000	April 1	Bal b/f	103,000
	Cash	950,000		Profit or Loss	1,647,000
	Bank	550,000		Prepaid c/f	385,000
	Owing c/f	185,000			
		2,135,000			2,135,000
					185,000
				Owing b/f (fire)	

Trade Receivables Account

2023		¢'000	2015	¢'000
April 1	Balance b/f	798,000	Bal b/f	103,000
			Bank	8,525,000
	Credit Sales	8,930,000	Irrecoverable debt	50,000
			Discount allowed	65,000
			Bal c/f	985,000
		9,728,000		9,728,000
	Bal b/f	985,000		

Stationery Account

2023	¢'000		2023	¢'000	
April 1	Balance b/f	235,000	April 1,	Bal b/f	109,000
		205,000	2024		
2024	Bank		March 31	Statement of Profit Or Loss	153,500
March 31	Owing c/f	97,500	March 31	Prepaid c/f	275,000
2024		537,500	2024		537,500
April 1	Prepaid b/f	275,000	April 1	Owing b/f	97,500

Solution to question 3 Santo Ltd.
Trade Receivables Account
a.

		¢'			¢
2022	Balance b/f	750,000	2022	Irrecoverable debt	150,000
				Bal c/f	600,000
		750,000			750,000
2023	Bal b/f	600,000	2023	Bank	550,000
2023	Credit sales	980,000	2023	Irrecoverable debt	85,000
2023	Dishonoured cheque	175,000			1,120,000
			2015	Bal c/f	
		1,755,000			1,755,000
2016	Bal b/f	1,120,000	2016	Bank	1,250,000
2016	Credit sales	850,000	2016	Irrecoverable debt	50,000
2016	Irrecoverable debt recovered account	150, 000		Bank (debt recovered)	150, 000
	Bal b/f			Bal c/f	
		2,120,000	2016		670, 000
2017		670, 000			2,120,000

Irrecoverable Debts Account

b.

		¢'		¢15
		150,000	Statement of Profit or Loss	0,00
		2022		0
2023	Trade	150.000		150.
		85.	Statement of Profit or Loss	85,
				000
2024	Trade	2024	Trade Receivables (Debt recovered)	
		50,000		
	Statemen	100,000		150.
	t of			
	Profit or			

a. Allowance for doubtful debts account

Solution to question 4

		¢'		¢30
2022	Balance	30,000	Statement of Profit or Loss	,000
		2022	(750,000–	30.
2023	Balance	30,000		
		56.	Balance b/d	30,
			Statement of profit or	000
			loss	26,
2				000
	Statement of profit or	22.		
		33,500	Balanc	33.

Kumasa Ltd.

Straight line method–Plant and machinery

Year	Beginning Depreciable Amount	Depreciation Rate	Depreciation For the year	Accumulated Depreciation
	¢		¢	¢
2021	940,000,000	10%	94,000,000	94,000,000
2022	940,000,000	10%	94,000,000	188,000,000
2023	940,000,000	10%	94,000,000	282,000,000
2024	940,000,000	10%	94,000,000	376,000,000

Straight line method- Motor Vehicles

Year	Beginning Depreciable Amount	Depreciation Rate	Depreciation forth year	Accumulated Depreciation
	¢		¢	¢
2021	650,000,000	25%	162,500,000	162,500,000
2022	650,000,000	25%	162,500,000	325,000,000
2023	650,000,000	25%	162,500,000	487,500,000
2024	650,000,000	25%	162,500,000	650,000,000

Reducing balance method – Plant and Machinery

Year	Beginning Depreciable Amount	Depreciation Rate	Depreciation for the year	Accumulated Depreciation	Closing Depreciable Amount
	¢		¢	¢	
2021	940,000,000	15%	141,000,000	141,000,000	799,000,000
2022	799,000,000	15%	119,850,000	260,850,000	679,150,000
2023	679,150,000	15%	101,872,500	362,722,500	577,277,500
2024	577,277,500	15%	86,591,625	449,314,125	490,685,875

Motor vehicles

Year	Beginning Depreciable amount	Depreciation Rate	Depreciation for the year	Accumulated Dep Recitation	Closing Depreciable amount
	¢		¢	¢	¢
2021	650,000,000	20%	130,000,000	130,000,000	520,000,000
2022	520,000,000	20%	104,000,000	234,000,000	416,000,000
2023	416,000,000	20%	83,200,000	317,200,000	332,800,000
2024	332,800,000	20%	66,560,000	383,760,000	266,240,000

Computation of Adjusted Net profit for the years ended 31 December 2021, 2022, 2023, and 2024.

	2021	2022	2023	2024
	¢000	¢000	¢000	¢000
Net profit before adjustment	450,000	598,000	515,000	798,000
Add Depreciation (wrong method)				
Motor vehicles Plant & equipment	162,500	162,500	162,500	162,500
	94,000		94,000	94,000
		94,000		
	706,500	854,500	771,500	1,054,500
Less Depreciation (correct method)	(130,000)	(104,000)	(83,200)	
Motor vehicles Plant & equipment	(141,000)		(101,873)	(66,560)
		(119,850)		(86,592)
Adjusted Net Profit	435,500	630,650	586,427	901,348

Chapter Five
Bank Reconciliation and Control account

Content

The Nature of Control Accounts
Uses of Receivables Control Accounts
Sources of Information for Receivables Control Accounts
Reasons for Differences between Receivables Control and Individual Ledger Balances
Reconciliation with Total of Individual Receivables Ledger Balances
Payables Ledger Control Account
Reconciliation with Total Individual Payables Ledger Balances
Suppliers' Statements and Their Reconciliation with the Ledgers
Bank Reconciliation Statement
The Need for Bank Reconciliation
Reasons for Differences between Bank Statements and Entities' Bank Balance
Determination of Correct Cash Book Balance
Preparation of Bank Reconciliation Statement

5.0 Objectives

At the end of this chapter, candidates should be able to:
Explain the nature of control accounts
Identify the uses of receivables control accounts
List sources of information for receivables control accounts
Explain reasons for differences between receivables control and individual ledger balances
Reconcile the receivables control account with the total of individual receivables ledger balances
Prepare a payables ledger control account
Reconcile the payables ledger control account with the total of individual payables ledger balances
Reconcile suppliers' statements with the ledgers
Explain the need for bank reconciliation
Identify reasons for differences between bank statements and entities' bank balance
Determine the correct cash book balance
Prepare a bank reconciliation statement

5.1 Control Accounts

Control accounts and reconciliations are essential tools in maintaining accurate and reliable financial records. In this chapter, we will explore the features and uses of control accounts, particularly in relation to receivables and payables. We will also discuss the importance of reconciliations in ensuring the integrity of financial data, including bank reconciliations and reconciliations between control accounts and individual ledger balances. By the end of this chapter, you will understand the principles and procedures involved in maintaining control accounts and performing reconciliations, and will be able to apply these skills in a practical context.

5.1.1 Features of Control Accounts

Control accounts are summary accounts in the general ledger that represent the total balance of a group of related accounts. They aggregate transactions from multiple subsidiary accounts, helping to verify accuracy by comparing the control account balance with the total of the subsidiary accounts, and serve as a control mechanism to ensure the accuracy and completeness of accounting records.

Control accounts are impersonal accounts that form part of the double-entry system. They are used to record and summarize transactions related to specific groups of accounts.

There are two main types of control accounts:

1) **Receivables Control Account**: This account represents the total amount owed to the business by its customers.
2) **Payables Control Account**: This account represents the total amount the business owes to its suppliers.

5.1.2 Uses of Control Accounts

Control accounts have several uses:

1) **Prompt extraction of the trial balance**: By having the control account in the general ledger, a trial balance can be extracted without reference to any other accounting ledger.
2) **Error detection and correction**: Control accounts help identify errors and discrepancies in the ledger accounts, allowing for timely corrections.
3) **Ledger balancing**: They facilitate the balancing of ledgers by providing a check on the accuracy of postings.
4) **Financial reporting**: Control accounts aid in preparing financial statements by providing a summary of transactions and balances.
5) **Accounting efficiency**: They streamline the accounting process by consolidating information and reducing the complexity of ledger accounts.
6) **Internal control**: Control accounts enhance internal control by providing a mechanism for monitoring and verifying transactions, helping to prevent and detect fraud.

5.2 Receivables Control Accounts

Features: A receivables control account is an impersonal account that forms part of the double-entry system, serving as a summary account that represents the total amount owed to the business by its customers. As an asset account, it plays a crucial role in tracking and managing a company's trade receivables.

The receivables control account will usually have a debit balance, which indicates that the customer is owing the entity for good purchased from the entity on credit. However, it may also have a credit balance, which indicates that the entity owes the customer.

The following can be responsible for credit balances in the receivables ledger control account.

1) Overpayment made by a credit customer;
2) Payment made in advance by credit customer;
3) The customer has paid for good and the returned them; and
4) Errors in posting or accounting.

5.2.1 Sources of information for Receivables Control Account

The books of prime entry provide the information for entries in the control accounts

The following table highlights it.

Source	Transactions
Sales day book	Credit sales
Sales returns day book	Returns on sales by credit customers
Cash book	Cash received from customers Refund to customers Discount allowed Dishonoured cheques
Journal	Irrecoverable or bad debts Contra entries Interest charged on customer's account
Note: Cash sales and allowances for doubtful receivables should not appear in the receivables control account.	

5.2.2 Entries in the Receivables Ledger Control Account

Summary of entries in the receivables control account are as follows:

Debit side:

i. Balance brought forward.
ii. Credit sales from sales day book.
iii. Dishonoured cheque.
iv. Interest charged on customer's account.

Credit side

i. Cash received from credit customers.
ii. Discount allowed
iii. Returns inwards
iv. Set off between the sales ledger control and the purchases ledger control
v. Bad debt written off.

Illustration 5.1

The following information is extracted from the books of

The following information is available for Foday Enterprises in for the month of March:

- Receivables ledger control Balance b/f: Le15,000,000
- Purchases ledger control balance b/f: Le8,000,000
- Credit sales: Le30,000,000
- Cash sales Le11,000,000
- Cash received from customers: Le20,000,000
- Discount allowed: Le1,500,000 Discount received: Le800,000
- Discount received: Le800,000
- Cash paid twice to supplier (error): Le400,000
- Bad debts written off: Le1,000,000
- Returns inwards: Le500,000
- Customer's dishonoured cheque: Le800,000
- Interest charged on customers' balance: Le300,000

- Credit purchases: Le25,000,000
- Cash paid to suppliers: Le18,000,000
- Returns outwards: Le1,200,000
- Payables set off against receivables Le2,000,000

Required:
Prepare the Receivables Ledger Control Account for Foday Enterprises for the month of March.

Foday Enterprises
Receivables ledger control Account

	Le'000		Le'000
Balance b/f	15,000	Cash received from customer	20,000
Credit sales	30,000	Discount allowed	1,500
Dishonoured cheque	800	Bad debt written off	1,000
Interest charged	300	Return inwards	500
		Payables set off-contra	2,000
	46,100		21,100

5.2.3 Purpose of Reconciliation between Control Accounts and the Aggregate of the Balances in Individual Ledger

Part of periodic review of the bookkeeping is to reconcile the accounts receivables in the general ledger to the total of balances in the individual accounts of the customer.
Normally, the balance in the control account should match the total balance of the individual personal accounts or list of balances in the corresponding ledger. However, differences may occur due to errors in the control account, the ledger accounts, or both. When this happens, the errors must be identified and reconciled to ensure accuracy and integrity of the accounting records. Hence, the purpose of reconciliation is to:

1) Ensure the accuracy of financial records;
2) Identify and correct errors;
3) Detect potential fraud or misappropriation; and
4) Maintain the integrity of financial reporting.

5.2.4 Reasons for Difference between the Receivables Control Account and the Total List of Accounts:

These are some common items that might cause differences between the receivables control account and the total list of accounts:

i. Omission of a transaction in the control account: A sale or receipt might be recorded in the individual customer's account but not in the control account.
ii. Error in totaling the sales day book or journal: An incorrect total might be posted to the control account.
iii. Error in posting to the control account: A transaction might be posted to the wrong side of the control account or with an incorrect amount.

iv. Omission or duplication of a transaction in the individual customer's account: A transaction might be omitted or duplicated in a customer's account, causing a discrepancy.
v. Error in carrying down balance: An error might occur when carrying down balances in individual customer accounts or the control account.
vi. Contra entries not recorded correctly: Contra entries between accounts receivable and accounts payable might not be recorded correctly.
vii. Discounts, returns, or allowances not recorded correctly: Discounts, returns, or allowances might be recorded incorrectly in either the control account or individual customer accounts

.

5.2.5 Steps in Reconciling a Control Account

i. Obtain the balance of the control account
ii. Obtain the total of the individual account balances in the subsidiary ledger
iii. Compare the two balances and identify any discrepancies
iv. Investigate and correct any discrepancies
v. Verify that the two balances agree

5.3 Payables Control Account

5.3.1 Features

A Payables Control Account is a general ledger account that summarizes the total amount owed to suppliers or vendors. It helps in maintaining accurate financial records and ensures that the company's liabilities are properly accounted for.

5.3.2 Sources of Information

The following sources provide information for the Payables Control Account:

i. Purchases Day Book
ii. Cash Book (for cash payments to suppliers)
iii. Returns Outwards Day Book
iv. Journal entries (for adjustments, discounts, etc

5.3.3 Entries in Payables control account

The Payables Control Account has the following entries:

Debit Side

i. Cash paid to suppliers
ii. Returns outwards (or returns to supplier
iii. Discounts received
iv. Contra entries

Credit Side

i. Balance b/f
ii. Credit purchases
iii. Increases in payables due to errors or adjustments

Illustration 5. 2 based on the information supplied in Illustration 5.1

Foday Enterprises
Payables ledger control account

	Le'000		Le'000
Discount received	8,000	Balance b/f	8,000
Cash paid twice	400	Purchases	25,000
Cash paid	18,000		
Return outwards	1,200		
Receivables control	2,000		
Bal c/f	3,400		
	33,000		33,000

5.3.4 Reasons for Differences

Differences between the Payables Control Account balance and the total of individual ledger balances may arise due to:

i. Errors in posting transactions to the control account or individual ledger accounts
ii. Omissions or incorrect entries in the control account or individual ledger accounts
iii. Timing differences in recording transactions
iv. Contra entries not properly recorded in both the control account and individual ledger accounts

5. 3. 5 Steps in Reconciling a Control Account

i. Obtain the balance of the control account
ii. Obtain the total of the individual account balances in the subsidiary ledger
iii. Compare the two balances and identify any discrepancies
iv. Investigate and correct any discrepancies
v. Verify that the two balances agree

Illustration 5.3

Afro-Ado Ltd designs and manufactures Afrosun Solar Panels
with corporate logos. The Afrosun Solar Panels are purchased and sold in bulk on credit. The
accountant is currently carrying out a reconciliation of the payables and receivables
ledger control account balances which are N218,320,000 and N172,120,000
respectively to the total of the balances on the individual accounts in the payables
and receivables ledgers, which are N197,660,000 and N156,134,000 respectively for
the month of March 2025.
The following has been detected:
(i) Cash received of N1,070,000 has been debited to the individual customer's
account in the accounts receivable ledger.
(ii) The total of discount received for the month, amounting to ₦17,150,000
has not been entered in the control account but has been entered in the
individual ledger accounts.
(iii) On listing-out, a supplier credit balance of ₦2,050,000 has been incorrectly
treated as a debit.
(iv) A cheque for ₦2,555,000 from a customer has been dishonoured. The
correct double entry has been posted but the individual accounts have not

been updated.
(v) A petty cash payment to a supplier amounting to ₦630,000 has been
correctly treated in the control account, but no entry has been made in the
supplier's individual ledger account.
(vi) A payment of ₦322,000 from a customer has been incorrectly entered in
the accounts receivable ledger as ₦233,000.
(vii) The purchases day book total for March has been undercast (understated)
by ₦20,000,000.
(viii) Total credit sales of ₦4,500,000 to an accountancy firm, TQ and Associates
have been posted correctly to the ledger account but not recorded in the
control account.
(ix) Contras (set-offs) with the receivables ledger, amounting in the total to
₦20,040,000, have been correctly treated in the individual ledger accounts
but no entry has been made in the control account.
(x) Discounts allowed totalling N120,000 has not been entered in the control account

Required:
a. Prepare the Trade payable ledger control account and reconcile this to the sum total of the individual accounts in the trade payable ledger.
b. Prepare the Trade receivable ledger control account and reconcile this to the sum total of the individual accounts in the trade receivable ledger.

Solution
Afro-Ado Ltd
Payable ledger control account

	₦'000		₦'000
Discount received	17,150	Balance b/f	218,320
Receivables control-contra	20,040	Purchases	20,000
Balance c/f	201,130		
	238,320		238,320

Reconciliation with individual payable ledger balances

	₦.000	₦'000
Balance as extracted		197,600
Credit balance incorrectly treated	2,050 x2	4,100
Petty cash paid to a supplier, not recorded		(630)
		201,130

Receivables ledger control accounts

	₦'000		₦'000
Bal b/f	172,120	Payables control account-contra	20,040
Credit sales	4,500	Discount allowed	120
		Balance c/f	156,460
	176,620		176,620

Reconciliation with individual receivable ledger balances

	₦'000	₦.000
Balance as per individual ledgers		156,134
Cheque dishonoured not posted here		2,555
Amount received from customer understated	(322-233)	(89)
Cash received wrongly debited to customer's account	1070 x2	(2,140)
Net total agreeing with receivables control account		156,460

5.3.6 Supplier Statements

A **Supplier Statement** is a document provided by a supplier or vendor to a customer, typically on a regular basis, that shows:

i. A summary of transactions between the customer and supplier.
ii. The outstanding balance owed by the customer to the supplier.
iii. Details of invoices, payments, credits, and debits.

Purpose of Reconciliation with Suppliers' Statements

The purpose of reconciling suppliers' statements with the company's records is to:

i. Ensure accuracy of financial purchases day book, returns records, specifically in the payables ledger account and payables control account.
ii. Verify the amount owed to suppliers, as recorded in the payables ledger account and payables control account.
iii. Identify and correct errors or discrepancies that may have arisen from:
   a. Incorrect or incomplete recording of transactions in the outwards day book, or cash book.
   b. Omissions or incorrect postings to the payables ledger account or payables control account.
iv. Confirm the validity of transactions, ensuring that they are properly supported by source documents such as invoices, delivery notes, and credit notes.

5.3.7 Reasons for Reconciliation

Reconciliation with suppliers' statements is necessary due to:

i. Differences in recording transactions between the company's records and the supplier's records.
ii. Errors in posting or omissions in the purchases day book, returns outwards day book, or cash book.
iii. Timing differences in recording transactions.
iv. Discrepancies in invoice or payment amounts.
v. Unrecorded transactions (e.g., returns, discounts).

Sample of Supplier Statement

Supplier Statement
Supplier Name: Alhaji Bichi Enterprises
Supplier Address: No. 12, Ibrahim Taiwo Road, Kano, Nigeria
Date: March 31, 2025
Customer Name: Omolara Ventures
Customer Address: Plot 345, Herbert Macaulay Way, Lagos, Nigeria
Statement Period: March 1, 2023 - March 31, 2023
Transaction Details:

Date	Invoice/Receipt No.	Description	Debit (₦)	Credit (₦)	Balance (₦)
March 1	Balance B/F				500,000.00
March 10	INV001	Goods supplied	250,000.00		750,000.00
March 15	Payment	Payment received		250,000.00	500,000.00
March 25	INV002	Goods supplied	150,000.00		650,000.00

Current Balance: ₦650,000.00

This sample supplier statement shows:

i. Transaction details, including invoices and payments.
ii. The current balance owed by the customer.
iii. A breakdown of debits and credits.

The supplier statement helps Omolara Ventures verify their accounts payable records and reconcile any differences.

Illustration 5.4

On October 31, 2024 Gbajo Limited receives a statement from a supplier showing a balance of ₦85,000. On checking the payable ledger account for the supplier, the balance is shown to be ₦140,806.

Investigation reveals the following:

- A recent payment of ₦20,519 has not been recorded by the supplier
- An invoice for ₦35,972 has not been recorded in the payable ledger account
- A credit note for ₦12,300 has not been recorded in the payable ledger account

Required:

Prepare the supplier statement reconciliation.

Agbadebo Limited

Supplier's statement as at October 31, 2024

	₦
Supplier's statement balance	185,000
Payment in transit	(20,588)
Invoice not recorded in the payable account	(35,975)
Credit note not recorded in payable account	12,300
Payable ledger account balance	140,806

5.4 Bank Reconciliation Statement

5. 4.1 Purpose of a Bank Reconciliation Statement

The primary purpose of a Bank Reconciliation Statement is to bridge the gap between a company's cash book balance and the balance shown on the bank statement. By preparing this statement, businesses can identify and rectify errors or omissions in their financial records, ensuring the accuracy and reliability of their accounting data.

The bank reconciliation statement also helps to account for timing differences that arise when transactions are recorded in the cash book at a different time than when they are processed by the bank. Furthermore, it enables companies to detect any unauthorized or suspicious transactions that may have taken place, thereby enhancing the security of their financial transactions.

Ultimately, the bank reconciliation statement helps in ensuring that a company's financial statements reflect the correct bank balance.

5.4.2 Reasons for Discrepancy between Cash Book Balance and Bank Statement Balance

Main Reasons for Differences between Bank Statement Balance and Cash Book Balance:*

i. Timing Differences:
- Cheques issued but not yet presented for payment.
- Deposits made but not yet credited by the bank.
- Bank charges or fees deducted by the bank but not recorded in the cash book.

ii. Errors:
- Errors in recording transactions in the cash book.
- Errors in recording transactions by the bank.

iii. Omissions
- Transactions recorded in the cash book but not in the bank statement (e.g., direct debits or credits).
- Bank transactions not recorded in the cash book (e.g., bank interest or charges).

iv. Unpresented Cheques:
- Cheques issued but not yet presented to the bank for payment.

v. Uncredited Deposits:
- Deposits made but not yet credited to the account by the bank.

5.4.3 Steps in Reconciling Bank Statement with Cash Book Balance:

i. Collect the bank statement and the cash book.
ii. Determine the balance as per the bank statement and the cash book.
iii. List the items that cause the difference between the two balances
iv. Make adjustments to the cash book balance for items such as:
- Bank charges or fees not recorded
- Interest or dividends not recorded
- Errors or omissions

v. Then prepare the bank reconciliation statement by adjusting for unpresented and uncredited lodgements

In examinations, you are likely to be provided with the figures listed in the steps above but in the real life situation, you must compare the entries in the cash book with the entries in the bank statement and derive your figures, as follows:

Step 1: Tick off matching transactions
Debit side of cash book vs credit side of bank statement:

- Tick off matching deposits (e.g., customer payments).
- Items on the debit side of the cash book missing on the credit side of the Bank Statement are uncredited lodgements.

Step 2: Tick off matching transactions
Credit side of Cash Book vs Debit side of Bank Statement:

- Tick off matching withdrawals (e.g., cheque payments).
- Items on the credit side of the Cash Book missing on the debit side of the Bank Statement are unpresented cheques.

Step 3: Identify other items
Identify the remaining items on the debit side of the bank statement that are not ticked off

- They are bank charges, direct debits, and standing orders

Step 4: Identify the remaining items on the credit side of the bank statement, they are;

- Deposits made directly into the bank account, such as customer payments or transfer
- Errors made by the bank, such as incorrect credits or duplicate credits.
- Interest earned on the account and credited by the bank.

Step 5: Prepare the adjusted cash book and the bank reconciliation statement to reconcile the cash book balance with the bank statement.

If the statements fail to balance, then there are some errors, which further investigation would reveal.

Illustration 5.5
Question
On April 6, 2025, Fatu Kamara Ventures received her bank statements for the month ended March 31, 2025. The bank statement showed a balance of L$ 41,740,000 (overdraft) as at March 31, while the cash book showed a balance of L$ 52,599,000 (Credit) as at that date. On examination of the cash book and the bank statements, the following were discovered:
(i) Bank charges of L$ 201,000 had not been recorded in the cash book; (ii) Fatu Kamara Ventures exceeded her overdraft limit during the month of March. The bank had therefore charged her a default penalty of L$ 250,000. This was not reflected in the cashbook; (iii) A sum of L$ 1,250,000 had been credited to Fatu Kamara Ventures' bank account in error; (iv) A cheque for L$ 1,230,000 had been returned by the bank as dishonoured, in effect, the bank charged Fatu Kamara Ventures L$ 15,000. This was not reflected in the cash book; (v) Cash receipts of L$ 3,740,000 were posted as cash payments of L$ 4,730,000 in the cash book; (vi) On March 21, Fatu Kamara Ventures transferred cash of L$ 650,000 to her personal bank account. This was credited to the business bank account in error by the bank; (vii) Standing orders and direct debits of L$ 1,115,000 had not been posted to the cash book; (viii) Customers had transferred L$ 2,170,000 directly to the bank account and credit alert received but no record had been made in the cash book; (ix) An amount of L$ 5,120,000 lodged into the bank account on March 31, 2025 had not been

credited by the bank; (x) The following cheques, drawn on the bank account amounting to L$ 6,250,000 had not been presented to the bank for payment as at March 31, 2025.
You are required to:
a. Prepare the adjusted cash book for the month of March, 2025. b. Prepare a statement on March 31, 2025 reconciling the bank statement balance with the adjusted cash book balance.

Solution

Fatu Kamara Ventures

a. Adjusted cash book for the month ended March 31, 2025

	L$'000		L$'000
Direct credit	2,170	Balance b/f	52,599
Error in posting cash receipt	8,470	Bank charges	201
		Default penalty on bank overdraft	250
		Dishonoured cheques	1,230
		Charge on dishonoured cheque	15
Balance c/f	44,770	Standing order	1,115
	55,410		55,410
		Balance b/f	44,770

Note: Cash receipts of L$ 3,740,000 posted as cash payment of L$ 4,730,000 is adjusted. In the journal as follows:

	Debit	Credit
	L$'000	L$'000
Cash	4,730	
Suspense		4,730
Being cancellation of cash receipt recorded as cash payment		
Cash	3,740	
Suspense		3,740
Being cash receipt formerly recorded as cash payment of L$4,730,000		
The net effect is L$8,470,000.		

b. Bank reconciliation statement

	L$'000	L$'000
Balance as per bank statement		(41,740)
Add uncredited lodgements		5,120
		(36,620)
Less unpresented cheques		(6,250)
Correct bank statement balance		(42,870)
Amount credited in error by bank	(1,250)	

Amount credited to business account in error, instead of personal account	(250)	(1,500)
Balance as per adjusted cash book		44,770

5.4.4 The Impact of Modern Technology on Bank Reconciliation Statements

The advent of modern technology has introduced various transactions that can impact a company's bank reconciliation statement. Online banking transactions, for instance, can affect the statement, particularly when online payments or transfers are made. Similarly, mobile banking transactions, such as mobile payments or transfers, can also have an impact on the bank reconciliation statement.

In addition to online and mobile transactions, Automated Clearing House (ACH) transactions and Electronic Funds Transfers (EFTs) can also influence the bank reconciliation statement. ACH transactions, including direct deposits and automatic payments, can cause discrepancies between the company's records and the bank statement. EFTs, such as wire transfers, can also affect the statement, requiring careful reconciliation to ensure accuracy.

Furthermore, automated bank fees and charges, including overdraft fees and monthly maintenance fees, can also impact the bank reconciliation statement. These modern technology-driven transactions can increase the complexity of bank reconciliation statements, making it essential for companies to perform reconciliations more frequently and with greater attention to detail.

5.5 Chapter Summary

In this chapter, you have learnt about control accounts and reconciliations, including the purpose and preparation of control accounts, such as sales ledger control accounts and purchases ledger control accounts. You have also learnt about the importance of reconciliations in ensuring the accuracy and reliability of financial records, including reconciling supplier statements with the purchases ledger account to verify the accuracy of trade payables.

Furthermore, you have also learnt about bank reconciliation, including the preparation of a bank reconciliation statement to reconcile the cash book balance with the bank statement balance, identifying and correcting errors, omissions and discrepancies, and the importance of regular reconciliations in maintaining good financial control and preventing fraud.

5.6 End of Chapter Questions

1. Which of the following does not appear in a bank statement?

a) Dividend received on behalf of customers
b) Dishonoured cheque
c) Uncredited charges
d) Insurance premium paid on behalf of customers
e) Bank charges

1 A stale cheque is a cheque that:

a) Has been drawn for a longer period than 6 months
b) Bears a date later than the current

c) Had been refused by a banker
d) May not be cashed over the counter
e) Has alteration made on them but are not initialed by the drawer

2 The purpose of preparing bank reconciliation is to:
a) Reconcile the differences between the balance shown by the bank statement and the cash book
b) Find out how much the business is indebted to the bank
c) Find out who are the creditors and how much is owed to them
d) Find out how much the bank is indebted to the business
e) Find out who are the debtors of the business and how much is owed by them

3 The effect of items that are recorded on the debit side of a bank statement but are not found on the credit side of the cash book is that:
a) It resulted in an overdraft
b) Bank balance is overstated
c) Has no effect on the bank balance
d) Bank balance in understated
e) It must have stated by error

4 A crossed cheque restricts the payee to:
a) Cash the cheque without any endorsement
b) Endorse the cheque before it becomes transferable to a third party
c) Collect the cash over the counter
d) Cash the cheque in person
e) Pay the amount into his bank account

5 What is the effect on the cash balance when a customer's cheque that is lodged is dishonoured by the bank?

6 Name the two main steps involved in preparing the bank reconciliation statement

7 On 31 December 2024, the cash book of Benji International a spare part dealer showed an overdraft of N60,000. However, the bank statement showed a credit balance of N579,000.
The following additional information was provided:
a) A cheque for N84,000 received by Benji and entered in the cash book on 31 December, 2024 was not credited by the bank until 4th January, 2025.
b) A credit transfer amounting to N342,000 in settlement of a trade debt by Momoh Ltd has not been posted to the cash book;
c) Cheques drawn by Benji on 30 November, 2024 amounting to N804,000 were yet to be paid by the bank;
d) In December, 2024, Benji's account was debited with bank charges amounting to N42,000 and this is yet to appear in Benji's cash book;
e) A dividend amounting to N174,000 was received by the bank;
f) A cash payment amounting to N36,000 was entered in the bank column of the cash account.
g) Standing order on trade subscription for N60,000 was paid by the bank;
h) A cheque for rent of N201,000 on 15 December 2024 was entered in the cash book as N228,000;
i) A cheque amounting to N189,000 paid by Benji was credited to Fashola's account in error;
j) A cheque of N369,000 was dishonoured and was not recorded in the cash book\.

You are required to:

i. Prepare the Adjusted cash book

ii. Reconcile the cash book and bank statement balances as at 31 December, 2024.

SOLUTIONS

1) C
2) A
3) A
4) B
5) E
6) It will reduce the cash balance
7) Determining the correct cash balance

Reconciling the adjusted cash book balance with the bank statement balance

BENJI INTERNATIONAL
ADJUSTED CASH BOOK

	N		N
Credit Transfer	342,000	Balance b/d	60,000
Dividend	174,000	Bank charges	42,000
Cash	36,000	Standing order	60,000
Rent overcast (228-201)	27,000	Dishonoured cheque	369,000
		Balance c/d	48,000
	579,000		579,000
Balance b/d	48,000		

BENJI INTERNATIONAL
BANK RECONCILIATION STATEMENT
FOR THE MONTH OF DECEMBER, 2024

	N	N
Balance as per bank statement		579,000
Add: Uncredited cheque (a)	84,000	
Reversal of wrong credit (i)	189,000	273,000
		852,000
Less: Unpresented cheques		804,000
Balance as per adjusted cash book		48,000

CHAPTER SIX
INCOMPLETE RECORD AND SINGLE ENTRY

Chapter contents

a. Introduction
b. Accounting for incomplete records
c. Preparation of financial statements from incomplete records.

6.0 Objectives

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

a) Use accounting equations to calculate profit where only opening and closing net assets figures are available.
b) Convert single entry and incomplete records into double entry
c) Prepare financial statement from records maintained on double entry basis
d) Determine the figures for purchases and revenue from purchases control account and revenue control accounts
e) Derive expenses and revenue earned from incomplete records.

6.1 Introduction

The term single entry "is applied to any system, which does not provide for the two fold aspect of transactions; while the alternative term, incomplete records" is often applied to books of account kept on such a single entry or incomplete double entry system.

"Single entry" recognises only the personal aspect of transactions, with receivables and payables. In practice, however, a cashbook is invariably kept, but, with this exception, the impersonal aspect of transactions is usually left entirely unrecorded.

In this chapter you will learn the procedure involved in preparing the Statement of Profit or Loss and Statement of Financial Position for an enterprise that has only opening and closing net assets and perhaps capital as the only known figures. You will also understand and learn how to ascertain the proprietor's drawings and any additional capital contribution during an accounting period from scanty information provided by a cashbook summary.
Questions on incomplete records and single entry are popular for examiners because they enable them to test techniques, which are also relevant for other topics such as ledger control accounts. It also provides the basic information necessary to prepare financial statement but without the examiner presenting it in the form of a Trial Balance.

6.2 The ascertainment of profit from incomplete records

Generally speaking, profits (or losses) are ascertained, under the single entry system, by a comparison of the values of the net assets at two specified dates, after taking into account additions to, or withdrawals from, capital during the period. The difference between these two values represents the profit or loss, according to whether there is an increase or decrease in the figures.

The accounting equation states that:
Business Assets = Owner's Capital+ Business Liabilities

The equation above can be restated as:
Owner's Capital = Business Net Assets – Business Liabilities
During an accounting period, the business realised an excess of income over expenditure, the

additional cash or assets generated belong to the owner(s), thus increasing the capital. The accounting equation will now become:

Opening capital +profit = opening net assets + increase in net assets.

The introduction or withdrawal of resources by the owner will also increase or decrease the owner`s capital. As a result profit can be calculated using the format below:

	¢
Closing capital	XXX
Less opening capital	XXX
Increase in net assets	XXX
Owners' Drawings	XXX
Additional Capital	(XXX)
Net profit for the year	XXX

Illustration 6.1

Calculate the net profit for the year ended December 31 2024 from the following information:

	31/12/2023 GH¢	31/12/2024 GH¢
Property	200,000	200,000
Equipment	60,000	90,000
Trade receivables	40,000	80,000
Cash	10,000	15,000
Overdraft	60,000	90,000
Trade payables	50,000	30,000

Drawings during the year were GH¢45,000 and additional capital introduced during the year was GH¢50,000.

Solution 6.1

	31/12/2023 GH¢	31/12/2024 GH¢
Total Assets	310,000	385,000
Total Liabilities	(110,000)	(120,000)
Net Assets	200,000	265,000
		¢
Closing capital		265,000
Less opening capital		200,000
Increase in net assets		65,000
Owners' Drawings		45,000
Additional Capital		(50,000)

Net profit for the year		60,000

6.3 Preparation of detailed financial statement from incomplete records

It is understandably certain that calculating the profit of an enterprise using the method presented above is not satisfactory. It is important for you to note that the accountant does not only prepare the final accounts of an enterprise but also communicates accounting and financial information to stakeholders. It is therefore much more informative when a Statement of Income is drawn. It is important for the accountant to convert these scanty and incomplete records into the acceptable double entry form.

For one to be able to prepare a Statement of Profit or loss and Statement of Financial Position from single entry and incomplete records, the procedures detailed below are recommended:

6.4 Preparation of statement of affairs

One must first construct a statement of financial position at the beginning of the accounting year. This means that the assets and liabilities of the business must be as curtained and calculated. The statement prepared to show the financial position of the business at the beginning of the year is technically called **statement of affairs**`.

In most practical situations the owner of the business will provide lists of values of non- current assets that he uses in the business together with the dates of acquisition. It should therefore be easy for one to calculate the accumulated provision for depreciation of the non-current assets from the date of their purchase to the date of reporting. Values of such items as inventories in trade, receivables and liabilities may have to be estimated with the help of the owner.

From the above information, a journal should be opened and accounting entries with the aim of achieving the dual purpose of recording accounting transactions should be effected. This means that appropriate debit entries must be posted into assets account and credit entries entered into capital or liabilities accounts.

The difference between the assets and liabilities, which usually ends up with the assets exceeding the liabilities may be assumed to be the initial amount that the owner used in starting the business and therefore will be recorded as the capital of the business. It is possible that the owner may be able to mention the initial amount he used in commencing the business. Where this is the case then, any difference between such capital and the net assets estimated may be recorded as the balance on the Statement of profit or loss retained in the business.

6.5 Preparation of cash and bank summary

Ascertain the Cash position of the business. This is usually done by carefully examining any available bank statement, any pay-in-slip and the cheque counterfoil. The bank statement together with the cheque counterfoil could reveal information concerning purchases, payment of rent, bank charges, wages, insurance, interest earned, the acquisition of non-current assets, and any personal withdrawals. Information extracted from the pay- in-slip, bank statement and credit alert received will help determine the amount of money paid in by customers to whom goods that were sold on credit and also direct sales by cheque instead of cash. The above information may be used to prepare a cash summary or a receipt and payment account for the business.

6.6 Analysis of unbanked cash sales

One must at this stage determine the amount of cash sales which have not been banked by the owner, but which might have been used by the owner to pay for business expenses, cash purchases, and personal drawings. It is possible that the owner might have made use of some of the physical inventory in trade

for his or her personal use. In such a situation conducting an informal interview with the owner could confirm the existence of such occurrences and so will help the book keeper make an appropriate estimate for inventory drawings. Physical inventory taking by counting of items in inventory at the close of business will give us the actual closing inventory figures and therefore may not need to be estimated.

6.7 Posting from the cash and bank summary

After the analysis above has been made, one can now carry out the following postings into the ledger. Note that in step one opening entries were made through the ledger, and therefore some of these entries will be made into existing ledger accounts irrespective of how inaccurate they may be.

From the analysis of the debit side of the cash and bank summary and information obtained from the pay-in-slips:

a) All cash sales or takings should be credited to the Trade receivables account in the sales ledger;
b) Any proceeds from the sale of non-current assets should be credited to the respective asset account;
c) Any interest or income from investment must also be credited to the appropriate revenue account;
d) Any other item should be posted to the credit of the relevant account;

From the analysis of the credit side of the cash and bank summary and information obtained from the cheque counterfoils:

a) All payments for goods purchased should be debited to the trade payables account in the purchase ledger account;
b) Payment of expenses should be debited to the relevant nominal account;
c) All purchases in connection with non- current assets should be debited to the appropriate asset accounts;
d) Any charges should be posted to debit of the bank charges account;
e) Any other item should be posted to the debit of the relevant account;

Where any difference exists on the cash book summary, entries should be posted to make it balance. If the difference is on the credit side then the cash book should be credited and the proprietor`s drawings account debited. If the difference is on the debit side then one can safely presume that the owner of the business has introduced additional capital. This difference should be debited to the cash and credited to the capital account of the business.

6.8 Preparation of trade receivables and trade payables

At a Stage, one will have to determine year-end adjustment and balances. A schedule will have to be compiled detailing all customers who are owing the business, as a result of goods sold to them on-credit. The total of the schedule of Trade receivables therefore represent debts owed to the business and as such must be carried forward to the credit of the total sales ledger control account. There is likely to be a missing figure in the debit side of the total Trade receivable account, which represent total sales on credit for the period and should be transferred to the credit of the Statement of profit or loss as sales or revenue.

Another schedule that must be prepared is a list of amount owing by the business to suppliers for goods purchased on credit. The total of this schedule represent total liabilities by way of trade payables outstanding at the end of the period and should therefore be carried forward to the debit of the purchases ledger control account. The total purchases for the period will be derived from the credit side of the purchases ledger control account as a balancing figure and should be transferred to the debit side of the statement of profit or loss.

6.9 Extraction of trial balance

This is the final stages as all the transactions would have been recorded and the entry will now have been completed and for that matter the business will be able to extract a trial balance which will form the basis for the preparation of the Statement of profit or loss and Statement of Financial Position.

Illustration 6.2

Boakye, a sole proprietor, trading as KKB Enterprise requested Oko & Associates, a firm of Chartered Accountants, where you are employed as a trainee Accountant, to prepare the accounts of his business for the year ended December 31, 2024.

Your audit Manager assigned this work to you. Your interview with Boakye revealed the following:

1 He did not maintain double entry book-keeping system.

2

3 All sales were on credit basis. During the year Boakye received GH¢9,025,000, GH¢475,000 in cheques and cash respectively from his customers.

4

5 Suppliers of goods during the year were paid GH¢6,840,000 by cheque.

6 Boakye rented 2 premises at Danso man and High Street for residential and business purposes respectively. In July 2023, he paid GH¢480,000 as one year rent in advance for his residence. In July 2024, he again paid a cheque of GH¢600,000 to cover year advance for his residence. The rent for the premises at High Street was GH¢60,000 per month in 2024. Boakye always paid all his rent by cheque.

7 General business expenses paid by cheque amounted to ¢106,200

8 He took cash of GH¢38,000 every month for his private use.

Boakye provided you with the following additional information.

	31/12/2024	31/12/2023
	GH¢	GH¢
Trade Receivables	1,254,000	1,045,000
Trade Payables	617,500	380,000
Rent Owing	60,000	120,000
Bank Balance	3,000,000	1,073,500
Cash in Hand	60,000	76,000
Inventories	1,700,500	1,510,500
Furniture &Fittings	--	920,000

9 Depreciation is provided annually at the rate of 20% on Furniture and Fittings.

10 Boakye agreed to pay GH¢100,000 as Accountancy fees.

11 Differences in cash and bank balances at the end o f 2024 represents additional drawings/capital respectively.

Required:

Compute the profit of Boakye.

Prepare cash and bank Summary for year 2024

Prepare statement of profit or loss for the year ended 31 December 2024

Solution to 6.2

(a) Calculate opening net assets to arrive at opening capital

We need the opening capital to enable us calculate the closing balance in the statement of financial position. All that is required is to pick up all opening balances not forgetting the balancing figures. The information is presented clearly, with the inclusion of bank and cash balances in the tabulation of the assets and liabilities figures.

Statement of affairs

	31/12/2024 GH¢	31/12/2023 GH¢
Furniture & fittings (w5)	736,000	920,000
Trade receivables	1,254,000	1,045,000
Inventories	1,700,500	1,510,500
Bank	3,000,000	1,073,500
Cash in hand	60.000	76,000
Trade payables	(617,500)	(380,000)
Rent owing	(60,000)	(120,000)
Accountancy fees	(100,000)	--
Net worth	5,973,000	4,125,000

Increase in net worth GH¢5,973,000 less GH¢4,125,000= GH¢1,848,000

Computation of profit

	GH¢
Increase in net worth	1,848,000
Add Drawings (456,000+600,000+35,000)	1,091,000
	2,939,000
Less Additional Capital (b)	1,227,700
Net Profit	1,711,300

CASH BOOK SUMMARY

	Cash	Bank		Cash	Bank
	GH¢	**GH¢**		**GH¢**	**GH¢**
Balance b/d	**76,000**	**1,073,500**	**Suppliers**	**-**	**6,840,000**
Received from Customers	**475,000**	**9,025,000**	**Drawings**	**456,000**	**-**
Capital (missing figure)	**-**	**1,227,700**	**Rent**	**-**	**600,000**
			Gen. Bus. Expenses	**-**	**106,200**
			Rent (w3)	**-**	**780,000**
			Drawings	**35,000**	**-**
			Balance (missing figures)	**60,000**	**3,000,000**
	551,000	**11,326,200**		**551,000**	**11,326,200**
Balance b/d	**60,000**	**3,000,000**			

(c) Statement of profit or loss.

	GH¢	GH¢
Revenue (w1)		9,709,000
Cost of sales (w4)		(6,887,500
Gross profit		2,821,500
Less Expenses:		
Depreciation (w5)	184,000	
Rent	720,000	
General business expenses	106,200	
Consultancy fees	100,000	
		1,110,200
Net profit		1,711,300

Workings

(W1) Prepare sales and purchases ledger control accounts
In a double entry-system, control accounts are used to confirm the arithmetical account of the sales and purchases ledger system. This technique will be used to calculate purchases as a missing figure.

Sales Ledger Control Account

	GH¢		GH¢
Balance b/d	1,045,000	Cash	475,000
Sales (missing figure)	9,709,000	Bank	9,025,000
		Balance c/d	1,254,000
	10,754,000		10,754,000
Balance b/d	1,254,000		

Purchases Ledger Control Account

	GH¢		**GH¢**
Bank	**6,840,000**	**Balance b/d**	**380,000**
Balance c/d	**617,500**	**Purchases (missing figure)**	**7,077,500**
	7,457,500		**7,457,500**
		Balance b/d	**617,500**

Sales Ledger Control Account

	GH¢		GH¢
Balance b/d	1,045,000	Cash	475,000
Sales (missing figure)	9,709,000	Bank	9,025,000
		Balance c/d	1,254,000
	10,754,000		10,754,000
Balance b/d	1,254,000		

Purchases Ledger Control Account

	GH¢		**GH¢**
Bank	**6,840,000**	**Balance b/d**	**380,000**
Balance c/d	**617,500**	**Purchases (missing figure)**	**7,077,500**
	7,457,500		**7,457,500**
		Balance b/d	**617,500**

(W2) Derive the accruals and prepayments

In addition to these four techniques it will be necessary to calculate figures for the Statement of profit or loss by adjusting cash paid for expenses for opening and closing accruals and prepayment.

(W3) Rent expense control

	GH¢		**GH¢**
Bank (missing figure)	**780,000**	**Balance b/d**	**120,000**
Balance c/d	**60,000**	**P or L (12@60,000)**	**720,000**
	840,000		**840,000**
		Balance b/d	**60,000**

	Computation of cost of goods sold	¢
	Opening inventory (1/1/24)	1,510,500
	Purchases (w1)	7,077,500
		8,588,000
	Less closing inventory (31/12/24)	1,700,500
	Cost of goods sold	6,887,500

(W5)	Computation of Depreciation	¢
	Fixtures and fittings at cost (1/1/24)	920,000
	Less Depreciation (20% @ ¢920,000)	184,000
	Net book value (31/12/24)	736,000

Illustration 6.3

Damask is a retailer who deals in spare parts at Kokompe. He pays into his bank account the amount of his cash takings, after retaining GH**¢10,000** per week for personal use and after payment of wages and expenses, which for the accounting period of 31 December 2024, were as follows:

¢

Staff wages	1,200,000
Goods	220,000
Cleaning	75,000
Carriage	35,000
Others	20,000

The transactions in his bank account during the period were:

	GH¢	Payments	GH¢
Balance as at 1 January, 2024	2,000,000	Suppliers	30,830,000
Lodgments		Rates	400,000
From Takings (cash)	30,100,000	Furniture & Fittings	600,000
Bulk sales account (cheques)	4,800,000	Telephone & Electricity	150,000
Interest on Treasury Bills	30,000	Rent	400,000
		Consultancy	70,000
		Repairs	150,000
		Others	70,000
		Air condition Expenses	220,000
		Fire Insurance	60,000
		Income Tax	900,000
		Drawings	180,000
		Balance c/d	2,900,000
	36,930,000		36,930,000

The following information were also provided:

	31/12/2023	**31/12/2024**
	¢	¢
Receivables –Bulk sales	490,000	430,000
Payables– Goods purchased	2,900,000	3,195,000
- Rent	80,000	30,000
- Electricity	25,000	65,000
Telephone	45,000	-
- Consultancy fees	40,000	40,000
Inventories in trade	2,050,000	1,875,000
Furniture and fittings	-	540,000

You are required to prepare a Statement of profit or loss for the ear ended 31 December 2024 and a statement of financial position as at that date.

Solution 6.3

1 Calculate opening net assets to arrive at opening capital

You have to calculate the capital of the business by using the information on asset and liabilities at the opening and closing dates. This is done by preparing a statement of the business by picking up all opening balances and calculating the net asset business as at 31 December 2023. The information on the bank and cash balances in the presentation of the liabilities.

The statement of affairs of Damask as at 31 December 2024 is as follows:

Rates and air condition expenses included ¢55,000 and ¢20,000 relating to his private residence.

STATEMENT OF AFFAIRS

	31/12/23	**31/12/24**
Assets:	¢	¢

Furniture & Fittings		-	540,000
Trade Receivables		490,000	430,000
Inventories		2,050,000	1,875,000
Cash in the bank		2,000,000	2,900,000
		4,540,000	5,745,000
Liabilities:			
Trade Payables	2,900,000		3,195,000
Rent Owing	80,000		30,000
Electricity Owing	25,000		65,000
Telephone owing	45,000		
Consultancy Fees	40,000		40,000
	3,090,000		3,330,000
Capital	1,450,000		2,415,000

1. Prepare sales and purchases ledger control accounts

In a double entry-system, control accounts are used to confirm the arithmetical accuracy of the sales and purchases ledger system. This technique will be used to calculate sales and purchases by way of missing figure. This calculation will explore the horizontal format of determining the sales and purchases figures as missing figures instead of the usual T' account that you are familiar with.

The sales figure will be determined as follows:

	¢	¢
Lodgments:		
Shop takings		30,100,000
Add Proprietor's drawings		520,000
Expenses paid	1,550,000	
Cash sales	32,170,000	
Bulk sales account	4,800,000	
Add closing balance of Trade Receivables	430,000	
Less opening balance of Trade Receivables	(490,000)	
Credit sales	4,740,000	
Total sales	36,910,000	

The amount for Purchase is determined as follows:

	¢	¢
Payments for goods supplied		30,830,000
Add closing balance of Trade Payables		3,195,000
		34,025,000
Less opening balance of Trade Payables		2,900,000
Credit purchases		31,125,000
Add cash payments		220,000
Total purchases		31,345,000

Statement of Profit or Loss for the year ended 31/12/2024

	¢	¢	¢
Sales/Revenue			36,910,000
Less cost of sales:			
Opening inventories	2,050,000		
Purchases	31,345,000		
Carriage inwards	35,000	31,380,000	33,430,000
Less closing inventories	1,875,000	31,555,000	
Gross profit	5,355,000		
Interest on treasury bills	30,000	5,385,000	
Less Expenses:			
Staff wages Rates	1,200,000	345,000	
Rent	350,000		
Telephone & Electricity	145,000		
Consultancy fees	70,000		
Repairs	150,000		
Air conditioner	200,000		
Fire insurance	60,000		
Cleaning		75,000	
Other expenses (70,000+20,000)		90,000	
Depreciation		60,000	2,745,000
Net profit before tax			2,640,000
Income tax			900,000
Net Profit for the year			1,740,000

Statement of Financial Position as at 31/12/2024

	¢	¢	¢
Non-current assets			
Furniture and fittings	600,000		
Less depreciation provision	60,000		
			540,000
Current Assets			
Inventories	1,875,000		
Trade Receivables	430,000		
Bank	2,900,000		
	5,205,000		
Current Liabilities			
Trade Payables	3,195,000		
Rent owing (W1)	30,000		
Electric it owing (W2)	65,000		
Accountancy fee owing (W3)	40,000		
	3,330,000		
			1,875,000
			2,415,000
Financed by			
Capital at 1/1/24			1,450,000
Net profit			
			1,740,000
Less drawings (W4)			3,190,000
			775,000
			2,415,000

(iii) Calculation of accruals and prepayments

In addition to the above techniques, it will be necessary to construct figures for the profit or loss account by adjusting cash paid for expenses for opening and closing accruals and prepayments.

WORKINGS

Rent expense Control

(W1)

	¢		¢
Bank	400,000	Bal b/d	80,000
P& La/c	350,000	Bal. c/d	30,000
	430,000		430,000
Bal. b/d	30,000		

(W2) Telephone & Electricity

	¢		¢
Bank	150,000	Bal. b/d	70,000
		P& La/c	145,000
Bal. c/d	65,000		215,000
	215,000		
		Bal. b/d	65,000

(W3) Consultancy fees

	¢		¢
Bank	70,000	Bal b/d	40,000
		P& La/c	70,000
Bal. c/d	40,000		
	110,000		110,000
Bal. b/d			40,000

(W4) Drawings

	¢		¢
Bank	180,000	Bal. c/d	775,000
Cash	520,000		
Rates	55,000		

Air-condition exp	20,000		
	775,000		775,000
Bal. b/d	775,000		

6.10 Chapter summary

In this chapter, we have explained the difference between a double entry accounting system and single entry system. We have also learned how to use the closing and opening capital figures to calculate the net profit of a trader that is not keeping his books of accounts on the double entry system.

We have learnt how to convert from a single entry system to a double entry which also aids the preparation of Statement of Profit or loss and Statement of Financial Position from records that were kept on single entry basis. We mentioned that figures such as sales and purchases could be calculated as missing figures from the sales ledger control account and purchases ledger control account respectively.

It is imperative for readers to note that as with all accounting topics, frequent practice of incomplete records questions is essential for skill and confidence required.

6.11 End of chapter questions

1. In which ledgers can data relating to discount be found?

A. Nominal ledger
B. Cash Book
C. Sales ledger
D. Private ledger
E. Public Ledger

Use the data below to answer Questions 2 to 5

	31/12/23 ¢	31/12/24 ¢
Non-Current assets (cost)	320,000	286,000
Current assets	750,000	920,000
Current liabilities	150,000	130,000
Provision for depreciation	70,000	74,000

During 2024, a Non-Current asset costing ¢54,000 with a book value of ¢20,000 was sold for ¢15,000

2. What was the capital of the business as at 31 December 2023?

A. ¢920,000
B. ¢865,000
C. ¢860,000
D. ¢850,000
E. ¢840,000

3. What is the capital of the business as at 31 December 2024

A. ¢1,076,00

B. ¢1,002,000
C. ¢865,000
D. ¢860,000
E. ¢850,000

4. What was the value of the net profit or loss for the year ended 31 December, 2024?
A. ¢152,000 loss
B. ¢152,000 profit
C. ¢147,000 profit
D. ¢120,000 loss
E. ¢120,000Profit

5. What was the depreciation charge for 2024?
A. ¢74,000
B. ¢70,000
C. ¢34,000
D. ¢4,000
E ¢1,000

6. A "statement of affair" is similar to
A. Statement of Income
B. Income and expenditure account
C. Statement of Financial Position
D. Trial Balance
E. Ledger Account

7. A Statement of Affairs may include only
A. Accrued expenses, assets, liabilities and outstanding revenues
B. Expenses, assets, accrued revenues and liabilities
C. Assets, liabilities and expenses
D. Expenses, profits, assets and liabilities
E. Net Income, Expanses and Assets

8. Koki started business on 1 January 2024 with ¢200,000. At the end of the year his total assets valued ¢500,000. He did not owe anybody. Throughout the year Koki took ¢70,000 out of the business to maintain his family. In June 2024, he won lotto of ¢150,000 and added the prize to the business capital. Calculate Koki`s profit for 2024.

A. ¢370,000
B. ¢300,000
C. ¢280,000
D. ¢220,000
E. ¢120,000

9. If cost price is ¢240,000 and selling price is ¢300,000 then
A. Mark-up is $33^1/3\%$
B. Margin is $33^1/3\%$
C. Margin is 20%
D. Mark-up is 20%
E. Make-up is 8%
10. What is the cost of goods sold, given the sales figure as ¢800,000 with a mark-up of 25%?
A. ¢640,000
B. ¢604,000
C. ¢540,000
D. ¢504,000
E ¢160,000

EXAMINATION TYPE QUESTIONS

1. Victorosky who does not keep proper books of account has presented the following information for the year ended 31 December 2024.

	2024(¢)	**2023(¢)**
Inventories	200,000	185,000
Cash at Bank	98,500	56,000
Trade Receivables	376,000	490,000
Office Equipment	450,000	400,000
Cash in hand	25,000	29,000
Trade Payables	160,000	158,500
Motor vehicle	740,000	755,000

You are required to calculate the profit or loss of Victorosky for the year ended 31 December 2024, after taking into consideration the following:

a) Victorosky makes monthly withdrawal of cash and goods valued at ¢20,000 and ¢3,000 respectively.
b) Customer with an outstanding bill to the tune of ¢5,400 was declared bankrupt by a court in Accra.
c) Rent prepaid and electricity owing amounted to ¢16,000 and ¢18,500 respectively.
d) Additional capital introduced during the year was 75,000.

2. Babariga is a trader who does not keep proper books of account. He has however provided you with the following information:

a. He paid ¢10,000 in bank account as his initial capital

b. He banked all sales after withdrawing cash for the following: Personal use ¢350,000 per week
Staff Salaries and wages ¢500,000 monthly
General expenses ¢11,140,000

c. Cash sales awaiting lodgment ¢8,102,000.

Lodgments made into the Bank amounted to ¢450,000,000

Withdrawals from the bank were: Rent ¢13,000,000

Insurance	10,000,000
Transport expenses	6,750,000
Payment to suppliers	245,000,000
Purchase of motorcar	63,500,000
Purchase of computers	18,000,000
Telephone expenses	8,698,000

The following balance was also available as at 30 September 2024 Trade Payables ¢134,000,000
Inventories ¢42,000,000
Bad debts ¢4,420,000
Trade receivables ¢25,000,000
Rent prepaid ¢2,800,000
Payables for insurance ¢2,150,000

Depreciation is to be provided on the cost of all non-current assets at the rate of 20%.
You are required to prepare the Statement of profit or loss for the year ended 30 September 2024 and a Statement of Financial position as at that date.

3. Richardosky has kept the following summary of accounts:

Statement of Financial Position as at 1 January 2024

	¢		¢
Sundry creditors	105,000	Office equipment	250,000
Rent and Rates	6,000	Fixtures and Fittings	50,000
		Stocks	120,000
Loan	250,000	Sundry Debtors	235,000
Surplus	404,000	Bank	110,000

Analysis of Trade Payables

	¢	¢
Balance 1/1/2024	105,000	
Purchases	548,000	
Cash paid	415,000	
Discounts	7,000	
Returns	4,000	
Balance 31/12/2024	227,000	
	653,000	653,000

Analysis of Receivables

	¢		¢
Balance 1/1/2024	235,000		
Sales	980,000		
Cash received	820,000		
Discounts	42,500		
Bad debts	35,000		
Returns	29,500		
Balance 31/12/2024			288,000
	1,215,000	1,215,000	

Analysis of Balances as at 31/12/2024

	¢
Inventories	235,000
Rent prepaid	8,000
Rates owing	4,000
General expenses owing	28,000
Office equipment	366,000
Fixtures & Fittings	45,000

Analysis of Cash Book	Dr.	Cr.
	¢	¢
Balance as at 1/1/2024	110,000	
Trade Receivables	820,000	
Creditors		415,000
Cash Sales	95,000	
Office equipment		150,000
Wages and Salaries	150,000	
General expenses	32,000	
Rent and Rates	42,500	
Cash Purchases	48,000	
Selling expenses	45,000	
Balance as at 31/12/2024	95,000	

You are required to prepare Richardosky's Statement of Financial Position as at 31 December 2024, together with statement of profit or loss for the year ended on that date.

6.12 Solution to end of chapter questions

1 A
2 D
3 B
4 B
5 D
6 C
7 A
8 D
9 C
10 A

Solution 1 Victorosky
Statement of Affairs

	31/12/23	31/12/24
Assets:	¢	¢
Office equipment	400,000	450,000
Motor vehicles	755,000	740,000
Trade Receivables	490,000	376,000

Inventories	185,000	200,000
Prepayments	-	16,000

Cash at bank		56,000	98,500
Cash in hand		29,000	25,000
		1,915,000	1,905,500
Liabilities:			
Trade Payables		158,500	160,000
Accruals		-	18,500
	158,500	178,500	
Capital	1,756,500	1,727,000	

The calculation of profit or loss could be based on the formula below:

Opening Capital + Net Profit (or – Net loss) + Additional Capital – Drawings= Closing Capital
¢1,756,500 + Net Profit + ¢75,000 - ¢276,000 = ¢1,727,000

Solving for Net Profit

Net Profit=¢1,727,000-¢1,756,500 - ¢75,000 +¢276,000

Net Profit=¢171,5000

Solution 2

Babariga Statement of profit or loss for the year ended 30 September 2024

	¢	¢
Sales		487,522,000
Less Cost of sales		
Purchases	379,000,000	
Less closing inventories	42,000,000	337,000,000
Gross profit		150,522,000
Less Expenses:		
Rent (13m – 2.8m)	10,200,000	
General expenses	11,140,000	
Staff salaries & wages	6,000,000	
Telephone	8,698,000	
Depreciation– Motor car	12,700,000	
Depreciation– computers	3,600,000	
Insurance (10m + 2.15m)	12,150,000	
Transport	6,750,000	
Bad debts	4,420,000	
		75,658,000
Net Profit for the year		74,864,000

STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 2024

	¢	¢	¢
NON-CURRENT ASSETS	Cost	Dep.	NETBOOK VALUE
Motorcar	63,500,000	12,700,000	50,800,000
Computers	18,000,000	3,600,000	14,400,000
	81,500,000	16,300,000	65,200,000
Current Assets:			
Inventories		42,000,000	
Receivables (Wii)		25,000,000	
Prepayment		2,800,000	
Bank (Wi)		67,814,000	

		137,614,000	
Current Liabilities:			
Trade Payables (WIII)			
134,000,000 Accruals			
2,150,000		(	
		136,150,000	
		)	1,464,000
			66,664,000
Financed by			
Capital	10,000,000		
Add Profit for the year	74,864,000	84,864,000	
Less Drawings		18,200,000	66,664,000

Workings:

(i) Cash book summary

	¢		¢
Capital	10,000,000	Rent	13,000,000
Lodgments	450,000,000	Insurance	10,000,000
Cash sales	8,102,000	Transport	6,750,000
		Payment to suppliers	245,000,000
		Purchases of motorcar	63,500,000
		Purchases of computers	18,000,000
		Telephone expenses	8,698,000
		Cash payments:	
		Drawings	18,200,000
		Staff salaries & Wages	6,000,000
		General expenses	11,140,000
		Balance c/d	67,814,000
	468,102,000		468,102,000
Balance b/d	67,814,000		

Sales Ledger Control Account

	¢		¢
Credit sales (missing figure)	479,420,000	Bank	450,000,000
		Bad debts	4,420,000
		Bal. c/d	25,000,000
	479,420,000		479,420,000
Bal. b/d	25,000,000		

Total sales = ¢479,420,000 +¢8,102,000 = ¢487,522,000.

Purchases Ledger Control Account

	¢		¢
Bank	245,000,000	Purchases (missing figure)	379,000,000
Bal. c/d			
379,000,000			
379,000,000			
		Bal, b/d	
134,000,000			

Solution 3

Richardosky Statement of Income for the year ended 31 December 2024

	¢	¢	¢
Revenue (95 +980)	1,075,000		
Less returns	29,500		
			104,500
Less Cost of sales:			
Opening stocks		120,000	
Purchases (548+48)	596,000		
Less returns	4,000	592,000	
		712,000	
Less closing stock		235,000	477,000
Gross profit			568,500
Discount received			7,.000
			575,500
Less Expenses:			
Rent (42.5 – 6 – 8 +4)		32,500	
General expenses (32 + 28)		60,000	
Salaries &Wages		150,000	
Bad debts		35,000	
Discount allowed		42,500	
Depreciation– Plant & Machinery		34,000	
Depreciation– Fixtures &Fittings		5,000	
Selling expenses		45,000	404,000
Net Profit			171,500

Richardosky Statement of Financial Position as at 31 December 2024

Current Assets:	¢ Cost	¢ Dep.	¢ Non-Net
Office equipment	400,000	34,000	366,000
Fixtures &Fittings	50,000	5,000	45,000
	450,000	39,000	411,000
Current Assets:			
Inventories		235,000	
Trade Receivables		288,000	
Prepayment		8,000	
Bank		95,000	
		626,000	
Current Liabilities:			
Trade Payable	227,000		
Accruals (4 +28)	32,000		
		(259,000)	367,000
			778,000
Less loans			250,000
			528,000
Financed by:			
Capital			404,000
Add Profit for the year			171,500
			575,500
Less Drawings			47,500
			528,000

CHAPTER SEVEN

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS –IAS 8

Chapter contents

Introduction
Explanation of changes in accounting policies**,** changes in accounting estimates and errors
Guidance for selection of accounting policies
Adjustments and disclose of accounting policies, accounting estimates and errors

7.0 Objectives

At the end of the chapter readers should be able to:

Identify and explain changes in accounting policies, changes in accounting estimates and errors

Explain the guidance on the selection of accounting policies
Adjust and disclose the effect on financial statements of changes in accounting policies, changes in accounting estimates and errors.

7.1 INTRODUCTION

IAS 8 deals with the selection and changes in policies and disclosure thereof. It also sets out the requirements and disclosure for changes in accounting estimates and correction of errors.

The objectives of the standard are:

i. To enhance relevance and reliability of financial statements
ii. To ensure comparability of the financial statements of an entity over time as well as with financial statements of other entities

7.2 What is accounting policies?

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements, (IAS 8). Accounting policies are important for a better understanding of the financial statements prepared by the management of an entity. Under International Financial Reporting Standards (IFRS), alternative treatments are possible making it more important for an entity to state clearly which accounting policy it has used for the preparation of the financial statements

The following are Examples of accounting policies:

- Valuation of inventory using FIFO, Average Cost or another suitable basis as per IAS 2
- Timing of recognition of assets, liabilities, expenses and income revaluation basis

7.3 Circumstances for change of Accounting Policy

Circumstances for Change of accounting Policy An entity can change an accounting policy only if:

i. It is required by a standard e.g.an IFRS
ii. The change results in the financial statements providing reliable and more relevant information

i.e. voluntary change.

7.4 Selection of Accounting Policies

1. An entity is required to apply the standard that applies to a transaction, item or event so that the entity can identify trends in its financial performance or financial position.
2. If no standards exist presently for the item management shall develop and apply a policy that is reliable and relevant to the decision-making needs of the user.

Generally, a change in accounting policy can be established where there is a change in recognition, measurement or presentation criteria of transactions and other events in the financial statements

Accounting policy shall be considered reliable if it:

i. Represents faithfully the financial position, the performance and cash flows reflects the economic substance of transactions, other events and conditions
ii. is neutral,
iii. is prudent,
iv. is complete in all material respects comparable and understandable

The entity may also consider the most recent pronouncement of other similar standards, accounting literature and accepted industry performance.

7.5 CONSISTENCY OF ACCOUNTING POLICIES

Entities are required to apply the accounting policies selected consistently for similar transactions, events and conditions.

If a standard permits categorisation of items, an accounting policy shall be selected and used consistently.

Once an accounting policy is selected it may be changed only if the change is required by the standard or it results in providing more reliable or relevant information in the financial statements.

7.6 Application or treatment of change of accounting policy:

When the change is required by a Standard, an entity shall account for the change in accordance with the specific transitional provisions, (that is, the standard may specify retrospective application or prospective application),

Where there are no specific transitional provisions in the Standard requiring the change in accounting policy or an entity changes an accounting policy voluntarily, it should apply the change retrospectively.

7.7 Retrospective Application

Where a change in accounting policy is applied retrospectively, an entity should adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts for each prior period presented as if the new accounting policy had always been

applied.

The impact of the new policy on the retained earnings prior to the earliest period should be adjusted against the opening balance of retained earnings.

If it is impracticable to determine the effects of the change, the entity shall apply the change prospectively from the start of the earliest period. The change and the reason for the change must be disclosed.

7.8 Disclosure of Accounting Policies

a. If the change in accounting policy is due to the initial application of standard, the entity must disclose the change when it has an effect on current and prior periods or it would have an effect in future periods. If it is impracticable to determine the impact, the entity must disclose the title of the standard and the nature of the change.

b. When the change is voluntary, and the entity is unable to determine the future or past impact, the entity shall also disclose the nature of the change and the reason for the new policy providing reliable and more relevant information.

7.9 Changes in Accounting Estimates/Definition of accounting estimates:

An accounting estimate is an approximation of the amount of a business transaction for which there are no precise means of measurement. Accounting estimates arise from inherent uncertainties in business activities, which means that many items in financial statements cannot be measured with precision but can only be estimated. Estimates are formed using judgements based on the latest available information.

7.9.1 Examples of accounting estimates

Common examples of accounting estimates are:

i. Allowance for doubtful receivables
ii. Useful lives of assets, or the expected pattern of consumption of the future economic benefits of an asset.
iii. Net realisable value of inventories
iv. Warranty obligations

7.9.2 Treatment of changes in accounting estimates

A change in accounting estimate gives rise to adjustment of carrying amount of an asset or a liability or of the amount of periodic consumption of an asset.

A change in accounting estimate is accounted for prospectively. The effect of the change is recognized in the current period and future periods affected by the change.

This means that the change is recognized by including it

i. In the statement of profit or loss for the period in which the change is made, if the change affects that period only, or
ii. In the statement of profit or loss for the period of change and future periods, if the change affects both.

iii. The effect of the change will be recognized by adjusting the carrying amount of any affected asset or liabilities in the period of change.

Accounting estimates may change as a result of measurement uncertainties. Estimates are revised as more information becomes available. Such change in estimate does not require restating the financial statements of a prior period, because they neither amount to correction of prior year errors nor change in accounting policy.

Examples are:

- Estimating allowances for doubtful debts
- Inventory obsolescence
- Estimating the useful lives of PPE
- Determining the fair values of financial assets and financial liabilities
- Estimating the amount of warranty obligations

The effect of a change in accounting estimate shall be recognised prospectively by including it in the profit or loss in the period of the change or if it affects future periods

in both the period and future periods.
The effect of the change (if any) on assets, liability and equity shall be adjusted on their carrying amount in the period of change.

7.9.3 Disclosure of Accounting Estimates

The active and financial effect of the change in accounting estimate of current and future periods should be disclosed.

7.10 Errors.
When the financial statements contain errors that are material, the entity shall correct errors retrospectively in the financial statements authorized for issue when the error is discovered.

7.11 Accounting for prior year error

The entity shall restate the comparative amounts for the period(s) presented for which the error occurred.

If the error occurred before earliest period presented, the entity shall restate the opening balances of assets, liabilities and equity of the earliest period presented.

7.11.1 Disclosure requirements of prior period errors.

i. The nature of the error
ii. The amount of the error and the line item affected in a financial statement
iii. Basic and diluted earnings per share
iv. The amount of the correction at the beginning of the earliest period presented.

ILLUSTRATION 7.1
The financial Accountant of Bournvilla Ltd encountered the following during the process of preparing the financial statement of the company.
In preparing the financial statement for year 31 December 2023 the Accountant discovers an error affecting the 31 December 2022 financial statement.
During the year 31 December 2024 the company changes its accounting policies Required:
State how the accountant should treat the situation above while complying with the provisions of IAS 8 on accounting policies, changes in accounting estimates and correction of errors.

Solution to Illustration 7.1
The error should be corrected in the 31 December 2023 financial statement by restating the comparative figures for 31 December 2022 at their correct amount.

Since there is a change in accounting policy, the company must also present a statement of financial position as 1 January 2023 the beginning of the earliest comparative period.

This means that the change should be applied to the balance as at 1 January 2023 as if the new policy had always been applied.

7.12 Chapter summary

In this chapter, we learned that the adoption of International Financial Reporting Standards (IFRS) is now universal; hence most countries around the world are now adopting it in preparation and presentation of financial statements.

The presentation and disclosure requirements in the financial statements in accordance with International Accounting Standards (IAS) 8 were fully discussed.

7.13 End of Chapter Questions

1. In accordance with IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors, which of the following is considered changes in accounting estimates?

i. Changing the useful life of an asset
ii. Changing from cost model to revaluation model
iii. Change in the allowances for doubtful receivables
iv. Change from FIFO to weighted average for valuation of inventory

A. I and II
B. I and III
C. II and III
D. II and IV

2 Which of the following is NOT a type of accounting change?

A. Change in accounting policy
B. Change in accounting estimates
C. Correction of an error
D. Change in management structure
E. None of the above

3 According to IAS 8, which of the following is the correct treatment for a change in accounting policy?

A. Prospective application
B. Retrospective application
C. Current period adjustment
D. None of the above
E. Disclosure only

4 What is the treatment for a change in accounting estimate?

A. Prospective application
B. Retrospective application
C. None of the above
D. Current period adjustment
E. Disclosure only

5 An entity discovers an error in the financial statements of a prior period. How should this error be corrected?

A. By adjusting the current period’s profit or loss
B. None of the above
C. By disclosure only
D. By prospective adjustment of the financial statements
E. By retrospective restatement of the financial statements

6 Which of the following is an example of a change in accounting estimate?

A. Changing from FIFO to weighted average cost formula for inventory valuation
B. Changing the depreciation method from straight-line to reducing balance
C. Revising the estimated useful life of a depreciable asset
D. Adopting a new accounting standard
E. None of the above

7.14 Solution to end of chapter questions

a. D
b. D
c. B
d. A
e. E
f. C

CHAPTER EIGHT

ACCOUNTING FOR NOT-FOR PROFIT ORGANISATIONS

Chapter contents

a. Introduction
b. Receipt and Payment Account
c. Income and Expenditure Account
d. Membership subscription
e. Bar Trading Account
f. Life Membership
g. Accumulated Fund/Equity Reserve Fund

8.0 Objectives

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

(a) Explain what a not- for- profit organisation is
(b) State the difference between a receipts and payments account and an income and expenditure account;
(c) Explain the difference between the final accounts of not-for profit organisations as those of sole traders and partnerships;
(d) Prepare receipts and payments account;
(e) Prepare income and expenditure account;
(f) Prepare subscription account making the necessary adjusting entries with respect to amount in arrears and payments in advance; and
(g) Prepare the accumulated fund or Equity Reserve of a not-for profit organisation

8.1 Introduction

There are many types of not-for profit organizations. They include government owned hospitals and voluntary health and welfare organizations. In Ghana and Nigeria and other West African countries, citizens depend heavily on such entities for religious, educational, social and recreation needs. Examples of other not-for profit organisations include the following:

1 Private and community foundations
2 Professionals
3 Research and scientific organisations
4 Social and country clubs
5 Trade associations
6 Labour organizations
7 Political parties

It is not only profit making organizations that need accounts. Organisations set up for purposes other than profit, also need to tell their stakeholders how they have dealt with the funds they have contributed.

The legal status of such entities is usually spelt out in club rules or regulations. Students must however remember that external financial information provided by such organizations must be inconformity to generally accepted accounting principles.

The accounts of clubs, societies and charitable organizations may consist of the following:

(i) Receipts and payments account
(ii) Income and expenditure account and
(iii) Statement of financial position.

8.2 Receipts and Payments Account

This is a statement of cash actually received and paid during a given period. Receipts being debited and payments credited. It is, in effect, a summary of the cash book, and therefore shows the opening and closing balances of cash in hand, and receipts and payments of any kind and on any account made during the period.

An example of a receipts and payments account is shown in below:

Receipts	¢"000	Payments	¢"000
Bank balance 1/6/2023	118,000	Printing & stationery	
228,000			
Sponsored walk	23,000	Management expenses	109,000
Subscription	580,000	Caterer for president ball	113,250
Sundry income	57,000	Electricity and water	78,500
Sale of clubs manual	230,000	Bar Payables	278,500
Sale of equipment	254,000	Bank balance 31/5/2024	454,750
	1,262,000		
			1,262,000

FEATURES OF RECEIPTS AND PAYMENTS ACCOUNTS

- It is a summary of all cash receipts and payments whether it is capital or revenue in nature.
- It shows the opening and closing cash and bank balances
- It does not distinguish between capital and revenue items as in the case of income and expenditure accounts
- It is easy to prepare as it does not require the complex application of double entry principle or accounting conventions.

8.3 Income and Expenditure Account

Income and expenditure account is the equivalent of Statement of profit or loss account of a trading concern. It contains only revenue items, being debited with all expenditure, and credited with all income of a period, whether or not it has actually been paid or received within that period. The final balance of an income and expenditure account represents the excess of income over expenditure (surplus) or the excess of expenditure over income (deficit), as the case may be, for the period. This balance is similar to the net profit or loss of a trading concern.

Readers must note that an income and expenditure account differs from the receipts and payments account. The latter records only cash movements, the former takes into consideration non-cash adjustments for amounts owing and owed at the period end and for depreciation. It also recognizes the accounting distinction between revenue and capital expenditure. The important point that readers must note is that the income and expenditure account is prepared on an accrual basis.

8.4 Membership Subscription

A club or society receives payments from members for benefits, which members have enjoyed. Annual membership subscriptions of clubs and societies are usually payable one year in advance. Such payments in advance by members is shown as liability in the Statement of financial position. This is because the year's membership has still to run as at the year end. A large number of club subscriptions in arrears may never be received and the financial position of the club or association could be distorted, since such amounts are usually shown as assets in the Statement of financial position.

Illustration 8.1

Receipts and payments account for the year ended 31 May 2023

Receipts	¢	**Payments**	¢
Bank balance 1/6/2023	118,000	Printing & stationery	228,000
Sponsored walk	23,000	Management expenses	109,000
Subscription	580,000	Caterer for President's ball	113,250
Sundry income	57,000	Electricity and water	78,500
Sale of club's manual	230,000	Bar creditors	278,500
Sale of equipment	254,000	Bank balance 31/5/2024	454,750
	1,262,000		1,262,000

Bank balance 1/6/2024 454,750

Extracts from the membership subscription book revealed that subscriptions due from members amounted to ¢80,000 on 31 December 2022 and ¢120,000 on 31 December 2023. The accounts clerk recorded subscription of ¢21,500 and ¢109,000 in respect of subscriptions that have been paid by members in advance for 2023 and 2024 respectively. The subscription account will be prepared as follows:

Subscription Account for the year ended 31 Dec. 2023

	¢"000		¢"000
Balance b/f	80,000	Bal b/f	21,500
Income and Expenditure a/c	532,500	Receipts & Payment a/c	580,000
Balance c/f	109,000	Balance c/f	120,000
	721,500		721,500
Balance b/f	120,000	Balance b/f	109,000

By carrying forward subscription in advance, the accountant is applying the matching concept. This is because the payment of ¢109,000 in 2022 represents income meant for 2024 accounting year. This must therefore be removed from the current year's income and expenditure account, hence the debit balance carry forward.

From the above solution, subscription in arrears has been treated as an asset. This will hold true as a result of the accrual concept since the subscription in arrears are income that have been earned for the accounting year of 2022 but for which cash has not been received.

In practice however, subscriptions in arrears are often excluded from the Statement of Financial Position

on grounds of the prudence concepts. This is due to the fact that subscriptions that are owed by members for a long time end up not being paid eventually.

In examination situations, however, readers are reminded to follow the policy of the club or society as provided by the examiner.

8.5 Bar Trading Account

It is not uncommon for clubs/ associations to engage in other income generating activities to raise additional revenue for the effective running of the club.

These other activities are done with the sole aim of making profit. For instance the aim of a local trade union is not to make profit but the union may operate a bar alongside its activities with the object of making profit. The profit will not be distributed among the members but rather used for the purpose of the union.

If a club has a bar, a separate Statement of profit or loss account will be prepared for its trading activities. The net profit from the bar activities is then included as income in the income and expenditure account of the club or association. Any loss on the bar activities will be shown in the expenditure side of the income and expenditure account.

8.6 Life Membership

Subscriptions are often received from life members who paid at once and for subscription which entitles them to membership facilities for the rest of their lives. The once and-for- all payments from life members are not income relating to the year in which they are received by the club, because the payment is for the life if the member's subscriptions are small, they are credited to income as received but if they are significant in amount, then they should be credited in equal proportion over the estimated active club membership of such members.

8.7 Accumulated Fund or Equity Reserve Fund.

This represents the opening capital of a not-for profit making organisation. It has the same meaning ascribed to the capital accounts of a sole trader and partnership and is calculated as the difference between total assets and liabilities. It is usually common to see most not- for profit organisations keeping accounts on single entry basis. For this reason the procedure for preparing the accumulated fund of a not-for profit organisation is the same as that of statement of affairs as obtained under incomplete records and single entry discussed in other chapter.

Illustration 8.2

The following is the Receipts and Payments Account for the Victorosky Fun Club for the year ended 31 October 2024.

RECEIPTS	¢"000	PAYMENTS	¢"000
Subscription	1,643,560	Printing & Stationery	59,160
Sponsored walk	478,802	Bar steward's salary	69,600
President's Ball connections	408,000	Caterers for President's ball	250,000
Sundry income	75,000	Light, cleaning etc	32,640
Bar takings	510,000	Petty cash	65,000
Sale of equipment	7,923	Bar payables	280,000

Raffle	183,030	Investment in ABC limited	450,000
		Donation	50,000
Sundry President's ball exp.	5,275	Prizes of raffle	21,600
Building project (materials)	839,000		

Rent	360,000
Secretary's salary	120,000
Sundry bar expenses	3,360
Insurance	18,000
New equipment	67,800
Bank charges	36,000
Hiring of hall for Pres. Ball	20,000
Building project (wages)	525,000

The following additional information has been given:

1. Current Assets and Liabilities were:

	2023 ¢"000		2024 ¢"000
Bar Inventories	27,000		36,000
Bar Payables	18,000		33,000
Subscriptions in arrears	240,000		360,000
Subscriptions in advance	150,000		210,000
Light and cleaning owing	4,200		6,800
Insurance prepaid	4,200		5,200
Petty cash float		3,000	1,000
Cash in hand		15,565	14,340
Bank balance	246,500		281,105

2. *The petty cash float is used exclusively for telephone and postages*
3. *The club started constructing its club House during the year. The project will take four years to complete.*
   Amount owed for building materials supplied at 31 October 2024 was ¢511,500,000. Wages owed for October 2024 was ¢175,000,000. Inventory of materials at the end was ¢220,500,000.
4. *Tickets for the President's Ball were sold at ¢300,000 each. The club engaged the services of a caterer who agreed to charge on the number of plates served under the following conditions:*

- *Below 1,500 plates, amount to be charged per plate was ¢250,000.*
- *From 1,501 to 2,000 plates, amount to be charged per plate was ¢220,000.*
- *Above 2,000 plates, amount to be charged per plate was ¢200,000. Of the 2,400 tickets sold, 90% attended the function and were served.*

5. *Depreciation of equipment is to be calculated at 10% per annum on written down value. The Club's equipment which wa*s disposed off during the year had a carrying value of ¢9,905,000 on 1 November 2023.
6. Subscriptions in arrears for more than one year are to be written off.

7. An amount of ¢1,000,000,000 is to be transferred from accumulated fund to building fund.
8. Investment in ABC limited is expected to be held for at least five years.
9. Included in subscription is an amount of ¢192,000,000 in respect of 2023.
10. Rent paid represents one and half years to 30 April, 2026

Required:

(a) Accounts showing the profit or loss on Bar operation and president's Ball
(b) The accumulated fund as at 1 November 2023.
(c) The income and expenditure account of Victorosky Fun Club for the year ended 31 October 2024 and statement of financial position as at that date.

Solution to illustration 2.2

Victorosky Fun Club

(i) President ball Income statement Account for the year ended 31 December 2024

	¢"000	¢"000
Sale of tickets (2,400@¢300,000)	720,000	
Less: Cost of meals served [2,400 x 90%@¢200,000]	432,000	288,000
Less Expenses:		
Hiring of Hall	20,000	
Sundry Expenses	5,275	25,275
Profit to I & E a/c		262,725

(ii) Bar Trading Account for the year Ended 31 October, 2024

	¢"000	¢"000
Takings		510,000
Opening Inventory	27,000	
Add purchases (w1)	295,500	
	322,500	
Less closing Inventory	36,000	286,500
		223,500
Less Expenses:		
Stewards salary	69,600	
Sundry expenses	3,360	72,960
		150,540

Accumulated fund as at 1 November, 2023

	¢"000	¢"000
Equipment		9,905
Cash in hand		15,565
Bank		246,500
Inventory		27,000
Subscriptions		240,000
Prepaid insurance		4,200
Petty cash		3,000
		546,170
Bar Payables	18,000	
Light and cleaning owing	4,200	
Subscriptions	150,000	172,200
ACCUMULATED FUND/ EQUITY RESERVE FUND		373,970

Victorosky funclub
Income and expenditure account For the year ended 31 October 2024

INCOME:	¢"000	¢"000
Subscription (W2)		1,751,560
Sponsored walk		478,802
Sundry income		75,000
Raffle (¢183,030-¢21,600)		161,430
Profit on Bar Trading		150,540
Profit on president Ball		262,725
		2,880,057
Expenditure:		
Bank charges	36,000	
Insurance (¢4,200 + ¢18,000 - ¢5,200)	17,000	
Printing & Stationery	59,160	

Light & cleaning (6,800 + 32,640 - 4,200)	35,240	
Telephone & Postage W3	67,000	
Depreciation (10% @ ¢67,800)	6,780	
Donation	50,000	
Secretary's Salary	120,000	
Rent [12/18 @ ¢360,000]	240,000	
Bad debt (W1)	48,000	
Loss on sale of equipment (¢7,923-¢9,905)	1,982	681,162
Surplus of income over expenditure		2,198,895

Victorosky fun club
Statement of financial position as at 31 October, 2024

ASSETS EMPLOYED	¢"000	¢"000
NON- CURRENT ASSETS:		
Equipment at cost	67,800	
Less depreciation	6,780	61,020
Construction in progress		1,830,000
		1,891,020
Investment in ABC Shares		450,000
		2,341,020
Current Assets:		
Inventory (¢220,500+¢36,000)		256,500
Receivables-President's ball (w4)		312,000
Subscription in arrears		360,000
Insurance prepaid		5,200
Rent prepaid		120,000
Bank balance		281,105
Cash (¢14,340+1,000)		15,340
		1,350,145
Current Liabilities:		
Creditors: Building project	511,500	
Bar	33,000	
Caterer (¢432,000-250,000)	182,000	
Subscription in advance	210,000	
Light & cleaning owing	6,800	
Wages outstanding	175,000	
		1,118,300
Net current Assets		231,845
Net Assets		2,572,865

EQUITY RESERVE FUND:

Accumulated fund (W6)	1,572,865
Building fund	1,000,000
	2,572,865

WORKINGS

(W1) Bar Purchases:	¢"000
Payables 2024	33,000
Receipts & Payment a/c	280,500
	313,500
Less Payables 2023	18,000
	295,500

(W2). Subscription Account

¢"000			¢"000
Balance b/f	240,000	Balance b/f	150,000
Income & Expenditure a/c	1,751,560	Receipts & Payment a/c	1,643,560
		Bad debt (240-192)	48,000
Balance c/f	210,000	Balance c/f	360,000
	2,201,560		2,201,560

(W3) Telephone & Postages

	¢"000
Petty cash 2023	3,000
Receipts &Payment	65,000
	68,000
Petty cash 2024	1,000
Income &Expenditure a/c	**67,000**

(W4) Receivables on President's Ball:

	¢"000
Tickets sold	720,000
Less Amount Paid	408,000
Amount to be collected	312,000

(W5)	Work in progress-Club House	¢"000	¢"000
	Payment for materials		839,000
	Add Amount owed (2024)		511,500
			1,350,500
	Less closing inventory		220,500
	Materials used on project		1,130,000
	Wages paid	525,000	
	Add amount owed (2021)	175,000	700,000
	Cost to date		1,830,000
(W6)	Accumulated Fund Balance as at 1/11/2023		¢"000 373,970
	Transfer from I & E a/c	2,198,895	
		2,572,865	
	Amount transferred to building fund	1,000,000	
		1,572,865	

8.8 Chapter Summary

The chapter explained the difference between a receipt and payment account and an income and expenditure account and that the receipts and payments account does not show the true financial position of an organization.

The profit or loss account of a not-for profit organisation is called income and expenditure account from which any surplus (profit) or deficit (loss) is calculated and also the accumulated fund is similar to the equity account of a trader.

We also learned that where the club or society engaged in any activity with the aim of earning income for the attainment of the objectives of the organization, a separate profit or loss account should be prepared and the resulting profit or loss transferred to the income and expenditure account.

The treatment of subscription owing should be seen as part of the earnings or in accordance with accounting policy of the organisation.

Similarly, life membership and entrance fees should be accounted for bearing in mind the accounting policy of the organisation.

8.9 Examination type questions

Use the data below to answer Questions 1– 4
Receipts and Payments Account for the year ended 31 December, 2024

		¢"0		¢"000
Balance b/f		00	General expenses Equipment	7,800
Subscriptions	50,000	8,00	9,000	
Bar Sales	36,000	0	Clubhouse furniture 27,000	
			Bar purchases 30,000 Bar keeper's wages 4,000	

The treasurer also stated that on 1 January 2024, the club had ¢24,000 worth of equipment and owed ¢500 for electricity. Bar Inventory on 1 January and 31 December are valued at ¢10,000 and ¢13,000 respectively. Non- current assets are depreciated at 10% per annum.

1. Bar operation's surplus for the year was
a. ¢36,000
b. ¢6,000
c. ¢5,000
d. ¢3,000

2. The accumulated fund at the beginning of the year was
a. ¢42,500
b. ¢41,500
c. ¢42,000
d. ¢32,000

3. The net value of the club's non-current assets as at 31 December, 2024 was
a. ¢60,000
b. ¢36,000
c. ¢54,000
d. ¢32,400

4. The cash balance at the end of the year was
   a. ¢16,200
   b. ¢18,200
   c. ¢16,000
   d. ¢16,700

5. In the final accounts of non-profit making organization, capital expenditures are recorded in
   a. Income and expenditure account
   b. Subscription account
   c. Statement of financial position
   d. Profit or loss account

6. Revenue receipts of a not-for profit making organisation are recorded in the
   a. Profit or loss account
   b. Income and expenditure Account
   c. Statement of Affairs
   d. Bar Purchases Account

7. Which of the following statements is NOT true about the accounts of clubs and societies?
   a. A deficit of income and expenditure account reduces accumulated fund.
   b. Income and expenditure account does not contain capital receipts and expenditure.
   c. The excess of total assets over liabilities represents accumulated fund
   d. The closing balance of receipt and payments account is transferred to income and expenditure account.

8. With regard to a not-for-profit organisation, a debit balance on the subscription account is reported on
   a. Income and Expenditure Account
   b. Statement of Financial Position (SFP)
   c. Accumulated Fund
   d. Receipts and Payments Account

Details of subscription account of "Big Men Keep Fit Club" are as follows:
¢"000

Subscription owing	1/1/24	30,000
Subscription received	2024	320,000

Subscription received in 2024 included ¢40,000 in respect of 2025 financial year.

9. What is the subscription to be transferred to income and expenditure account for 2024?
a. ¢390,000
b. ¢330,000
c. ¢310,000
d. ¢250,000

10. A club received the following life membership fees in each of its first two years:

Year 1¢300,000 Year 2¢160,000

The club's policy is to take credit for life membership fees in equal amounts over 10 years. Determine the amount to be transferred to income and expenditure account in year 2.

a. ¢16,000
b. ¢43,000
c. ¢46,000
d. ¢32,000

8.10 Solution to end of chapter questions

1. C
2. B
3. D
4. A
5. C
6. B
7. D
8. B
9. C
10. C

THEORY QUESTIONS

1. The information below relates to the Madonna Youth Club for the accounting period of 2023.

	¢"000
Cash in hand 1/7/22	1,800
Subscription received:	
2023.....	2,000
2024 .	18,000
Receipts for renting of park	1,000
Receipts refreshing guest	6,000
Sundry receipts	12,500
Payments:	
Repairs	1,200
Salaries and wages	10,000
Printing and Stationary	3,000
Caretakers wages	6,800
Refreshment materials	8,500
Electricity expenses	4,500
Vehicle running expenses	5,000
Payables for repair	800

Payables for vehicle running expenses 400 Payables for refreshment materials 2,200 Subscription owing for 2020 3,000

You are required to prepare:

a) Receipts and payments accounts

b) Income and expenditure account for the year ended 30 June 2023.

2) The Financial Treasurer of Ayoyo Fun Club has presented the following summary of receipts and payments account for the year ended 31 December 2024.

Receipts and Payments Account for the year ended 31 December 2024

	¢"000			¢"000
Balance b/f	4,900		Rent and rates	804
Membership Subscription Membership admission	5,760		Social activities expenses	3,000
	840		Bar purchases	3,580
Bar receipts	7,500		Bar wages	1,104
Other receipts	3,800		General wages	2,560
			Equipment	5,720
			Electricity expenses	208
			Postage &Telephone	352
			Bank charges	116
			Insurance	604
			Balance c/f	4,752
	22,800			22,800

The following additional information is available:

	31/12/23	31/12/24
Premises	60,000	60,000
Furniture and fittings	4,400	2,840
Bar Inventory	1,040	1,420
Subscription in arrears	80	120
General wages owing	180	-
Subscriptions in advance	400	-
Insurance prepaid	136	180

Depreciation of 20% is to be written off equipment.

You are required to prepare:

a) Bar Profit or loss Accounts
b) Income and expenditure account for the year ended 31 December 2024.
c) Statement of financial position as at 31 December 2024

CHAPTER 9

ACCOUNT FOR NON-CURRENT ASSETS

9.0 LEARNING OBJECTIVES

After studying this chapter you should be able to:
State the types and characteristics of non-current assets.

- Appreciate the difference between capital and revenue expenditure
- Explain the chance depreciation
- Understand the basic method of calculating depreciation
- Calculate any profit or loss on the disposable of non-current assets
- Make the necessary entries to record the accusation disposal of non-current assets.

9.1 INTRODUCTION

In this chapter you would be introduced to the following:

- The definition and type of non-current assets.
- The definition an example of capital and revenue expenditures
- The concepts of depreciation and I'm motivation
- Some basic methods of calculating depreciation.
- How to calculate profit on loss arising from disposal of non-current assets
- Ledger accounts recording for acquisition and disposal of non-current assets
- Provisions of 1ASI6 on property, plant and equipment

9.2 Definition and types of Non-Current Assets

The assets of a business entity are classified as current assets or no-current assets. Current assets are seen as those assets which the business entity expects to realise or intend to sell or consume in it's normal operating cycle or holds the assets primarily for the purpose of trading or are reasonable within the twelve months after the reported. Examples of current assets include cash receivable, prepayments and inventory. Such assets will be used or recovered in the short term.

According to one IAS1 "presentation of financial statements" all other assets which could not be classified as current assets must be regarded as non-current assets. A non-current assets is an asset which is used by the business entity over a number of years. They are not expected to be converted into cash within one year or within the entity's normal operating circle, whichever is longer. There are two types of non-current assets, VI3 Tangible and Intangible.

9.2.1 TANGIBLE Non-current assets: These are physical assets which can be seen and touched. Such as property, (land and building), plant and equipment, including motor vehicles. They are usually depreciated at end of each accounting period to provide an expense that matches the cost of a non-current to the benefit earned from its ownership.

9.2.2 INTANGIBLE Non-Current assets:

These are assets that do not have a physical existence such as patent rights, goodwill, copywrite, and brand. They are usually amortized or tested for impairment at end of each accounting period.

9.3 COMPOSITION OF THE COST OF NON CURRENT ASSETS

Non-current assets are not acquired for resale but rather they are used in the business to increase the earning capacity or productivity in the business entity. An item of expenditure, which qualities for

recognition as a non-current asset, should be initially recorded at its history cost. Historical cost is measured by the cash or cash equivalent price of obtaining the asset and brings it to the location and condition necessary for its intended use.

According to 1AS16 – properties, plant and equipment, the cost of an item of property, plant and equipment consists of:

It's purchase price after any trade discount has been deducted, plus any import taxes on non-refundable sales tax; plus.

The directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. These directly attributable costs of bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

These directly attributable costs may include:

- Employee costs arising directly from the installation or construction of the cost;
- The cost of site preparation;
- Delivery costs
- Installation and assembly costs
- Testing costs to assess whether the asset is functioning properly (net of sale proceeds of items produced during the testing phase).
- Professional fees directly attributable to the purchase.

When the entity has an obligation to dismantle and remove the asset at the end of its life, its initial cost should also include an estimate of the cost of dismantling and removing the asset and restoring the site where it is located.

Illustration 9.1
Mensa (Ghana) Ltd. orders equipment for a Nigeria tools company Plc at an invoice price of ₵300,000,000. Payment will be made 50 monthly installments of ₵7,200,000 which include ₵60,000,000 interest charge. Value Added Tax of ₵35,000,000 must be paid as well as freight charges of ₵30,850,000. Installation and other start-up costs amount to ₵14,000,000.

Determine the cost of the equipment

Solution	₵
Invoice Price	300,000,000
VAT	35,000,000
Transportation Charges (freight)	30,850,000
Cost of Installation	14,000,000
	379,850,000

Note that the ₵60,000,000 interest charges on the installment purchase will be recognized as interest expense over the next 50 months and written of in the statement of comprehensive income.

Illustration 9.2
The cost information below relate to a large manufacturing plant acquired by Gbenga Nigeria Plc.

₦

List Price of the Machinery	25,000,000
Trade discount received	500,000
Delivery cost	2,250,000
Installation cost	3,450,000
Cost of site preparation	5,200,000
Architects fees	300,000
Administration expense	2,500,000
Test run cost	1,400,000

The test run cost was to ensure that the asset was installed and working correctly. Items of inventory produced during the test run had a sale value 200,000.

State government licensing condition stipulates that the Gbenga Plc will remove the asset and return the site to its former condition at the end of the asset's life. Gbenga Plc has recognized a liability of 3,600,000 in respect of the expected clearance cost.

Solution

Purchase Price of the Machinery (25,000,000-5000,000)	24,500,000
Delivery cost	2,250,000
Installation cost	3,450,000
Cost of site preparation	5,200,000
Architects fees	300,000
Decommissioning cost	3,600,000
Test run cost (1,400,000-200,000)	1,200,000
	40,500,000

Note that: The recognition of costs ceases when the asset is ready for use. That is, when the asset is in the location and condition necessary for optimal performance as intended by management.

9.4 EXCLUSION FROM COST OF NON-CURRENT ASSETS

According to 1AS16, the following list of cost are not to be included as part of cost property, plant and equipment.

- Costs of opening a new facility
- Costs of introducing a new product or service (including cost of advertising and promotional activities)

- Costs of conducting business in a new location or with a new class of customers (including cost of training) and
- Administration and other general overhead costs.

9.5 CAPITAL AND REVENUE EXPENDITURE

A business entity normally operates over many years but prepared financial statement annually at the end of each financial period. It spends money for the long term by investing in machinery, equipment and other assets and also spend money on day-to-day expenses, such as paying for suppliers and services, and wages or salaries to employers.

Capital expenditure is that type of expenditure which is incurred in acquiring or purchasing an asset used in the business activity for more than one year accounting year or acquired in order either after or improve existing assets, so that the earning capacity of the business is increased.

Examples include

- Purchase a property, plant and equipment, office equipment and motor vehicles
- Installation costs associated with new equipment or plants
- Improvements and additions to existing non-current assets (such as building extensions, installation of air conditioner etc)
- Fees paid to raise long term finance
- Legal fees of acquiring land or building
- The cost incurred in bringing any non-current asset to its present location.

Revenue expenditure is incurring of any cost in which it's earning potential is exhausted within one accounting period. They do not increase or improve the value of non-current assets but rather are incurred for maintenance and day-to-day operation of the business.

Examples include

- Purchase of goods meant for resale in the normal course of business
- Purchase of raw materials and components used to manufacture goods for resale in the normal course of business.
- Expenditure made to meet the day-to-day running cost of a business such as rent, electricity, wages, insurance, etc.
- Expenditure made to repair non-current assets
- Expenditure made to distribute goods to customers
- Cost of administrating a business such as accounting services, licence fees, etc.
- Discount allowed on credit sales.

9.6 DISTINCTION BETWEEN CAPITAL AND REVENUE EXPENDITURE

The importance of the district ion between capital and revenue expenditure lies in the fact that the profit for the accounting period would be affected where incorrect district ion is made. That is the profit would either be overstated or understated. Where capital expenditure is wrongly classified as revenue expenditure, the profit would be highly understated while the non-current asset is equally understated and the overall networth of the business would decline.

It is important to note that capital expenditure bring long-term benefits to the owner. This benefit arising from incurring capital expenditure is spread over a number of accounting periods while the benefit from incurring revenue expenditure is related to one a country period only. Therefore capital expenditure is written off over a long period and is shown the statement of financial position while revenue expenditure is written off to statement of profit or loss annually.

9.7 DEPRECIATION OF NON-CURRENT ASSETS

Depreciation is the loss in value of non-current assets due to wear and tear, passage of time, obsolescence or some other cause. Non-current asset is acquired for use in generating income for the business overtime and when the asset become unuseable, it will have to be replaced.
Depreciation is an expense that matches the cost of a non-current asset to the benefit earned from its ownership. It is calculated so that a business recognizes the full cost associated with a non-current asset over the entire period that the asset is used.

According to IAS16, depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount is the cost of an asset or other amount

substituted for the cost less its residual value. The residual value of an asset is the estimated amount that an entity wound currently obtained from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

9.7.1 ASSETS SUBJECT TO DEPRECIATION

The non-current assets usually subject to depreciation are;

i. Land and buildings including factories, offices, staff quarters warehouses etc. note that buildings depreciate slowing while land does not depreciate rather land is expected to appreciate
ii. Plant and machinery, equipment and tools, furniture and fittings e.t.c. these items of non-current asset are mostly depreciated.
iii. Wasting assets, that is, natural resources like coal mines, quarries, oil well e.t.c.
iv. Patents and copy rights, lease. These intangible non-current assets have limited life span and are subjected to amortization rather than depreciation.

9.7.2 CAUSES OF DEPRECIATION

As assets are used, they gradually lose value. Even if they are idle, they may deteriorate faster. The following are some major causes of depreciation;

1. Usage: through usage non-current assets supper wear and tear and hence loss in value.
2. Effluxion or passage of time: Whether or not an asset is in use, its value tends to reduce wish passage of time include leasehold property for which there is specific time of ownership.
3. Obsolescence: this may be caused by change in taste or fashion, etc. it could also be caused as a result of improved technology. Invention of a new machine which are more efficient will render older machines less useful in that it will cost more to use the old machines. The old asset which could still be in good working condition would technically loose value.
4. Exhaustion: this relates more to western aspects such as mines and quarries.
5. Physical factors: conditions like humidity, flood, dampness, excessive sunshine or heat can cause damage to an asset so that the value is reduced.
6. Environmental changes: the market conditions may change to render a product unsalable hence the need to replace the plant or machinery which is used to produce the product, though the non-current asset is technically useful.
7. Others include price fluctuations such as general change in foreign exchange rates or prices. Also, installation of excess capacity especially when the useful life of the asset is dependent on passage of time rather than usage.

9.7.3 PURPOSE OF DEPRECIATION

The main purpose of providing for depreciation is to present the non-current assets at their realistic values at any point in time by spreading the depreciable amount of the asset over its useful life. This will achieve there following;

i. It helps prevent overstatement of profit of a period.
ii. It provide fund for the fund for the replacement of the depreciated asset.
iii. It ensures that the assets values in the statement of financial position show a true and fair view of the state of the assets.

iv. It matches costs against revenues
v. It helps maintain the capital of a business by preventing excessive distribution of dividends.
vi. It makes it easier to show the expired cost of non-current assets.

9.8 FACTORS TO CONSIDER IN DETERMINING DEPRECIATION CHARGE

The following three major factors must be considered in order to determine the amount by which an asset should be depreciated at any point in time. The factors are the cost, estimated useful life and residual value of the asset.

COST

The relevant cost to be used for computation of depreciation is the original or historic cost of purchasing or constructing the asset. This figure could however be adjusted to include other pre-use costs like delivery, installation, import duty etc. Also the revalued cost of the assets could be used for such computation where asset is recorded in the books at valuation.

ESTIMATED USEFUL LIFE

Useful life is the period over which an asset is expected to be available for use by an entity. This is normally affected by the usage intensity as the greator the usage, the shorter the life and vice-verse. Useful life could also be the number of production or similar units expected to be obtained from the asset by an entity. Drawing from industry experience may be necessary when estimating the useful life of an asset.

RESIDUAL VALUE

Residual value is also referred to as scrap or break-up value of the asset. It is the estimated amount that an entity would current obtain on disposal of the asset, after deducting the estimated cost of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. It the asset is worthless at the end of its useful life, then the scrap value will be nil.

Note that in all cases annual depreciation charge is more of an estimate. It also be noted that though depreciation is an expense, it is a non-cash expense.

9.9 METHODS OF COMPUTING DEPRECIATION

There are many methods that can be used for calculating depreciation and the including:

- Straight line or fixed installment method
- Reducing or diminishing or declining balance method
- Sum of years digits method
- Production or machine hour method
- Sinking fund method
- Production unit method
- Annuity method
- Revaluation method
- Insurance policy method
- Depletion unit method

At this stage you will be introduced to only three different methods.

Straight Line Method

This method is also known as the fixed installment method. Under this method a uniform amount is written off the cost of an asset in every year of its useful life. That is, a fixed percentage of the original cost of the assets is written off every year to the statement of profit or loss so as to reduce the asset either to nil value or to residual value.

The percentage is determined as follows;

Depreciation amount = Original Cost - Residual value

Annual Depreciation charge = Depreciation amount

Estimated useful life

Annual percentage = Annual Depreciation charge / Original cost × 100/1

The annual percentage is applied to arrive at the depreciation charge for the periods.

Illustration 9.3

Babatunde and Mensah purchased an industrial machine costing 415,8000,000. The machine has an economic useful life often years. It is estimated that the machine can be sold at the end the ninth year for 83,097,000.

Calculate the following

a) Amount of depreciation charge per year
b) Prevision for depreciation/Accumulated allowance depreciation
c) The carrying Amount for the first five year's.

Suggested solution to illustration 9.3

Step 1. Let us calculate the depreciable amount

Depreciable amount is the cost of the assets less the residual that is

415,800,000 - 83,097,000

332,703,000

Step 2. Let us calculate annual Depreciation charge.

This is the depreciable amount divided by the economic useful life.

That is 332,703,000 / 9

= 36,967,000

Provision for depreciation will be 36,967,000 for the first year. At the end of the 2nd year an additional amount of 36,967,000 would be posted to the provision for depreciation account.

For the first five years, the provision for Depreciation and the carrying Amount would be as follows:

Table

Year	Depreciation charge	Provision for depreciation	Carrying Amount
	000	000	000
1st	36,967	36,967	378,833
2nd	36,967	73,934	341,866
3rd	36,967	110,901	304,899

4th	36,967	147,868	267,932
5th	36,967	184,835	230,965

Note that the carrying amount is cost of asset less total provision for depreciation to date. That is cost less accumulated allowance for depreciation.

If we want to use the percentage, we will have to calculate the percentage as follows:
Annual Depreciation charge (as calculated) is 36,967,000
Cost of machine (given) 415,800,000
Therefore:

$$\text{Depreciation charge percentage} = \frac{36{,}967{,}000}{415{,}800{,}000} \times \frac{100}{1}$$

= 8.89%
Annual Depreciation charge = 8.89% x 415,800,000
=37,006,200

Illustration 9.4
Bosco Holdings Plc acquired a plant at a cost of 24,000,000 it paid transport and other handling charges totaling 1,200,000, installation expenses 650,000 and pre-usage services of 580,000. The asset is to be depreciated at the rate of 20% per annum on straight-line basis. Calculate the annual Depreciation charge

Suggested solution to illustration 9.4
Cost of plant

Cash cost	24,000,000
Handling charge	1,200,000
Installation expenses	650,000
Pre-usage services	580,000
	26,430,000

Annual Depreciation charge = 20% of 26,430,000

$$= \frac{20}{100} \times \frac{26{,}430{,}000}{1}$$

= 5,286,000

Reducing or Diminishing Balance method
This is a scientific method whereby a fixed percentage is written of the cost or carrying amount of an assets annually. This method is more applicable to plant and machinery, furniture, fixture and fittings whose useful lives are difficult to estimate. With this method, the depreciation charge for a period is calculated by multiplying a fixed percentage and the carrying amount of the cost unlike the straight line method, the annual Depreciation charges tend to reduce is determined by the following formulae:

$$r = \left[1 - \sqrt[n]{\frac{s}{c}}\right] \times \frac{}{1} \times 100$$

Where r = percentage rate of depreciation
n = the useful life of the asset in years

s = scrap or residual value
c = cost of the asset

Illustration 9.5
Kwame Company acquired a tractor for use in agricultural production at the cost of 225 million. The residual value of the tractor after five years is estimated at 38 million show:

a) The depreciation charge for the first four years
b) The provision for Depreciation for the first four years
c) The carrying Amount at the financial years 1 to 4.

Solution to illustration 9.5
Step1 is to determine the percentage rate of depreciation using the above formulae
The above formulae

$$\text{Rate (r)} = \left(1 - \sqrt[n]{\frac{s}{c}}\right) \times 100$$

$$= \left(1 - \sqrt[5]{\frac{38m}{225m}}\right) \times 100$$

$$= (1 - \sqrt[5]{0.16889}) \times 100$$

$$= (1 - 0.701 \times 100) = 29.9\% = 30\%$$

The rounding up to 30% for ease of calculation

Year	Carrying Amount	Rate	Depreciation charge	Accumulated Depreciation	Carrying Amount
	b/f cm		Cm	Cm	c/f cm
1	225,000	30%	67,500	67,500	157,500
2	157,500	30%	47,500	114,750	110,250
3	110,250	30%	33,075	147,825	77,175
4	77,175	30%	23,153	170,978	54,022

Note that the carrying amount at the beginning of the second year was calculated as cost minus depreciation charge for the first year. At the beginning of the third and subsequent years, it was calculated at cost minus accumulated depreciation from the first year to the relevant date.

Sum of the years- Digitals method
This method reckons the useful life in the form of digits. Each year is allocated a digit. The total digits is used to divide the cost or depreciable amount of the asset while the digits are allocated in a reverse order to each of the years. This method like the reducing balance method, charges a higher depreciation amount in the earlier years but less in the latter years.

Illustration 9.6
Assume that in illustration 9.5 we are required to calculate the depreciation charge all the five years using sum-of-the-years-digits method.
Solution to illustration 9.6
Step 1 determine the sum of years digit for five years
X= 1+2+3+4+5=15
Step 2: determine the depreciable amount

X= original cost less scrap value
=225m -38m
=187m

Using tabular presentation we have:

Year	Property	Depreciation charge	Accumulated Depreciation	Carrying Amount
		Cm	Cm	cm
1	5/15	62.33	62.33	162.67
2	4/15	49.87	112.20	112.80
3	3/15	37.40	149.60	75.40
4	2/15	24.93	174.53	50.47
5	1/15	12.47	167.00	38.00

9.7 ADVANTAGES AND DISADVANTAGES OF THE THREE METHODS

STRAIGHT LINE METHOD

Advantages

i. It is simple to understand and calculate
ii. It is also popular
iii. It is acceptable to the Revenue Authorise
iv. It is the best method for depreciating assets which loose value due to passage of time.

Disadvantages

i. It does not consider the efficiency of the asset as it declined year after year.
ii. An asset may be written down to zero value.

REDUCING BALANCE METHOD AND THE SUM-OF-THE-YEARS-DIGITS METHOD

Advantages

i. The early years are charged with more depreciation
ii. The asset is never completely written off, so in each year a charge is made against the statement of profit or loss.
iii. The method is more realistic in that it tends to charge a reasonable figure for depreciation and repairs against the profit of the period

9.11 RECORDING OF DEPRECIATION AND ACCOUNTING ENTERIES IN RESPECT OF ACQUISITION AND DISPOSAL OF NON-CURRENT ASSETS

Recording of Depreciation

There are two known methods of recording depreciation allowance or charge in the books. They are:

i. Where the amount of depreciation allowance is written off the asset account

In this method, the depreciation charge for the period is credited to the asset account and debited to the depreciation expense account. The amount is the charge to the statement of profit or loss by

crediting the depreciation expense account with the same amount and debiting statement of profit or loss. The balance on the asset account at the end of the year represents the carrying amount of the asset which will appear in the statement of financial position. A major drawback of this method is that it does not disclose the cost of the asset in the statement of financial position.

ii. Where Provision For depreciation account is maintained.

In this method, the asset account is left at cost or valuation While a separate provision or allowance for depreciation charge and statement of profit or loss debited with same amount yearly. At the end of each financial year, the provision or allowance for depreciation account is balanced off and the credit balance brought down. I the statement of financial position the asset is shown at cost and then, the accumulated allowance for depreciation deducted to arrive at the carrying amount. This method is preferred by international financial reporting standard.

Illustration 9.7

Damusa and son manufacturing company acquired office equipment at a cost of 4,800,000 on January 1, 2021. The office equipment is to be depreciated at the rate of 20% per annum on the reducing balance method. Show for the first three years the

a) Office equipment account
b) Allowance for depreciation account
c) Statement of profit or loss (extract)
d) Statement of financial position (extract)

Solution to illustration 9.7

Step 1- calculate of annual depreciation charge/allowance

2021 – Depreciation charge = 20% of cost of office equipment

$= \frac{20}{100} \times \frac{4{,}800{,}000}{1}$

$= 960{,}000$

2022 – Depreciation Charge = 20% of carrying amount of office equipment at end of 2021

$= \frac{20}{100} \times \frac{(4{,}800{,}000 - 960{,}000)}{1}$

$= 768{,}000$

2023- Depreciation charge = 20% of carrying amount of office equipment at end of 2022

$= \frac{20}{100} \times \frac{4{,}800{,}000 - (960{,}000 + 768{,}000)}{1}$

$= \frac{20}{100} \times 3{,}072{,}000$

$= 614{,}400$

Office Equipment Account

Jan 1 2021 Bank 4,800,000	

Allowance for depreciation Account

Dec 31 2021 Balance c/d	960,000	Dec 31. 2021 Profit or Loss	960,000
Dec 31 2022 Balance c/d	1,728,000	Jan 1 2022 Balance b/d	960,000
		Dec 31 2022 profit or loss	768,000
	1,728,000		1,728,000
Dec 31 2023 Balance c/d	2,342,400	Jan 1 2023 Balance b/d	1,728,000
		Dec 31 2023 Profit or Loss	614,400
	2,342,400		2,342,400
		Jan 1 2024 Balance b/d	2,342,400

Statement of financial position (Extract)

Dec 31 2021 Office Equipment at cost	4,800,000	
Less depreciation	960,000	3,840,000
Dec 31 2022 Office Equipment at cost	4,800,000	
Less accumulated depreciation	1,728,000	3,072,000
Dec 31 2023 office Equipment at cost	4,800,000	
Less accumulated depreciation	2,342,000	2,458,000

Accounting Entries in respect of Acquisition and Disposal of Non- current Assets
Accounting Entries in respect of Acquisition and Disposal of Non – current Assets
Accounting for non – current assets, whether on acquisition, or disposal follows the double entry bookkeeping principle. The procedure is as follows:

1. On purchase of non – current assets by cash
   Debit: Non – current Asset Account
   Credit: Bank/cash Account
   With the cost of the assets acquired

2. On purchase of non – current assets on credit
   Debit: Non – current Asset Account
   Credit: Supplier's Account
   With the cost of the asset acquired
3. When depreciation allowance or charge are calculated at the end of the accounting period or year.
   Debit: Statement of profit or loss
   Credit: Allowance or Provision for depreciation Account
   With the amount of the annual depreciation charge

4. On disposal of non – current asset in use by an entity
   Debit: Non – current Asset Disposal Account
   Credit: Non – current Asset Account
   With the cost of the non – current asset disposed. Note that the entry will close the non – current asset of one asset or reduce the number of non – current assets available

5. To eliminate the accumulated depreciation allowance made the non – current asset disposal.
   Debit: Allowance or provision for depreciation Account
   Credit: Non – current Asset Disposal Account
   With the total accumulated depreciation allowance on the asset disposed up to the date of sale

6. To record the proceed received from the sale of the asset
   Debit: Bank/cash Account
   Credit: Non – current Asset Disposal Accounts
   With the proceed received on sale of the asset disposal.

7. To determine the profit or loss made on disposal of the asset and close the disposal account. The asset disposal account is balanced off and the difference would either be profit or loss on disposal

a) For profit on disposal of assets sold
   Debit: Asset Disposal Account
   Credit: Statement of profit or loss
   With the profit arising on the disposal of the asset

b) For loss on disposal of assets sold
   Debit: Statement of profit or loss
   Credit: Asset Disposal Account
   With the loss arising on the disposal of the asset

Illustration 9.8
Adanna Nigeria Limited purchased a machinery on the 1st of January, 2020 for ₦58,600,000 The machinery would be used in business in business for ten years and would be sold at the end of the tenth year at an estimated value of ₦5,400,000. The company accounting year end is 31st December annually.

Using the straight line method of depreciation show for the trust five years following.
a) The Asset Account
b) Provision or Allowance for Depreciation Account
c) Extracts of statement of profit or loss
d) Extracts of the statement of financial position

Suggested solution to illustration 9.8
Annual Depreciation charge = $\frac{\text{Cost – Scrap value}}{\text{Useful life}}$

= ₦58, 600,000 – ₦5,400,000
10
= ₦5,320,000

Machinery Account

	₦'000		₦'000
Jan 1,2020 Bank Account	58,000	Dec 31, 2020 Balance c/d	58,600
Jan 1, 2021 Balance b/d	58,600	Dec 31, 2021 Balance c/d	58,600
Jan 1, 2022 Balance b/d	58,600	Dec 31, 2022 Balance c/d	58,600
Jan 1, 2023 Balance b/d	58,600	Dec 31,2023 Balance c/d	58,600
Jan 1, 2024 Balance b/d	58,600	Dec 31, 2024 Balance c/d	58,600
Jan 1, 2025 Balance b/d	58,600		

Allowance/Provision for Depreciation on Machinery Account

	₦'000
Dec 31,2020 Balance c/d	5,320
Dec 31, 2021 Bal b/d	10,640
	10,640
Dec 31, 2022 Balance c/d	15,960
	15,960
Dec 31, 2023 balance c/d	21,280
	21,280
Dec 31, 2024 Bal c/d	26,600
	26,600

	₦'000
Dec 31, 2020 Statement of profit or loss	5,320
Jan 1, 2021 Balance c/d	5,320
Dec 31, 2021 Statement of profit or loss	5,320
	10,640
Jan 1,2022 Balance b/d	10,640
Dec 31, 2022 Statement of profit or loss	5,320
	15,960
Jan 1, 2022 Balance b/d	15,960
Dec 31, 2023 Statement of profit or loss	5,320
	21,280
Jan 1, 2024 Balance b/d	21,280
Dec 31 Statement of profit or loss	5,320
	26,600
Jan 1, 2025 Balance b/d	26,600

Statement of profit or loss (Extracts)

	₦'000	₦'000
Dec 31, 2020 Provision of Depreciation	5,320	
Dec 31, 2021 Provision of Depreciation	5,320	
Dec 31, 2022 Provision of Depreciation	5,320	
Dec 31, 2023 Provision of Depreciation	5,320	
Dec 31, 2024 Provision of Depreciation	5,320	

Statement of Financial Position (Extracts)

	Cost	Accumulated Depreciation	Carrying Amount
Machinery	₦'000	₦'000	₦'000
2020	58,600	5,320	53,280
2021	58,600	10,640	47,96
2022	58,600	15,960	42,640
2023	58,600	21,280	37,320
2024	58,600	26,600	32,000

Assume that in illustration 9.8 that the reducing balance method of depreciation was to be used and that the depreciation rate is 10%. This will require calculating annual depreciation charge separately for each of the five years as follows:

Calculation of annual depreciation charge

2020: Annual depreciation Charge = $\frac{10}{100}$ x ₦58, 600,000

= ₦5,860,000

2021: Annual Depreciation Charge = $\frac{10}{100}$ x $\frac{(₦\ 58,600,000 - ₦\ 5,860,000)}{1}$

= ₦ 5,274,000

2022: Annual Depreciation Charge = $\frac{10}{100}$ x $\frac{(₦\ 58,600,000 - ₦\ 11,134,000)}{1}$

= ₦ 4,746,600

2023: Annual Depreciation Charge = $\frac{10}{100}$ x (₦ 58,600,000 – ₦ 20,152,540)

= ₦ 4,271,940

2024: Annual Depreciation charge = $\frac{10}{100}$ x (₦58, 600,000 – ₦20,152,540)

= ₦3,844,746

The allowance/Provision for depreciation on Machinery Account will now be represented using the annual depreciation charge calculated based on the reducing balance method. Note that the figures in statements of profit or loss and statement of financial position will change as follows:

Allowance/Provision for Depreciation on Machinery Account

	₦'000		₦'000
Dec 31, 2020 Balance c/d	₦5,860	Dec 31, 2020 statement of Profit or loss	₦5,860
Dec 31, 2021 Balance c/d	₦11,134	Dec 31, 2020 Balance b/d	₦5,860

		Dec31, 2021 statement of profit	₦5,274
	₦11. 134		**₦11. 134**
Dec 31, 2022 Balance c/d	₦15,880.6	Jan 1, 2022 Balance b/d	₦11, 134
		Dec 31, 2022 statement of profit or loss	₦4,746.6
₦15,880.6			**₦ 15,880.6**
Dec 31, 2023 Balance c/d	**₦20,152.54**	Jan, 2023 Balance b/d	₦11,134
		Dec 31, 2022 statement of profit or loss	₦5,274
	₦20,152.54		**₦20,152.54**
Dec 31, 2024 Balance c/d	N23,997.29	Jan 1, 2024 Balance b/d	20,152.54
		Dec 31, 2024 statement of profit or loss	3,844.75
	23,997.29		**23,997.29**
		Jan 1, 2025 Balance b/d	**23,997.29**

Statement of profit or loss (Extracts)

	₦'000
Dec 31, 2020 Provision for Depreciation	
Dec 31, 2021 Provision for Depreciation	
Dec 31, 2022 Provision for Depreciation	
Dec 31, 2023 Provision for Depreciation	
Dec 31, 2024 Provision for Depreciation	

Statement of Financial Position (Extracts)

Cost	Accumulated Depreciation	Carrying Amount	
Machinery	N'000	N'000	N'000
2020	58,600	5,860	52,740
2021	58,600	11,134	47,466
2022	58,600	15,881	42,719
2023	58,600	20,153	38,447
2024	58,600	23,997	34,603

Illustration 9.9

The following information were extracted from the books of Dan Musa Limited.

	N'000
Plant and Machinery at Cost	360,000
Motor Vehicles at cost	298,000
Equipment at Cost	105,000

These assets were acquired on 1st April 20-5.

During the year to 31st December 20-8, the following additional assets were purchased by cheques. On 1st July two Delivary Vans at N300 million each and a plant and machinery at N250 Million were purchased. On 1st January 20-9, the plant and machinery purchase on 1st April 20-5 and the motor Vehicles were sold for N220 million and N148 Million respectively. Dan Musa Limited depreciates non-current assets on straight line method at the following rates:

Plant and Machinery	10%
Motor Vehicles	20%
Equipment	15%

You are required to prepare the following accounts to 31st December 20-9

a. Equipment
b. Plant and Machinery Account
c. Motor Vehicles Account
d. Provision for Depreciation accounts for the plant and machinery and motor Vehicles.

Suggested solution to illustration 9.9

Let us note that the original non-current assets purchased on 1st April 20-5 must be depreciated proportionately starting from the date of purchase. That is for 9 months, 1st April to 31st December 20-5. Also in 20-8 additional assets were purchase on 1st July requiring 6 months depreciation for that years. That is 1st July to 31st December 20-8.

Step 1- Calculation of depreciation charge

20-5: Plant and Machinery 10% of N360 million X 9/12=	N27 million
Motor Vehicles 20% of N298 million X 9/12=	N44.7 million
Equipment 15% of N105 million X 9/12=	N11.81 million

Subsequent years will be full depreciation charge for assets purchased in 20-5. Thus

Plant and machinery 10% of N360 million =	N36 million
Motor vehicles 20% of N298 million =	N59.6million
Equipment 15% of N105 million =	N15.75 million

20-8 Depreciation charge on additional assets acquired

Plant and Machinery 10% of N250 million X 6/12=	N125 million
Motor Vehicles 20% of N 600 million X 6/12 =	N60 million

Calculation of Accumulated depreciation on Assets disposed

Plant and Machinery		
Motor Vehicles		
20-5	27 million	44.7 million
20-6	36 million	59.6 million
20-7	36 million	59.6 million
20-8	36 million	59.6 million
	135 million	223.5 million

PLANT AND MACHINERY ACCOUNT

	N'000		N'000
April 1 20-5 Bank	360,000	Dec 31 20-5 Balance c/d	360,000
Jan 1 20-6 Balance b/d	360,000	Dec 31 20-6 Balance c/d	360,000
Jan 1 20-7 balance b/d	360,000	Dec 31 20-7 Balance c/d	360,000
Jan 1 20-8 Balance b/d	360,000	Dec 31 20-8 Balance c/d	360,000
July 1 Bank	250,000		
	610000		610000
Jan 1 20-9 Balance b/d	610,000	Jan 1 20-9 plant and Machinery	
		Disposal Account	360,000
		Dec 31 20-9 Balance c/d	250,000
	610,000		
Jan 1 20-0	250,000		

MOTOR VEHICLES ACCOUNT

	N'000	N'000	
April 1 20-5 Bank	298,000	Dec 31 Balance c/d	298,000
Jan 1 20-6 Balance b/d	298,000	Dec 31 20-6 Balance c/d	298,000
Jan 1 20-7 Balance b/d	298,000	Dec 31 20-7 Balance c/d	298,000
Jan 1 20-8 Balance b/d	298,000	Dec 31 20-8 Balance c/d	898,000
July 1 20-8 bank	600,000		898000
Jan 1 20-9 Balance b/d	898,000	Jan 1 20-9 Motor vehicle	
		Disposal account	298,000
		Dec 31 20-9 Balance c/d	600,000
	898,000		898,000
Jan 1 20-0 Balance b/d	600,000		

EQUIPMENT ACCOUNT

	N'000		N'000
Jan 1 20-5 Bank	105,000	Dec 31 20-5 Balance c/d	105,000
Jan 1 20-6 Balance	105,000	Dec 31 20-6 Balance c/d	105,000
Jan 1 20-7 Balance	105,000	Dec 31 20-7 Balance c/d	105,000
Jan 1 20-8 Balance	105,000	Dec 31 20-8 Balance c/d	105,000
Jan 1 20-9 Balance	105,000	Dec 31 20-9 Balance c/d	105,000
Jan 1 20-9 Balance b/d			

Motor Vehicles Disposal Account

Jan 1 20-9 Motor Vehicle Account	298,000	Jan 1 20-9 Provision for Depreciation	223,500
Jan 1 Statement of profit or loss	63,500	Jan 1 20-9 Bank (proceed)	148,000

Plant and Machinery Disposal Account

Jan 1 20-9 Plant and Machinery	360,000	Jan 1 20-9 Provision for Depreciation	145,000
		Jan 1 20-9 Bank (proceed)	220,000
		Jan 1 20-9 Statement of profit or loss	51,000
	360,000		360,000

Provision for depreciation on plant and machinery

	N'000		N'000
Dec 31 20-5 Balance c/d	27,000	Dec 31 20-5 statement of profit or loss	27,000
Dec 31 20-6 Balance c/d	63,000	Jan 1 20-6 Balance b/d	27,000
		Dec 31 20-6 statement of profit or loss	36,000
	63000		63,000
Dec 31 20-7 Balance c/d	99,000	Jan 1 20-7 balance b/d	63,000
		Dec 31 20-6 statement of profit or loss	36,000
	99,000		99,000
Dec 31 20-8 Balance c/d	147,500	Jan 1 20-8 Balance b/d	147,500
Jan 1 20-9 Plant and machinery		Jan 1 20-9 Balance b/d	147,500
Disposal Account	135,000	Dec 31 20-9 statement of profit or loss	25,000
Dec 31 20-9 Balance c/d	37,500		
	172,500		172,500
		Jan 1 20-0 Balance b/d	58,500

Provision for depreciation on Motor Vehicles Account

	N'000		N'000
Dec 31 20-5 Balance c/d	44,700	Dec 31 20-5 statement of profit or loss	44,700
Dec 31 20-6 Balance c/d	104,300	Jan 1 20-6 Balance b/d	44,700
		Dec 31 20-6 statement of profit or loss	59,600
	104,300		104,300
Dec 31 20-7 Balance c/d	163,900	Jan 1 20-7 Balance b/d	104,300
		Dec 31 20-7 statement of	

		profit or loss	59,600
	163,900		163,900
Dec 31 Balance c/d	283,500	Jan 1 20-8 Balance b/d	163,900
		Dec 31 20-8 statement of profit or loss	119,600
	283,500		283,500
Jan 1 20-9 Motor Vehicle		Jan 1 20-8 Balance b/d	283,500
Disposal account	225,500	Dec 31 20-8 statement of profit or loss	120,000
Dec 31 20-9 Balance c/d	178,000		
	403,500		403,500
		Jan 1 20-0 Balance b/d	178,000

9.12 SUMMARY

In this chapter the distinction between capital expenditure and revenue expenditure has been clearly explained. This distinction is significant since capital expenditure affects the statement of financial position but revenue expenditure relates to the statement of profit or loss. We also explained that non-current asset could be tangible or intangible and that the cost of non-current asset must include all directly attributable pre-use costs.

We also defined depreciation to mean an expense that matches the cost of a non-current to the benefit earned from its ownership. Non-current assts are depreciated over their useful economic life and the purpose of depreciating non-current asset is basically to spread the depreciated amount of the asset over its economic useful life. There are many methods of depreciating non-current assets but only the three popular methods- straight line method, reducing balance method and sum-of-the-years-digits method are considered.

9.13 END OF CHAPTER QUESTIONS

MULTIPLE CHICE QUESTIONS & SHORT ANSWER QUESTIONS

1. A non-current asset to one company may be a current asset to another company.
   (a) True (b) False
2. Expenditure which brings short term benefit to a business entity will normally be classified as ……..

(a) Revenue expenditure (b) Tangible assets (c) Capital expenditure

3. Which among these is an tangible non-current asset?

(a) Goodwill (b) Copy right (c) Plant (d) Brand

4. Depreciation of an asset with fixed period of legal life is often referred to as?

(a) Obsolescence (b) Amortization (c) Diminishing balance (d) Depletion

5. An increase in the value of a non-current asset over and above its original cost is termed?

(a) Depreciation (b) Appreciation (c) Inflation (d) Residual value

6. The main reason for depreciating an asset is to provide funds for the replacement of the asset at end of its useful life

(a) True (b) False

7. Depreciable amount of a non-current asset is ……

   (a) Carrying amount (b) Cost less residual value (c) Residual value plus carrying

amount (d) Residual value less carrying amount

8. State three basic methods of calculating depreciation.
9. What are the causes of depreciation.
10. In the first year of use of a non-current asset, the depreciation charge will be the same for both s straight line and Reducing balance method.

(a) True (b) False

Solution To Multiple Choice Questions and Short Answer Question

1. (a)
2. (a)
3. (c)
4. (b)
5. (b)
6. (b)
7. (b)
8. i. Straight-line method
   ii. Reducing balance method
   iii. Sum-of-the-years digit method
9. i. Wear and Tear arising from usage
   ii. Passage of time
   iii. Environmental factors
   iv. Obsolescence
   v. Exhaustion
10. (a)

EXAMINATION TYPE QUESTION

1. Baba Mensa has been in business for several years.
   The following balance were extracted from his books on December 31, 20-5

Motor vehicle at cost	10,000,000
Provision for Depreciation on motor vehicle	4,500,000

During the years 20-5 to 20-8 the following transactions took place:

i. On April 30, 20-6 a motor vehicle which cost 3,800,000 to purchase on January 1, 20-4 was sold for 1,260,000.
ii. On January I, 20-8 an additional motor vehicle was bought for 5,200,000.
iii. On September 1, 20-8, a motor vehicle which was bought on January 1, 20-6 for 4,200,000 was sold for 2,950,000.

Depreciation is charged at 20% per annum on cost no depreciation was charged in the year of disposal.

Write up for all the relevant year, the following:

a) Motor vehicle Account
b) Provision/Allowance for Depreciation Account
c) Motor Vehicle Disposal Accounts

2. An extract from the books of Emeka Kofi Enterprice as at December 31, 20-6 is as follow:

Equipment at cost	250,000,000
Carrying Amount at 31/12/20-6	156,978,000

Additional Information

Depreciation is provided on Equipment at a rate of 15% per annum or reducing balance basis. Annual depreciation is calculated on assets in use at the end of the year.

The following transactions took place in 20-7:

i. An equipment which cost 43,750,000 and had been used for four year was sold for 30,000,000.

ii. A new equipment costing 50,000,000 was purchased on January 1, 20-7

Required: Prepare for the year 20-7

a) Equipment Account

b) Provision/Allowance for Depreciation Account

c) Equipment Disposal account

3. The following information have been extracted from the books of Tunde Kivame as at December 31, 20-4.

Plant & Machinery at cost	180,000
Motor Vehicle at cost	156,000
Provision for Depreciation:	
Plant & Machinery	10,000
Motor vehicles	6,000

The following additional non-current assets were acquired by cheques:

i. On March 31, 20 – 5 two Delivery trucks at 4,000,000,000 each and a plant for 10,000,000,000.

ii. On April 1, 20 – 6, one saloon care at 5,000,000,000 and your machines at 5,000,000,000 each.

iii. On June 30, 20 – 6, two machines purchased on January 1, 20 – 2 at 3,000,000,000, each sold for 1,700,000,000 and 1,300,000,000 respectively.

On the same date, one saloon car purchased on January 1, 20 – 3 for 4,000,000,000 was auctioned for 3,000,000,000.

Tuned Kwame depreciate motor vehicles and plant and machinery at 15% and 10% per annum respectively on straight-line method.

Required: Write up the following accounts to December 31, 20 – 7

a) Plant and machinery Account

b) Motor Vehicles Account

c) Provisions/Allowance for Depreciation (i) Plant and machinery (ii) Motor vehicles Accounts

d) Disposal of plant and Machinery and Motor Vehicle Accounts.

ANSWER TO EXAMINATION TYPE QUESTIONS

Question I

i. Calculation of annual Depreciation charge:

20 – 6 = 20% x (10,000,000 less disposal cost 3,800,000)
=1,240,000

20 – 8 = 20% x (6,200,000 + addition 5,200,000 less Disposal 4,200,000)
= 1,440,000

ii. Calculation of accumulated depreciation on disposal

20- 6 =20%x N3, 800,000x2years (20-4 and 20-5) = N1, 520,000

2-8 = 20%x N4, 200, x2years (20-6 and 20-7)
= 1, 680,000

Motor Vehicle Account

	000		000
1/1/20-5 Balance b\d	10,000	30\4\20\6 motor disposal account	3,800
	10,000	31\12\20-6 Balance b/d	6,200
			10,000
1\1\20-7 balance b\d	6,200	31/12/20-8	6,200
1\1\20-8 balance b\d	6,200	1\9\20-8 motor disposal account	4200
1\1\20-8 bank account	5,200	31\12\20-8 balance b\d	7200
	11,400		11,400

Allowance for Depreciation Account

	000		000
30/4/20-6 motor vehicle disposal	1,520	1/1/20-6 Balance b/d	4,500
31\12\20-7 balance b/d	4,220	31/12/20-6 stmt of profit or loss	1,240
	5,740		5,740
31/12/20-7 balance b\d	5,460	1/1/20-7 Balance b/d	4,220
		31/12/20-7 stmt of profit or loss	1,240
	5,460		5,460
11,9/20-8 motor vehicle disposal	1,680	1/1/20-8 Balance b/d	5,460
31/12/ 20-8 Balance c/d	6,900	31/12/20-8 stmt of profit or loss	1,440
			6,900
		1/1/20-9 Balance b/d	5,220

Motor Vehicles Disposal Account

	000		000
30/4/20-6 motor vehicle A/c	3,800	30/4/20-6 Allowance for Depreciation	1,520
		30/4/20-6 Bank (proceed)	1,260
		30/4/20-6 stmt of profit or loss	1,020
	3,800		3,800
1/1/20-8 motor vehicle A/c	4,200	1/9/20-8 Allowance for Depreciation	1,680
1/9/20-8 stmt of profit or loss	430	1/9/20-8 Bank (proceed)	2,950
	4,630		4,630

Question 2

i. Calculate of accumulated depreciation on 31/12/20-6

	000
Equipment at cost	250,000
Carrying amount at 30/12/20-6	156,978
Accumulated depreciation	93,022

ii. Calculation of carrying amount of equipment sold

	000
Cost of Equipment sold	43,750
Less Depreciation for 1st year at 15%	6,563

	Carrying amount at start of 2nd year	37,187
	Less Depreciation for 2nd year at 15%	5,578
	Carrying amount at start of 3rd year	31,609
	Less Depreciation for 3rd year at 15%	4,741
	Carrying amount at start of 4th year	26,868
	Less Depreciation for 4th year at 15%	4,030
	Carrying amount at start of 5th year	22,838

iii.	Calculation of annual depreciation charge for 20-7	000
	Cost of new equipment	50,000
	Carrying amount of old equipment	156,978
	Less carry amount of equipment sold	(22,838)
		184,140
	Less Annual depreciation charge for 20-7 at 15%	27,621
	Carrying amount at 31/12/20-7	156,519

Equipment account

	000		000
1/1/20-7 Balance b/d	250,000	31/12/20-7 Equipment Disposal A/c	43,750
1/1/20-7 Bank A/c	50,000	31/12/20-7 Balance c/d	206,250
	250,000		250,000
1/1/20-8 Balance b/d	206,250		

Allowance for Depreciation Account

	000		000
31/12/20-7 Equipment Disposal A/c	20,912	1/1/20-7 Balance b/d	93,022
31/12/20-7 Balance c/d	99,731	31/12/20-7 stmt of profit or loss	27,621
	120,643		120,643
		1/1/20-8 Balance b/d	99,731

Equipment Disposal Account

	000		000
31/12/20-7 Equipment A/c	43,750	31/12/20-7 Allowance for Dep	20,912
31/12/20-7 stmt of profit or loss	7,162	31/12/20-7 Bank A/c	30,00
	50,912		

Question 3
Calculation of annual depreciation charge (C million)
20-5
Plant and machinery = 10% x 180,000 + 10% of addition for 9 months
= 10% x 180,000 + 10% x 10,000 x 9/12
=18,750
Motor vehicles = 15% x 156,000 + 15% of addition for 9 months

= 15% x 156,000 + 15% x 8,000 x 9/12
= 24,300

20-6
Plant and machinery = 10% x (190,000 less Disposal) + of addition for 9 months
= 10% x (190,000 – 6,000) + 10% x 20,000 x 9/12
= 19,900
Motor vehicles = 15% x (164,000 less Disposal) + 15% of addition for 9 months
= 15% x (164,000 – 4,000) + 10% x 50,000 x 9/12
= 24,563

20-7
Plant and machinery = 10% x 204,000 = 20,400
Motor vehicles= 15% x 165,000 =24,750

Calculation of Accumulated depreciation on Disposals
Plant and machinery 10% x 6,000 x 4 years (20-2 to 20-5)
= 2,400
Motor vehicles 15% x 4,000 x 3 years (20 -3 to 20 – 5)
= 1,800

Plant and machinery Account

	Million		Million
1/1/20-5 Balance b/d	180,000	31/12/20-5 Balance c/d	190,000
31/3/20-5 Bank A/c	10,000		
	190,000		190,000
1/1/20-6 Balance b/d	190,000	30/6/20-6 P&M Disposal A/c	6,000
1/4/20-6 Bank A/c	20,000	31/12/20-6 Balance c/d	204,000
	210,000		210,000
1/1/20-7 Balance b/d	204,000	31/12/20-7 Balance c/d	204,000
1/1/20-8 Balance b/d	204,000		

Motor Vehicle Account

	Million		Million
1/1/20-5 Balance b/d	156,000	31/12/20-5 Balance c/d	164,000
31/3/20-5 Bank A/c	8,000		
	164,000		164,000
1/1/20-6 Balance b/d	164,000	30/6/20-6 M/V Disposal A/c	4,000
1/4/20-6 Bank A/c	5,000	31/12/20-6 Balance c/d	165,000
	169,000		169,000
1/1/20-7 Balance b/d	165,000	31/12/20-7 Balance c/d	165,000
1/1/20-8 Balance b/d	165,000		

Allowance for Depreciation on plant and Machinery Account

	Million		Million
31/12/20-5 Balance c/d	28,750	1/1/20-5 Balance b/d	10,000
		31/12/20-5 of profit or loss	18,750
	28,750		28,750
30/6/20-6 P&M Disposal A/c	2,400	1/1/20-6 Balance b/d	28,750
31/12/20-6 Balance c/d	46,250	31/12/20-6 stmt of profit or loss	19,900

	48,650		48,650
31/12/20-7 Balance c/d	66,150	1/1/20-7 Balance b/d	46,250
		31/12/20-7 stmt of profit or loss	20,400
	66,650		66,650
		1/1/20-8 Balance b/d	66,650

Allowance for Depreciation on motor vehicles Account

	Million		Million
31/12/20-5 Balance c/d	30,300	1/1/20-5 Balance b/d	6,000
		31/12/20-5 stmt of profit or loss	24,300
	30,300		30,300
30/6/20-6 motor veh disposal A/c	1,800	1/1/20-6 Balance b/d	30,300
31/12/20-6 Balance c/d	53,063	31/12/20-6 stmt of profit or loss	24,563
	54,863		54,863
31/12/20-7 Balance c/d	77,813	1/1/20-7 Balance b/d	53,063
	77,813	31/12/20-7 stmt of profit or loss	24,750
			77,813
		1/1/20-8 Balance b/d	77,813

Plant and machinery Disposal Account

Million		Million	
30/6/20-6 plant & mach A/c	6,000	30/6/20-6 Allowance for Dep A/c	2,400
		30/6/20-6 Bank (proceed)	3,000
	6,000	30/6/20-6 stmt of profit or loss	600
			6,000

Motor vehicle Disposal Account

	Million		Million
30/6/20-6 motor vehicles A/c	4,000	30/6/20-6 Allowance for Dep A/c	1,800
30/6/20-6 stmt of profit or loss	800	30/6/20-6 Bank (proceed)	3,000
	4,800		4,800

CHAPTER TEN
PARTNERSHIP ACCOUNTS

10.0 Learning Objectives

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

(i) Define Partnership and state types of Partners in a Partnership
(ii) Explain how a Partnership is Formed
(iii) State the contents of a Partnership Agreement and Rules Applicable in case there is no Agreement
(iv) Identify accounts that are peculiar to the Partnership Business and
(v) Prepare Partnership Accounts under normal situations

10.1 Definition of Partnership

A partnership is an association that brings the talents and resources of two or more people together to carry on a business in common with a view of profit. The business could be carried on by all or any of them for the benefit of all of them. The minimum number to form a partnership is two people with a maximum limit of twenty persons except for firms of professionals such as solicitors, accountants and chartered engineers and surveyors, which are exempted from the maximum rule.

10.2 Types of Partners in a Partnership

In a partnership, there are different types of partners based on different types of classification. Participation in management and the extent of liability borne are the two major criteria used to classify the partners. The different types are enumerated and discussed below one after the other with their different characteristics.

General Partner or Active Partner: this partner has full power of participating in the conduct of the partnership business and is liable to the full extent of his estate for the partnership debt hence have unlimited liability.

Limited Partner: this partner is liable for the debts of the partnership only up to the amount he has agreed to contribute to the business and he cannot take part in the management of the business.
Sleeping or Dormant Partner: he does not take active part in the management of the partnership business; he contributes money and share in the partnership profit. By inference, this partner usually has limited liability.

Nominal Partner: this partner has no capital contribution in the partnership business but share in the profit. This is usually based on agreement as such partner must have allowed his name to be used by the business as a result of his good image, which the partnership would want to be associated with, to enhance their business privileges.

One or more partners in a partnership may limit their liability, but at least one partner must have unlimited liability. Every partner in a partnership is an agent of the firm and the other partners for the purpose of the business of the partnership.

10.3Formation of Partnership

In order to form a partnership, a copy of the partnership agreement and a prescribed form signed by all the partners should be delivered to the regulatory authority in charge of business and

company registration in the country where the partnership business is to be domiciled. For instance, in Ghana, the Registrar General is the relevant authority while in Nigeria; the documents will be delivered to the Corporate Affairs Commission for registration. The form would contain the following:

i. The name of the partnership
ii. The general nature of business
iii. The principal place of business and any other places where the business is carried on The address and post office box number
iv. he names and any other former names, residential addresses and business is carried on; and
v. The date of commencement of the partnership

The firm would be registered upon satisfaction that the contents of the documents are in order and after payment of the prescribed fee.

10.4Partnership Agreement

It is possible to form a partnership at will with or without the existence of any agreement, whether oral or written. However, it is expedient that, the partners before doing business together should come to an understanding on how issues are to be handled in the course of the partnership. The basic document that sets out the conditions under which the partners would carry on the business of partnership is the Partnership Agreement otherwise known as Partnership Deed. Usually the issues set forth in the agreement would include the following:

a. **Capital:** The agreement would indicate whether each partner should contribute a fixed amount of capital or not and how much each partner should contribute.
b. **Profit Sharing:** How profits and losses should be shared among the partners will be spelt out; whether they are capital or revenue profits or losses.
c. **Interest on capital and drawings:** Whether interest on capital or drawings should be allowed or charged before arriving at divisible profits, and if so at what rate.
d. **Interest on loan by partners:** The rate of interest payable on any loan advanced by any of the partners.
e. Whether current accounts are to bear interest, and if so at what rate;
f. Whether partners' drawings are to be limited in amount so that the current account does not turn into debit balance or not;
g. Whether partners are entitled to remuneration for their services before arriving at divisible profits and if so what amounts and which of the partners;
h. How the books of account would be kept and where they should be kept.
i. The method for the valuation of assets i.e. goodwill in case of an incoming or outgoing partner;
j. The method and procedures for settlement of disputes;
k. The condition for admission of new partner

It should be noted that partnership is by mutual agreement and issues that have been clearly spelt out in the deed cannot be set aside. However, the partners can all agree to either change or modify any of the clauses in the agreement at any time.

10.5Rules Applicable in the Absence of Partnership Agreement

Where there is no partnership agreement or the existing one is silent over a number of vital issues, and then the following rules shall apply:

a) Partners shall share profits and losses equally and shall contribute equally to capital.
b) The firm shall indemnify every partner in respect of payments made and liabilities incurred by him/her in the ordinary and proper conduct of the business of the firm;
c) Any advance or payment in excess of agreed share of capital will attract an interest at the rate of 5%;
d) Every partner may take part in the management of the firm;
e) Nopartnershallbeentitledtoremunerationforactinginthefirm'sbusiness;
f) No person may be introduced as a partner without his consent and the consent of all the existing partners.
g) Partners shall not be entitled to payment of interest on capital before ascertainment of profits of the firm;
h) The partnership books and accounts shall be kept at the place of business of the firm or at the principal place of business and every partner, may when he/she deems fit, have access to and inspect and copy any of them; and.
i) Differences arising from ordinary matters in connection with the partnership business may be decided by majority of the partners.
j)
k) However, no change in the nature of the partnership business may be made without the consent of all existing partners.

10.6Accounts That Are Peculiar To the Partnership Business

The capital of a partnership business would normally be contributed by more than one person. Therefore, in addition to keeping the record of the partnership business transactions, record of each partner's contribution to the business must be kept. This is usually done through a current account and/or a capital account depending on whether the capital account has been decided by the partners to be fixed or fluctuating.

In most cases, partners would want their original or initial contributions to remain intact, at least in the books. In such a case, there is the need to keep a "Current Account" on behalf of the partners to take care of other dealings between a partner and the firm. The Current Account, if it is kept, is a very important account which records all transactions between the partners and the firm, except the initial contributions. Thus, interest on capital, interest on loans, salaries and share of residual profits must pass through the Current Accounts. Drawings by partners, whether cash or in kind, should either be directly debited to either the Drawings Account or the Current Account.

Drawings should not be debited against the Statement of Profit or Loss because it is neither an expense nor a charge against profit. It is debited to the current account.

Where a partner makes an advance to the firm, the amount so advanced should be credited to a loan Account. Normally such advance would attract an interest of 5% or the partnership agreement might stipulate the rate agreed on by all the partners. Interest on loans would be deducted from profit before arriving at distributable profit. Where the partners agree that there should be interest on capital accounts, the interest on capital should never be charged to Income Statement, it must be charged against the statement of distribution of income.

The Statement of Distribution of Income would be credited with the interest on drawings, and debited with interest on capital, share of profit or loss, and salaries of partners if any.

Therefore in a partnership business, the following accounts could be found for e ach of the partners:

i Fixed Capital Account
ii. Current Account
iii. Fluctuating Or Floating Capital Account (combined i and ii)
iv. Loan Account
v. Salary Account
vi. Drawings Account
vii. Interest Account

In addition to the above, a partnership business will prepare a Statement of Distribution of Income to show how partnership profit is to be shared among the partners. This is the additional statement prepared by a partnership business which distinguished it from a sole proprietors business.

10.7 Guaranteed Share of Profit

Occasionally, there are agreements that a partner will not receive a share of profit that is less than a specified amount annually from the partnership business. If there is a year when the share of profit due to such partner is less than the stated amount, then the deficiency willbebornebytheotherpartnersintheirprofitandlosssharingratioortheratioinwhich they contribute to capital if that was the initial agreement.

10.8 Recording of Partnership Transactions

The relevant accounting entries for recording transactions in a Partnership are as follows:

Drawing of stocks for personal use:
Debit: Partner's Current Account]
Credit: Trading Account

Payment of expenses of the Firm from personal resources: Debit: Profit & Loss Account

Credit: Current Account

Interest on loan advanced by a partner: Debit: Profit & Loss Account
Credit: Partner's Current Account

Interest on drawings:
Debit: Partner's Current Account
Credit: Statement of distribution of income

Interest on Capital Account:
Debit: Statement of distribution of income
Credit: Partners Current Account

Partner's Salary:
Debit: Statement of distribution of income
Credit: Partner's Current Account

Share of Profit:
Debit: Statement of distribution of income
Credit: Partner's Current Account

Share of Loss:
Debit: Partner's Current Account
Credit: Statement of distribution of income

Drawings by a partner:
Debit: Partner's Current Account
Credit: Partner's Drawings Account

Illustration 10.1

Mamah and kwesi have been in partnership for the past ten years. The accounts of the partnership are made up to 31 December. Interest on drawings is charged at the rate of 15% and interest allowed On Capital is at 10%. Kwesi received a salary of 76 million per annum.The balance of profit is shared as follows: Mamah 3/5 and Kwesi 2/5. At 31/12/2024 the following balances appeared in the firm's books:

Capital Accounts:

Mamah	190
Kwesi	114

Current Accounts:

Mamah	95 Cr
Kwesi	57 Cr

The net profit for the year ended 31 December 2024 was N285 million and at that date, the balances on the Partner's Drawings Accounts were: Mamah N114 million and Kwesi N95 million.

Prepare the following:

(a) The Statement of Distribution of income of the Partnership for the year to 31 December 2024.

The Partner's Current Accounts as at 31 December 2024.

Solution10.1

Statements of Distribution of Income for the Year Ended 31 December 2024

		₵m		₵m
Current account			Net Profit b/d	285.0
Interest on Drawings:	Mamah	17.1	Current accounts:	
	Kwesi	14.3	Interest on drawings Mamah	17.1
Salary	Kwesi	76.0	Kwesi	14.3
Share of profit				
Mamah (3/5)	126.0			
Kwesi	84.0			
316.4		316.4		

Table 10.1

Partners' current accounts

Mamah		Kwesi		Mamah	Kwesi
31/12/2024 interest on					
Drawings	17.1	14.3	31/12/2024	95.0	57.0
31/12/2024	114.0	14.3	Interest of capital	19.0	11.4
Bal .c/d	108.9	119.1	Salary	-	76.0
			Share of profits	126.0	84.0
	240	228.4		240.0	228.4

Table 10.1

Partners' Current Accounts

	Ma	K		Mamah	
31/12/2024	Inte	₵	₵	1/7/2024Bal.	₵	₵
		1	1	31/12/2024	9	5
31/12/2024	Dra			Interest on Capital	5.	7
				Salary	0	.
Bal.		1	9	Share of	1	0
					2	1
		1	1			2
		2	2			

Illustration 10.2

Zumi, Brah and Zotu started a partnership on the14th of January, 2024 sharing profits and losses in the ratio 2:2:1.The partners agreed that partners' capital accounts and drawings were to attract interest. The trial balance of the partnership as at 30 September 2024 after the preparation of the Profit & Loss Account for the period was as follows:

Current Accounts:	DR	CR
Zumi		24,000
Brah	6,000	
Zotu		13,500
Capital Accounts:		
Zumi		150,000
Brah		135,000
Zotu		120,000
Loan by zotu		30,000
Bank & cash	31,500	
Creditors		27,000
Profits & loss account		51,000
Debtors	40,500	
Stocks at 30/9/24	52,500	

Vehicle	97,500	
Furniture & fittings	22,500	
Buildings	300,000	
	550,500	550,500

The following have not been taken into consideration before preparing the trial balance.

(a) Goods taken for personal use by Zumi ₦7,000; and Brah ₦3,500.
(b) General expenses paid by Brah personally was ₦2,250
(c) Zotu received ₦4,500 as salary from the partnership
(d) Cash drawings made were as follows:
Zumi N9,000 Brah ₦6,000 and Zotu ₦4,500
(e) Interest on drawings: Zumi ₦1,000; Brah ₦550: Zotu N450
(f) Interest on loan Zotu ₦3,000
(g) Interest on Capital account is charged at the rate of 5%

You are required to prepare:

(a) The Profit or Loss and the Statement of distribution of incomes
(b) The Partners Current Accounts
(c) The statement of financial position as at 30/09/24

Solution10.2

(a) Income Statement of Zumi, Brah, Zotu & Co. for the year ended 30 September 2024

		N	N
Balance per Trail balance			51,000
Current a/c's: Goods taken			
Zumi		7,000	
Brah		3,500	
		10,500	10,500
Current a/c's: Brah (General expenses)		2,250	
Zotu (Interest on loan)	3,000		(5,250)
			56,250

Statement of distribution of Income account for the year ended 30 September 2024

	N	N
Net profitability	56,250	56,250
Current account:		
Interest on drawings:		
Zumi	1,000	
Brah	550	
Zotu	450	2,000
		58,250

Current accounts:	Salary to Zotu	4,500	
	Interest on Capital		
	Zumi	7,500	
	Brah	6,750	
	Zotu	6,000	
		24,750	

Current accounts:	Share of profit:	
	mi (2/5)	13,400
	Brah (2/5)	13,400
	Zotu (1/5)	6,700
		58,250

Partners Current Account

	Zumi	Brah	Zotu		Zumi	Brah	Zotu
	₦	₦	₦		₦	₦	₦
Bal b/d	-	6,000	-	Bal b/d	24,000	-	13,000
Goods taken	7,000	3,500	-	Interest on loan	-	-	3,000
				Salary			4,500
Interest on Drawings	1,000	550	450	General expenses	-	2,250	-
Drawings	9,000	6,000	4,500	Interest on Capital	7,500	6,750	6,000
Balance c/d	22,900	6,350		Share of Profit	13,400	13,400	6,700
			28,750				
	44,900	22,400	33,700				33,700
						22,400	
					44,900		

10.9 Accounting for Goodwill in Partnership

Goodwill is an intangible asset usually not listed in an entity's financial statement like other tangible assets. It is the excess value of a business over the net realizable value of its separately ascertainable assets. Goodwill may be as a result of the following attributes found in a firm:

i. Monopolistic advantage
ii. Strategic location of the firm
iii. A long established list of experienced employees
iv. Reputable customers' patronage built sustained customers demand and taste satisfaction.
v. High reputation for credit ratings
vi. Good employer and employee relationship
vii. High quality products and services
viii. Competent Management Team
ix. Organized and effective advertising and marketing strategy

Goodwill could be purchased, un-purchased or negative. Un-purchased goodwill is inherent in the firm, generated within the business in the course of normal business activities. Purchased goodwill is derived from valuation during the acquisition of a business when the purchase consideration is more than the carrying amount of the assets acquired. If such purchase consideration is lower than the carrying amount of the assets then negative goodwill is the difference.

In a partnership, a number of events take place that will give rise to the recognition and valuation of goodwill in the partnership business whether such is to be kept in the books or not. As long as there is a change in the structure or composition of the partnership, then goodwill must be recognized and could be treated in different ways. These events include: Admission of a new partner, retirement or death of a partner, amalgamation and conversion of partnership business.

Recording of Goodwill in Partnership Accounts

Goodwill could be calculated based on:

i. Purchase of profits or average profits of some years
ii. Weighted average method or
iii. Super-profit method.

At this stage the bookkeeping aspects of goodwill is what is required, hence valuation issues are deferred to another stage of the examination.

There are a number of ways in which goodwill recognized and valued could be treated in the books of accounts. These include the following:

i.

ii.
iii.
iv.
v. among the old partners and credited in their old profit and loss sharing ratio.

Debit: Goodwill Account

Credit: Capital Accounts of partners in the old firm in the existing profit sharing ratio

vi. **Payment for goodwill:** In this case the goodwill account is not to be maintained in the books; the new partner pays for his own share of the goodwill in addition to the capital contribution. The cash book will be debited with the payment while the old partners will be credited in the old profit and loss sharing ratio.

vii. **Direct payment to old members for goodwill:** No record of this in the partnership books as the new member paid directly to the old partners in old profit and loss ratio.

viii. **Withdrawal of cash by old partners:** Instead of crediting old partners and debiting goodwill, the old partners will withdraw cash equivalent to their share of goodwill. Goodwill account is debited while cash account is credited.

ix. **Adjustment of capital account of partners:** If the new partner is not to pay cash for goodwill and goodwill account is not to be maintained in the books of the partnership despite its existence, then it might be necessary to adjust the capital account of partners. The new partner's share of goodwill will be credited to the old members in their profit and loss sharing ratio and debited to the new partner's capital account.

Debit: Goodwill Account

Credit: Capital Accounts of partners in the old firm in the old profit sharing ratios.

Debit: Capital Accounts of partners in the new firm in the new profit sharing ratio

Credit: Goodwill Account to close the account

10.10 Revaluation of Assets

Apart from recognition and valuation of goodwill, revaluation of assets also usually accompanies change in structure or composition of a partnership business in the interest of fairness and to maintain equity between the partners.

Bookkeeping in Respect of Revaluation

If an asset is re-valued, three situations can arise. The asset may increase in value; decrease in value or

The value placed on it may be the same as the carrying amount .If the value does not change, there will not be any bookkeeping entries to be made .If there is an increase in value, that is a capital profit, you need to debit the Asset account with the difference between the previous value and the new value and credit the Revaluation Account.

On the other hand, if there is a decrease in value, there is a capital loss on revaluation, debit the Revaluation Account of partners and credit Asset Account.

Illustration 10.3

Mensah and Babatunde have been Partners for some time. On 26th March 2025, they decided to admit Shola. So they requested for are valuation of the assets of the partnership.

The Statement of Financial position of Mensah and Babatunde as at 31st March 2025, was as follows:

Non-Current Assets	Cost	Depreciation	Carrying Ar
	¢000	¢000	¢000
Freehold Property	7,600	2,850	4,750
Plant& Machinery	4,275	2,375	1,900
Motor Vehicles	3,610	2,185	1,425
	15,483	7,410	8,075
Current Assets:			
Inventories		1,330	
Receivables		1,140	
Bank and Cash		7,125	
		9,595	
Less Acct. Payable		4,485	5,110
			13,185
Capital Accounts			
Mensah			4,800
Babatunde			4,800
Current accounts:			
Mensah			1,585
Babatunde			2,000
			13,185

The new valuations were as follows:

	¢000	
Freehold Property	9,500	
Plant and Machinery	1,425	
Motor vehicles	1,140	

It was also agreed that allowance for doubtful debts should be made to 21/2 of debt receivables.

Trade Payables agreed to receive ¢3,000,000 for full settlement of their interest.

Required:

(a) Pass the necessary journal entries to give effect to the valuation of the assets.
(b) Show the Partners Capital Accounts
(c) Show the Revaluation Account

Solution 10.3

Note:

Let us note that in the accounts proper, non-current assets are usually shown at cost or revalued amounts. Hence, the net assets shown in the statement of financial position would not have any T accounts. Therefore, it would be necessary to close the provision for Depreciation account. We would then be left with the assets accounts.

Compare the balances on the assets accounts with the valued figures. If the valued amounts are higher, it means the assets have increased in value. The only way to record increases in the assets accounts is to debit the assets accounts with the difference. In the same way, to record a decrease in an asset account, you need to credit the asset account. To complete the double entry you need to pass the other entry through the Revaluation Account.

On receivables, a 2½% of provision has to be made. So let us debit the Revaluation account with ¢28,500 and credit Provision for Doubtful Debt Account with the same amount.

		DR	CR
Debit:	Provision for depreciation:	7410	
Credit:	Revaluation Account		7,410

a) Debit: Freehold Property 1,900
Credit: Revaluation Account 1,900
To record increase in the balance on freehold property

2. Revaluation Account 5,348.5

Plant and Machinery 2,850

Motor Vehicles 2,470
Provision for doubtful debt 28.5
Being adjustment needed to reflect the revalued amounts

3. Payables Account 1,485

Revaluation Account 1,485

To record the decrease in the payable balance

4. Debit: Revaluation Account 5,446.5 Credit :Partners‟ Capital Account 5446.5

To close off the Revaluation Account

(a) Revaluation Account

¢000		¢000	
Plant and Machinery	2,850	Provision for Depreciation Freehold Property	7,410
Motor Vehicles	2,470		
	1,900	Provision for doubtful debts	28.5
		CreditorsAccount	1.485
		Partners' Capital Account	
		Mensah (1/2)	

2,723.25
Babatunde(1/2) 2,723.25
10,795

10,795

Capital Accounts

Mensah ¢000		Babatunde ¢000		Mensah ¢000	Babatunde ¢000
Bal c/d	7,523.25	7,523.25	Balance b/d	4,800.00	4,800.00
	7523.25			2,723.25	7,523.25
		2,723.25	Revaluation		7,523.25
			7,523.25		
b/d	7,523.25	7,523.25			
			Bal b/d		

10.11 Chapter Summary

A partnership is an association between two or more people carrying on a business in common with a view of profit. The business could be carried on by all or any of them for the benefit of all of them; any member could take active part in the management of partnership. The number of members ranges from two to twenty except for firms of professionals that could have up to fifty members. The partners could have their liability limited or unlimited but there must be at least a general partner whose liability will be unlimited. We also have sleeping or dormant partners who contribute capital and share in the profit but do not take active part in the management of the company. Nominal partners do not contribute capital but share in the profit of the partnership perhaps because he allowed his name to be used in the business.

Partnership business is one of the simplest business enterprises to form. The firm would be registered upon satisfaction that the contents of the partnership agreement and prescribed form are in order and with the payment of the prescribed fee. It is possible to form a partnership at will with or without the existence of any agreement, whether oral or written. Partnership is by mutual agreement and issues that have been clearly spelt out in the deed cannot be set aside. However, the partners can all agree to either change or modify any of the clauses in the agreement at anytime. In case of dispute and circumstances not provided for in the partnership deed or when there is no written agreement at all, there are provisions in the Partnership Act on how to resolve issues relating to the business.

In addition to keeping the record of the partnership business transactions, a partnership keeps record of each partner's contribution to the business through a current account and/or a capital account depending on whether the capital account has been decided by the partners to be fixed or fluctuating. Therefore, it is usual to find the following accounts being kept in respect of each partner: Fixed Capital Account, Current Account, Fluctuating Or Floating Capital Account, Loan Account, Salary Account, Drawings Account and Interest Account. A Statement of Distribution of Income (known as Profit and Loss Appropriation Account) will also be prepared by the partnership business after determination of trading profit.

A partner may be given a guaranteed share of profit whereby if at any period the share of profit due to the partner is lower than the agreed amount, the other partners will share the deficiency in the profit and loss sharing ratio. Normal double entry principles are followed in the partnership rules with adherence to basic accounting principles and concepts except when there are changes in the structure of partnership

CHAPTER ELEVEN

PARTNERSHIPACCOUNTS 2

Chapter contents

a. Changes in the structure of Partnership;
b. Goodwill;
c. Revaluation of assets and liabilities;
d. Admission of a new Partner;
e. Retirement and death of a Partner;
f. Amalgamation of Partnership;
g. Dissolution of Partnership; and
h. Conversion of Partnership to a Limited Liability company

11.0 Objectives

After studying this chapter, students should be able to understand:

a. The various types of circumstances that would change the structure of partnership;
b. The adjustments that are made to the partner's accounts on admission of a New partner(s);
c. Accounting for revaluation of assets, and dissolution of partnership;
d. The various treatments of goodwill in partner's accounts; and
e. The Accounting entries necessary to close the existing partnerships and form a new one.

11.1 Changes in the Structure of Partnership

The structure of a partnership can change as a result of admission of more partners, retirement of a partner or death of a partner. In any of the three events, the partnership structure would have changed. Before we take the three events one by one, it is necessary to consider two important issues that usually affect changes in structure of partnership, these are goodwill and revaluation.

Irrespective of the very reason for admitting a new partner, it is required that all the existing partners should agree on the ratio of sharing both profits and losses and the amount of capital the incoming partner should contribute.

11.2 Goodwill

"Goodwill is that which enables business to earn super-normal profit, because of the reputation or special advantages which the business engages with the rest of the world". It is also defined as "the difference between the value of the business as a whole and the
Aggregate of a fair value of its separable net assets".

The goodwill a firm has may be due to the following:

(a) Superior management skills of its top management
(b) The possession of efficient and dedicated employees;
(c) Advantageous or strategic location of the firm;
(d) The nature of the firm's services or products;
(e) Possession of favourable contract, trademarks, patents and others;
(f) High quality of goods or services; and
(g) Effective and efficient advertising campaign.

Goodwill is an intangible asset. Where it is internally generated. It is normally not recorded in the books. If it is unrecorded it means that the partners' interests in the business have been understated.

11.2.1 Accounting for Goodwill

There are many different ways of calculating for internally generated goodwill. At this stage you would learn the bookkeeping aspects and leave the valuation out.

There are two cases

a. Goodwill to remain in the books**: Debit** Goodwill Account
Credit Capital Accounts of partners in the old firm in the existing profit sharing ratio

b. If the goodwill is not to be in the books:
Debit Goodwill Account
Credit Capital Accounts of partners in the old firm in the old profit sharing ratios.
Debit Capital Accounts of partners in the new firm in the new profit sharing ratio
Credit Goodwill Account

To close the account

Illustration 11.1

Panyin and Kakrah are partners in a firm and share profits and losses equally. Their capital accounts have the following balances. Panyin ¢25,000,000; Kakrah ¢15,000,000. On1/9/2024 they admitted Olu as a partner and agreed on profit sharing ratio as $^{2}/_{5}$, $^{2}/_{5}$, and $^{1}/_{5}$ for Panyin, Kakrah and Olu respectively.

Goodwill has been valued at ¢18,000,000 but has not been recorded in the books of the partnership. Olu paid into the firm's bank account an amount of ¢35,000,000 as his capital.

Show the bookkeeping entries to record the above transactions:
(a) If goodwill is to remain in the books
(b) If goodwill is not to remain in the books

SOLUTION TO ILLUSTRATION 11.1

Partners' Capital Account

	Panyin	Kakrah	Olu		Panyin	Kakrah	Olu
	¢m	¢m	¢m		¢m	¢m	¢m
				1/9/2024 Bal.b/d	25	15	-
1/9/2024 Bal c/d	34	24	35	1/9/2024 Bank	-	-	35
				1/9/2024 Goodwill	9	9	9
	34	24	25		34	24	35
				Balb/d	34	24	35

Goodwill Account

1/1/2024	Partners' Capital Account	¢m		¢m	18

(b) If Goodwill is not to remain in the books
In this case, in effect the goodwill account is to be closed against the partners‟ accounts
In the new profit sharing ratio. The full accounts would be as follows:

Partners' Capital Accounts

	Panyin	Kakrah	Olu		Panyin	Kakrah	Olu
	¢m	¢m	¢m		¢m	¢m	¢m
1/9/2024 Goodwill	7.2	7.2	3.6	1/1/2024 Bal b/d	25	15	
Bal.c/d	26.8	16.8	31.4	1/9/2024 Bank	-	-	35
				1/9/2024 Goodwill	9	9	-
	34	24	35		34	24	35
				Bal. b/d	26.8	16.8	31.4

Goodwill Accounts

	¢m		¢m
1/9/2024 Partners Capital Accounts	18	1/9/2024 Partners Capital Account	18

11.3 Revaluation of Assets and Liabilities

Since partnership by its very definition implies the carrying on of business by more than one person for the purpose of making profit, it is desirable and necessary that the true interest of each partner in the firm, as far as possible is shown.

To be able to do this, the accounts of the partners must be adjusted periodically to reflect the financial position of the firm. Some of the assets of the firm may have either appreciated or deteriorated in value. Note that the partners‟ capitals must be equal to the net worth of their business. The net worth must also be equal to the net assets.

The "true" net assets would depend on a realistic valuation of the assets and liabilities. Hence, it is necessary to review the values of these assets and liabilities of the firm whenever there is a change in the partnership.

Bookkeeping in Respect of Revaluation

If an asset is revalued, three situations can arise. The asset may increase in value, decrease in value or the value placed on it may be the same as the book value. If the value does not change, there will not be any bookkeeping entries to be made. If there is an increase in value, you need to debit the Asset account with the difference between the previous value and the new value and credit the Revaluation Account.

On the other hand, if there is a decrease in value, the Revaluation Account in respect of the asset. These is done by debiting the Provision Account and crediting the Revaluation Account and credit the partners Capital Accounts. If there is a capital loss on revaluation, debit the Capital Account and credit Revaluation Account.

Let us illustrate the above points with the following question:

Illustration 11.2

Mensah and Babatunde have been partners for some time. On 26thMarch2024, they decided to admit Shola. So they invited a Valuer to revalue the assets of the partnership.

The Statement of Financial position of Mensah and Babatunde as at 31stMarch 2026, was as follows:

Non-Current Assets	Cost	Depreciation	Carrying Value
	¢000	¢000	¢000
Freehold Property	7,600	2,850	4,750
Plant& Machinery	4,275	2,375	1,900
Motor Vehicles	3,610	2,185	1,425
	15,485	7,410	8,075
Current Assets:			
Inventories		1,330	
Receivables		1,140	
Bank and Cash		7,125	
		9,595	
Less Acct. Payable		4,485	5,110
			13,185
Capital Accounts			
Mensah			4,800
Babatunde			4,800
CurrentAccount:			
Mensah			1,585
Babatunde			2,000
			13,185

The new valuations were as follows:

	¢000
Freehold Property	9,500
Plant and Machinery	1,425
Motor Vehicles	1,140

It was also agreed that allowance for doubtful debts should be made to 2½% of receivables.
Creditors agreed to receive ¢3,000,000for full settlement of their interest.

Required:

(a) Pass the necessary journal entries to give effect to there valuation of the assets.
(b) Show the Partners Capital Accounts
(c) Show the Revaluation Accounts

Solution 11.2

Note:

Let us note that in the accounts proper, non-current assets are usually shown at cost or revalued amounts. Hence, the net assets shown in the statement of financial position would not have any T accounts. Therefore, it would be necessary to close the provision for Depreciation Account. We would then be left with the assets accounts.

Compare the balances on the assets accounts with the revalued figures. If the revalued amounts are higher, it means the assets have increased in value. The only way to record increases in the assets accounts is to debit the accounts with the difference. In the same way, to record a decrease in an asset account, you need to credit the asset account. To complete the double entry you need to pass the other entry through the Revaluation Account.

On receivables, a 2½% of provision has to be made. So let us debit the Revaluation account with ¢28,500 and credit Allowance for Doubtful Debt Account with the same amount.

(a) Debit: Provision for depreciation:

1. Freehold Property	¢000 2,850		¢000
Plant and Machinery	2,375		
Motor Vehicles		2,185	
Credit: Revaluation Account			7,410
To close the provisions for accounts 2.Debit: Freehold Property	Depreciati on	 1,900	
Credit: Revaluation Account			1,900
To record increase in the balance on freehold property			
3. Revaluation Account	5,348.5		
Plant and Machinery			2,850
Motor Vehicles			2,470

Provision for doubtful debt 28.5
Being adjustment needed to reflect the revalued amounts

4. Payables Account 1,485
Revaluation Account 1,485

5. To record the decrease in the payable balance Debit: Debit: Revaluation Account 5446.5

Credit: Partners' Capital Account 5446.5
To close off the Revaluation Account

(b) Revaluation Account

	¢000		¢000
Plantand Machinery Motor Vehicles	2,850 2,470	Provision for Depreciation	7,410 1,900
Provision for doubtful debts	28.5	Freehold Property	1.485
		CreditorsAccount	

Partners' Capital Accounts

Share of profit			
Mensah(1/2)	2,723.25		
Babatunde(1/2)	2,723.25		
	10,795		10,795

Capital Accounts

Mensah ¢000		Babatunde ¢000	Mensah ¢000		Babatunde
Bal c/d	7,523.25	7,523.25	Balance b/d	4,800.00	4,800.00
			Revaluation	2,723.25	2,723.25
7,523.25		7,523.25			
				7,523.25	7,523.25
Balance b/d	7,523.25	7,523.25			

11.4ADMISSIONOFANEWPARTNER

A new partner may be invited to join a partnership for various reasons. It may be that the firm has expanded its operations so much that the existing partners feel they need an additional person with some skills. It may also be that more capital is required to take advantage of opportunities to expand the business. At times a new partner may be admitted to replace an outgoing partner, whether due to death or retirement.

For whatever reason for admitting a new partner, it is necessary to take account of the following:

i. Change in terms of the partnership agreement with particular reference to capital contribution and profit and loss sharing ratios.
ii. Revaluation of the assets of the firm in order to reflect the true values of the assets; and
iii. Put a value on the goodwill the firm has required.

It is only fair to adjust the books to ensure that the balances on the partners‟capitalrepresentafairvalueofeachpartner`sinterestinthepartnership. This will mean that if there are undisclosed assets and liabilities, they should be reflected in the books. This may take the form of recognizing the existence of goodwill or revaluing the assets of the partnership. So long as you remember how to account for goodwill, revaluation of assets and liabilities, there would be very little difficulty in accounting for admission of additional partners.

Let us illustrate the necessary accounting treatment with an example:

Illustration 11.3

Gyamfi and Lawal were in partnership sharing profits and losses equally. As a result of expansion of business, they decided to admit Ekiti who contributed N65,000 as his capital. The partners agreed that the ratio of sharing profits and losses should be Gyamfi $^{2}/_{5}$, Lawal $^{2}/_{5}$ and Ekiti $^{1}/_{5}$. The statemen t of financial position of the partnership was as follows:

Statement of Financial Position As At The Date Of Admission

	~~₦~~**000**		~~₦~~**000**
Capital Accounts:			
Gyamfi	75,000	Non-current assets	
Lawal	75,000	Plant and Machinery	120,000
		Motor Vehicle	65,000

Current Accounts:

Gyamfi	20,000	Current Assets:	
Lawal	30,000	Inventory	45,000
		Receivables	58,000
		Cash	4,000

Current Liabilities:	
Payables	52,000
Overdrafts	40,000
	292,000
	292,000

The following information were to be taken into account:

1. On the admission of Ekiti the following revaluations were made:
   Plant and machinery ₦250,000,000, Motor Vehicle ₦80,000,000, Inventory ₦40,000,000 Receivable ₦45,000,000
2. Goodwill had been estimated at ₦45,000,000 but it should not be kept in the books.
3. Suppliers had given thepartnershipadiscountof₦6,000,000

You are required to prepare the following accounts:

(a) Revaluation Account
(b) Partners' Capital Accounts
(c) Statement of financial position immediately after the admission of Ekiti.

Solution 11.3

Goodwill was not shown on the Statement of Financial Position. The only reason for its estimation was to ensure that the old partners are compensated. Hence, the Capital Accounts of the old partners should be adjusted. In the same way, the net effect of the revaluation of the assets and liabilities should be for the benefits or to the detriment of the existing partners.

In writing off the goodwill, the new partner would be affected.

Revaluation Account

	N000		N000
Inventory	5,000	Plant &Machinery	130,000
Receivables	13,000	Motor Vehicle	15,000
		Goodwill	45,000
Capital Accounts: Share of Rev. profit		Suppliers(Payable)	6,000
Gyamfi	89,000		
Lawal	89,000		
	196,000		196,000
Goodwill Account	45,000	Capital Accounts:	
		Gyamfi	18,000
		Lawal	18,000
			9,000
	45,000	Ekiti	45,000

Partners Capital Accounts

	Gyamfi	Lawal	Ekiti		Gyamfi	Lawal	Ekiti
	₦000	₦000	₦000		₦000	₦000	₦000
Revaluation Account	18,000	18,000	9,000	Balance b/d	75,000	75,000	-
Bal. c/d	146,000	146,000	56,000	Bank	-	-	65,000
				Revaluation A/c	89,000	89,000	-
	164,000	164,000	65,000		164,000	164,000	65,000
				b/d	146,000	146,000	56,000

Gyarafi, Lawal & Ekiti

Statement of Financial position(After the revaluation)

	N`000		N`000
Capital Accounts:		Non-current assets	250,000
Gyamfi	146,000	Plant & Machinery	
Lawal	146,000	Motor Vehicle	80,000
Ekiti	56,000		330,000
	348,000	Current Assets:	
		Inventories	40,000
Current Accounts:		Receivables	45,000
Gyamfi	20,000	Bank and Cash	69,000
Lawal	30,000		154,000
Ekiti	50,000		
Current Liabilities			
Payables	46,000		
Overdraft	40,000		
	484,000		484,000

11.5 RETIREMENT AND DEATH OF A PARTNER

A partner may retire from a partnership for many reasons. Indeed, when a partner dies, he has effectively retired from the partnership. For purposes of accounting, the reasons for retirement would not be important. Usually, the partnership deed, if it is properly drawn, would provide the necessary guidelines as to how the affairs between the partners should be settled. In the absence of specific guidance from the partnership agreement, the normal rules are as follows:

(a) Prepare a Profit and Loss Account to the date of retirement/death. Note that retirement/death might not coincide with the end or beginning of the accounting period. Hence the results of the operation to the date of retirement/death must be shared i.e. credited to the partners Capital Accounts in their profit sharing ratios. If the result is a loss, the partners Capital Accounts must be debited accordingly;

(b) Transfer the balance on the current account of the retiring partner to the Capital Account;

(c) Credit/debit the outgoing partner with his share of the difference between the net revalued amount of the assets and the book value; and

(d) Credit the outgoing partner with his share of goodwill of the firm, if any.

The credit balance on there tiring partner's account becomes a liability to the firm which should be settled. The partnership deed would give an indication of how the settlement of the retiring partner should be dealt with.

Illustration 11.4

Yekini, Olu and Essien formed a partnership in 1990 and agreed to share profits or losses in the ratio 4:3:3. Olu decided to retire on 31/12/2023 due to both ill health and misunderstanding between the partners. The Statement of financial position as at 31/12/2023 was as shown below:

Statement of financial position as at 31/12/23

	¢m	¢m
Non-current Assets:		
Freehold Land and Buildings	540	
Machinery	180	
Office Equipment	45	
Motor Vehicles	105	870
Current Assets:		
Inventory	100	
Receivable	125	
Bank	23	
		248
Current Liabilities:		
Payables	158	
Bank Overdraft	30	188
		60
		930
Capital Accounts:		
Yekini		420
Olu		300
Essien		210
		930

The partners noted that the account did not reflect the following:

i. Interest on the following drawings should have been charged at5%.

	¢m
Yekini	60
Olu	60
Essien	60

ii. Interest on partners Capital Account at 6% had not been credited. Partners account for the purpose of the interest calculation was to be taken as follows:
Yekini ¢210m; Olu¢150m and Essien¢105m.

iii. Olu received ¢24million payable by cheque immediately.

iv. Goodwill was valued at ¢300million and was to be kept in the books.

v. Other assets and Liabilities were revalued as follows:
Freehold Land and Buildings ¢600million. Machinery ¢240million; Office Equipment ¢35million and Motor Vehicles ¢156 million.
Discount to be received from creditors amounted to ₦27million.
20% of the receivables was irrecoverable, whilst 15% of inventory was obsolete
balance due to Olu was to be kept in the firm as a loan.

Required:
Prepare the Revaluation Account, the Partners Capital Accounts and the Adjusted Statement of financial position on 31/12/2023.

Solution 11.4

Note the import of notes b, e, and f carefully

Revaluation Account

	¢m		¢m
Office equipment	10	Freehold land and building	60
	25	Machinery	60
	15	Motor vehicles	51
	448	Goodwill	300
		Payables	27
	498		498
Capital accounts:			
Yekumi (4/10)	179.2		
Olu (3/10)	134.4	Bal. b/d	448
Essien (3/10)	134.4		
	448.0		448.0

Partners' Capital Accounts

	Yekini	Olu	Essien		Yekini	Olu	Essien
	¢m	¢m	¢m		¢m	¢m	¢m
Interest on Drawings	3.0	3.0	3.0	Balance b/d	420.0	300.0	210.0
Bank		24		Revaluation A/c	179.2	134.4	134.4
Statement of income distribution	7.56	5.67	5.67	Interest on Capital	12.6	9.0	6.3
Bal. c/d	601.24	410.73	342.03				
	611.8	443.4	350.7		611.8	443.4	350.7
				Balance b/d	601.24	410.73	342.03

Yekini, Essien & Co
Statement of financial position as at 31/12/2023

Non-current Assets	¢m	¢m	¢m
Goodwill		300	
Freehold, Land and Buildings		600	
Machinery		240	
Motor Vehicles		156	
Office Equipment		35	1,331
Current Assets:			
Inventory	85		
Receivable	100	185	
Current Liabilities:			
Payable	131		
Bank Overdraft	31	162	
			23
			1,354

Non-current Liabilities (Loan)	(410.73)		943.27
Capital Accounts:			
Yekini 601.24			
Essien 342.03		943.27	

Workings:

Statement of Income Distribution

Interest on capital	¢m			Interest on drawing	¢m
Yekini	12.6			Yekini	3
Olu	9.0			Olu	3
Essien	6.3			Essien	3
					9
		Share of balance			
		Yekini	7.56		
		Olu	5.67		
		Essien	5.67		18.9
	27.9				27.9

11.6 AMALGAMATION OF PARTNERSHIPS

Two separate partnerships may decide to merge into one firm. The reasons may include the following: The partners of each firm believe that coming together would bring economies of scale or they might have worked together in the past, or the businesses are similar, or they are complimentary. It may often due to the existence of variety of skills, expertise and experience concentrated in one firm.

So far as accounting for the amalgamation goes, the main point to note is that the accounts of the two firms would need to be adjusted to ensure that the capital accounts are fairly stated in their individual books before the amalgamation.

In order to fairly state the balances of each partner's account, the assets may be revalued
And good will may need to be recognized. Let us illustrate some of the points

Illustration 11.5

Eghan and Adepate are partners in the firm of Egapate & Co. sharing profits and losses equally. Shola and Boafo are partners in the firm of ShoBoafo & Co and share profits and losses in the ratio 3/5 amd 2/5 respectively.

The partners of each firm agree to amalgamate under the new name Ega Sho & Co. The profits and losses in the new firm will be shared as follows:

Eghan	25%
Adepate	30%
Shola	25%
Boafo	20%

Statement of financial position are:

	Egapate	ShoBoafo
	¢m	¢m
Non-current	120	160
Assets	8	24
Inventory	10	5
Cash	138	189
Capital accounts:		
Eghan	100	
Adepate	38	
Shola		99
Boafo		90
	138	189

For the purpose of the amalgamation, the assets were revalued as follows:

	Egapate ¢m	SholaBoafo ¢m
Non-Current Assets	180	200
Inventory	12	16
Goodwill	80	320

The new partnership does not want to show goodwill in its statement of financial position.
The capitals of the partners in the new firms are to be:

	¢m
Eghan	100
Adepate	150
Shola	300
Boafo	250

Required:

a. The Capital Accounts of the partners.

b. The Opening Statement of financial Position of Egasho & Co.

Solution 11.5
Before the amalgamation, it is necessary to adjust each partners account to reflect his true interest in the business. Since goodwill will not be shown in the books of the new partnership, the total goodwill (80+320) should be written off against the four partners in their new profit and loss sharing ratio. The question did not ask for a revaluation account but it will be advisable to prepare one.

Revaluation account of Egapate & Co.

	¢m		¢m
Capital account:			
Eghan	72	Non-current assets	60
Adepate	72	Inventory	4
		Goodwill	80
	144		144

Revaluation account of Shoboafo & Co.

	¢m		¢m
Inventory	8	Non-current assets	40
Capital accounts:			
Shola	211.2		
		Goodwill	320
Boafa	140.8		360

Partners' Capital Account

	Eghan	Adepate	Shola	Boafo		Eghan	Adepate	Shola	Boafo
	Ÿm	Ÿm	Ÿm	Ÿm		Ÿm	ÿm	ÿm	ÿm
Goodwill	100	120	100	80	Balances b/f	100	38	99	90
Balc/d	100	150	300	250	Revaluation	72	72	211.2	140.8
					Bank	28	160	89.8	99.2
	200	270	400	330		200	270	400	330
					b/d	100	150	300	250

Statement of financial position Egasho & Co.

	¢m
Non-Current Assets	380
Inventories	28
Cash	392
	800
Capital Accounts:	
Eghan	100
Adepate	150
Shola	300
Boafo	250
	800

11.7 Dissolution of Partnership

Partners of a firm may decide to dissolve the firm for various reasons. The reasons may include the following:

- The death of a partner
- The bankruptcy of a partner
- The lunacy of a partner
- The partnership can only be carried on at lose
- The partnership business becomes illegal/outlawed.

Whatever the cause of the dissolution, the following steps are necessary:

- Transfer all non cash assets to the Realization Account by debiting the Realization Account with the book value of the assets and crediting the Assets Accounts with the same.
- Debit the Realization Account with all relevant expenses and credit Cash or Bank Account.
- Debit Bank or Cash with proceeds on sale of assets and credit Realization Account.
- Assets taken over by any partners must be debited to the partners Capital Account and Realization Account credited with the agreed price.
- Pay off liabilities by crediting Bank or Cash and debiting the Liability Account. Any discount allowed by
  creditors must be debited to the Creditor's Accounts and credited to the Realization Account.
- Close the Realization Account to the Partner's Capital Accounts.
- Transfer the Partner's current accounts to their capital accounts, by debiting the Current Accounts and crediting Partner's Capital Accounts.
- Close off the Partner's Capital Accounts by paying the amount due to them or by Receiving the amount due from them.

Rule in Garner VS Murray
Where a partner becomes insolvent during dissolution of a partnership, the solvent partners must bear the deficiency of the insolvent partner in their last agreed capital ratio and NOT in their profit sharing ratio. The accounting treatment will be:

Debit– Solvent Partners Capital Accounts. Credit – Insolvent Partner Capital Account With the amount of the deficiency shared.

Let us illustrate the above points Illustration 11.6
John David and Ajomale have been partners for sometime, making up their account to 30th September every year. The following was their balance sheet as at 30th September 2021.

Non-current Asset	¢m	¢m	¢m
Leasehold Properties		550	
Motor Vehicles		220	
Furniture and fittings		150	
Current Assets:			
Inventories	420		
Receivables	350	770	
		1,690	
Current Liabilities			
Trade payables	390		
Bank Overdraft	91	481	
	289		
		1,209	
Loan from Amogu		(305)	
		904	
Capitals:			
John	225		
David	200		
Ajomale	275	700	
Current accounts:			
John	75		
David	50		
Ajomale	49	179	
		904	

The partners share profits and losses in the ratio 2:2:1. On 30 September 2006, they agreed to dissolve the partnership. John took over one of the vehicles which had a book value of ¢80m at a valuation of ¢150m. Mr. Ajomale took over half of stock for ¢250m.The lease hold properties, the remaining vehicle, fixtures and fittings realized ¢720m. Receivable realized ¢320m.After paying the trade payables in full, the partners received the monies due them on capital account or paid what was due to the firm from them.

Required:

1. Show the Realization Account
2. The Bank Account
3. The partner's Capital Accounts

Solution to Illustration 11.6

Realization Account

	¢m		¢m
Sundry Assets:			
Leasehold Properties	550	Capital Accounts:	
Motor Vehicle	220	Assets taken over	
Furniture and Fittings	150	John	150
Account Receivables	350	Ajomale	250
Stocks	420		
		Bank:	
		Sundry Assets	720
		Account Receivables	320
		Capital Accounts:	
		Share of loss	
		John (2/5)	100
		David (2/5)	100
		Ajomale (1/5)	50
	1,690		1,690

Partners' Capital Accounts

	John	David	Ajomale		John	David	Ajomale
	¢m	¢m	¢m		¢m	¢m	¢m
Assets taken over	150	-	250	Balance b/d	255	200	275
Realization	100	100	50	Current A/c	75	50	49
Bank	80	150	24				
	330	150	324		330	250	324

Bank account

	¢m		¢m
Sundry assets	720	Balance b/d	91
Account receivables	320	Loan account	305
		Account payable	390
		Partners	
		Accounts: John	80
		David	150
		Ajomale	24
	1,040		1,040

11.8 Conversion of a Partnership to a Limited Company

When a partnership is converted to a Company, the partnership is dissolved. The former partners may become shareholders in the company or not. The price put on the firm is known as the purchase price or the purchase consideration. The purchase consideration can be settled by cash, by issue of shares to the partners or by issue of debentures. It could also be partly by cash and shares or partly by shares and partly by debentures. It could also be partly by cash and shares or partly by shares and partly by debentures or by a combination of the three. In order to retain their comparative positions in the shareholding in the new company, the shares could be divided in the partners‟ profit sharing ratio and the balances in their capital accounts are settled through either cash being paid by or received from the dissolution.

It is obvious that since the partnership would cease forth with, the Realization Account and the Capital Accounts of partners would be used. Indeed, the accounting treatment of the sale of the partnership would be akin to the entries passed when considering the dissolution of partnership.

Note that the settlement of the purchase would cease forthwith, the Realization Account and the Capital Accounts of partners would be used. Indeed, the accounting treatment of the sale of the partnership would be akin to the entries passed when considering the dissolution of partnership.

Note that the settlement of the purchase consideration would necessitate the following:

1. Treat the purchaser as a Receivable: That is, debit the Purchaser and credit the Realization Account.
2. Payment by cash. Debit Bank Account and Credit the Purchaser
3. Payment by issue of shares. Debit Ordinary Shares in Purchaser Name and Credit
4. the Purchaser.
   Payment by issue of loan notes. Debit loan notes in Purchaser's Name and Credit Purchaser.
5. Closure of Partners Capital Account.

Debit Partners' Capital Accounts and Credit Bank, Ordinary Shares, Debentures in Purchaser's Account with appropriate amounts.

You should remember that in this instance the purchaser is a limited liability company. Let us illustrate the bookkeeping aspects with a question.

Illustration 11.7

Olu, Mosho and Aryee have been in partnership for several years sharing profits and losses in the ratio5:3: 2respectively. On1/1/2022 they decided to convert their business into a limited liability company Olumosho Ltd, on the same date. The statement of financial position at the close of business on 31/12/2021 was as shown below:

Statement of Financial Position as at 31/12/2005

		Olu	Mosho	Aryee		
Total						
		¢000	¢000	¢000		¢000
Capital Account		36,000	24,000	18,000		78,000
Current Account	1,560		1,920	840	4,320	
Loan	2,000		2,000	2,000	2,000	
	39,560		27,920	20,840	88,320	

Freehold buildings	36,000
Vehicles(Cost less Depreciation)	14,400
Equipment(Cost Less Depreciation)	7,500
Inventories	18,375
Receivables(Less provision for doubtful debt)	14,445
Bank	6,600
	97,320
Less Payables	9,000
	88,320

Apart from the cash and one of the vehicles, all assets and liabilities were taken over by the company. Mr. Aryee took over one of the vehicles at a valuation of ¢6,000,000.The purchase consideration was calculated as follows:

	¢000
Freehold buildings	69,000
Vehicle	7,200
Equipment	4,800
Inventories	12,000
Receivable	13,800
Goodwill	24,000
	130,800
Trade payables	9,000
	121,800

The company was to issue fully paid shares of ¢1,000 each to meet the purchase consideration.

Required:
Close the books of the partnership on the assumption that realization expenses was ¢5,000,000.

SolutiontoIllustration11.7

Realization Account

	¢000		¢000
Expenses	5,000	Capital(Car taken over by Aryee)	6,000
Freehold buildings	36,000		
Vehicles	14,400	Olumosho–Ltd	
Equipment	7,500	Purchase Consideration (PC)	1 21,800
Inventories	18,375	Trade payables	9,000
Receivables	14,445		
Bal c/d	41,080		
	136,800	Balb/d	136,800
			41,080
Capital Accounts			
Olu (5/10) 20,540			
Mosho (3/10) 12,324			
Aryee (2/10) 8,216	41,080		
	41,080	Account	41,080

Olumosho Ltd

	¢000		¢000
Realization(PC)	121,800	Shares in Olumosho Ltd Account:	121,800
		Olu 60,900	
		Mosho 36,540	
	121,800	Aryee 24,360 121,800	

Shares in new Olumosho's Ltd Account

	¢000		¢000
O lumosho Ltd	121,800	Partners Capital Accounts:	
		Olu (5/10)	60,900
		Mosho (3/10)	36,540
		Aryee (2/10)	24,360
	121,800		121,800

Partners' Capital Accounts

	Olu	Mosho	Aryee		Olu	Mosho	Aryee
	¢m	¢m	¢m		¢m	¢m	¢m
Realization–Car	-	-	6,000	Balance b/d	36,000	24,000	18,000
Shares Olumosho	60,900	36,540	24,360	Current A/c	1,560	1,920	840
Banka/c	-	1,704	-	Realization	20,540	12,324	8,216
	60,900	38,244	30,360	Cash	60,900	38,244	30,360
				Bank a/c	2,800	3,304	3,304
					60,900	38,244	30,360

Bank Account

	¢000		¢000
Bal.b/f	6,600	Realisation Expenses	5,000
Olu‟s Capital A/c	2,800	Partners Loan A/cs	6,000
Aryee‟s Capial A/c	3,304	Mosho‟s Capital A/c	1,704
	12,704		12,704

11.9 Chapter Summary

Surpluses and deficits on revaluation will be transferred to a revaluation account. The balance on this account must be shared between the partners in their profit sharing ratio.

Goodwill is an intangible asset; it is the value placed upon the ability of an organization to earn supernormal profits. Any value placed on unrecorded goodwill can be adjusted for by contra entries on the partners‟ capital accounts.

If there is a change in partnership pathway through an accounting period, the profit up to the date of the change will be shared between the old partners in accordance with the old agreement.

Note that a realization account will record the book values of assets disposed of and the proceeds realized. The profit or loss on disposal will be shared between the partners in their profit sharing ratio. The partners‟ capital accounts will be debited with the value placed upon assets they receive from the firm and with the final cash settlement.

11.10 Multiple Choice and Short Answer Questions

Usethefollowinginformationtoanswerquestions1and2.

Shola and Bada are in partnership and share profits in the ratio 2:3 on 1 September 2021, a new partner; Carol joins the business introducing N24 million capital.

The following also took place at this date

A. GoodwillisvaluedatN80million
B. The profit share ratio is to be 3:6:1
C. Propertyisre-valuedupwardsbyN70 million

Shola had a balance of N90m credit prior to adjusting the accounts. Goodwill is not retained in the business.

1. Calculate the total amount of goodwill and revaluation surplus credit into Bada‟s Capital Account.

A. N32m
B. N42m
C. N48m
D. N60m
E. N90m

2. What is the balance in Shola's Capital account after all adjustment?

A. ₦112m
B. ₦118m
C. ₦126m
D. ₦136m
E. ₦150m

Use the following information to answer questions 3 and 4
Joe, Okon and Koko were in partnership, sharing profits in the ratio1:1:2respectively.
The capital balance after the partnership was dissolved and all accounts closed were:

Joe ₦40 million Credit Okon ₦60 million Credit Koko ₦50 million Debit

3. State how Koko's debit balance should be accounted for if he is not insolvent.
4. How much would Joe contribute to the deficiency of Koko, assuming that Koko is insolvent?
5. When a partnership is converted to a Company, the purchase consideration could be inform of (i) Cash and (ii)……
6. What is the accounting entry for asset taken over by a partner, when a partnership is dissolved? When a partner retires, the balance in his capital account after all adjustments has been completed is transferred to… account.

11.11 SOLUTIONS

1. B

2. C
3. Koko deficit would be settled from the surplus in his private estate
4. N20million (40/100x N50m)The rule in Garner V Murray
5. Ordinary Share Capital account
6. Debit the partner's Capital account Credit the Realisation account
7. Bank Account

Tutorial
Question1 Bada

Share of goodwill $^{3}/5$ x $^{80}/1$	=	48
Share of revaluation surplus $=^{3}/5x^{70}/1$		42
		90
Goodwillwrittenback$^{6}/10$ x 80		48
		42

Capital b/f	90
Share of Goodwill 2/5x 80	32
Shareofsurplus2/5x70	28
Goodwill written back=3/10x80	(24)

CHAPTER TWELVE
ACCOUNTING FOR INVENTORIES

Chapter contents

a) Nature of inventories
b) Determination of cost of inventories
c) Valuation of inventories
d) Computing claims for loss of inventories

12.0 Objectives

At the end of this chapter, the readers will be able to

i. Determine the nature of inventory
ii. Determine the cost of inventories
iii. Recognise an expense, including any write-down to net realisable value.
iv. Identify and apply the cost formulas that are used to assign costs to inventories
v. Understand the procedures for computing a claim for loss of inventory

12.1 Definition of an Inventory

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

12.2 Cost of Inventories

Cost should include all:

- Costs of purchase (including taxes, transport, and handling) net of trade discounts received
- Costs of conversion (including fixed and variable manufacturing overheads) and
- Othercostsincurredinbringingtheinventoriestotheirpresentlocation and condition

12.3 Cost of Purchase

Cost of purchase is the invoice price. It should be exclusive of recoverable VAT, trade discounts, rebates etc. but inclusive of import duties, transport and handling costs, non-recoverable taxes and any other directly attributable costs.

Illustration12.1

Kofi Ltd (which is registered for VAT) purchased 10,000units of raw materials from Kofi on credit on 31 October 2024. The invoice details were as follows:

	GH₵
10,000 units of product Kofi	100,000
Less trade discounts@5%	(5,000)
	95,000
Transport and handling costs	8,000
	87,000
VAT @7.5% (~~₦~~95,000x7.5%)	7,125
Total invoice price	79,875

Required:

Show how Kofi Ltd should record the purchase of raw materials. Solution to Illustration 12.1
Kofi Ltd should be record the purchase of raw materials in its nominal ledger as follows:

	Dr	Cr
	GH₵	GH₵
Raw materials purchased	95,000	
VAT– statement of financial position		7,125
Trade payables		79,875

12.4 Conversion cost

- Costs of conversion include costs directly related to the units of production, such as direct labour;
- Systematically, allocated fixed (such as depreciation) and variable production overheads(such as indirect materials and indirect labour) incurred in producing finished goods; and
- Other costs like design and borrowing costs.

Fixed production overheads are allocated to the costs of conversion based on the normal capacity of the production facilities. Any unallocated fixed overhead cost is expensed in the period it is incurred. Normal capacity is the production expected to be achieved on average over a number of periods over a number of periods under normal circumstances.

Costs of conversion will be incurred in respect of work in progress and finished goods, both of which are added to as part of the production process

12.5 Costs excluded from valuation of inventory

Under IAS2, the costs that are excluded from inventory include:

i. Abnormal costs that are incurred as a result of material waste, labour or other production conversion (overheads) costs;
ii. Storage costs (unless required as part of the production process),
iii. Administrative overheads; and
iv. Selling costs.

These excluded costs are treated as expenses and recognised in the statement of profit or loss during the period in which they are incurred.

12.6 General Principle for Valuation of Inventory

IAS2 requires that inventory should be valued at the lower of cost and net realisable value (NRV).

Net Realisable Value (NRV) is defined by IAS2 as the selling price less:

i. All further costs to completion; and
ii. The estimated costs necessary to make the sale.

These estimates are based on the most reliable evidence at the time the estimates are made.

To arrive at these estimated values, the reasons for holding the inventories should be taken into account. Inventories are usually written down to NRV based on the following principles:

i. Items are treated on an item-by-item basis not on total inventory
ii. Similar items are normally grouped together

NRV of inventories may be lower than their costs due to the following reasons:

i. Inventories are damaged;
ii. Inventories have become obsolete;
iii. Selling prices of the goods have fallen.
iv. A decision as part of a company's marketing strategy to manufacture and sell Products at a loss
v. Errors in production or purchasing

12.7 Accounting for write down on inventory

The amounts of any write down of inventories to NRV and all losses of Inventories are recognized as an expense in the period the write down occurs.

Illustration 12.2

In year ended 30 June 2025, the cost of the inventory of a beverage company ₦34m but the NRV was ₦32.8million.

Explain the effect of the write down in the financial statements for the year ended 30 June,2024.

Solution to Illustration 12.2
In the year ended 30 June,2025, the company write down the inventory by ₦1.2m that is, to the NRV of ₦32.8m. Inventory will decrease by ₦1.2m while cost of sales will also increase by ₦1.2m
Dr. Cost of sales with ₦1.2m Cr. Inventory with ₦1.2m

When the goods produced with raw materials which net realizable value is less than the cost, the value of raw materials is not reduced below cost only if the NRV of the goods produced is not greater than the cost.

Illustration 12.3

Liam plc has 100 units of raw material in inventory at 31 July 2024. These cost a total of ₦30,000. Since purchasing the material, the purchase price has dropped to ₦19,000. However, the material will be incorporated into a final product which is expected to sell for ₦75,000 after further conversion costs of ₦25,000 are incurred. At what amount should the inventory be carried in the Financial statements for reporting date 31July, 2024?

Solution to Illustration 12.3
Here, the cost of the raw material is ₦30,000. The NRV of the raw material is ₦19,000. However, the NRV of the completed product in its current state is ₦75,000– ₦25,000= ₦50,000. This is in excess of its cost, hence the appropriate accounting value for the raw material is its cost, ₦30,000

12.8 Methods of calculating cost of inventories:

There are various methods for calculating cost of inventory, but we shall deal with three acceptable ones under IAS 2.

i. Specific identification method: This is the actual cost of purchasing identifiable units of inventory. This method can only be used when item of inventory is individually distinguishable and of high value
ii. First-in-first-out method (FIFO): This method is based on the assumption that the first goods acquired is first sold. Each sale is made out of the oldest goods in the store, while the closing inventory consists

of goods most recently acquired
.

Advantages of FIFO method

The inventory valuation reflects recent costs and it provides a realistic value of the inventory balance recognised in the statement of financial position.

iii Weighted Average Method (WAC)

The cost of goods sold per unit is computed by dividing the number of the total cost of goods available for sale by the number of units of the goods available for sale. Then the unit cost is multiplied by the units of the goods not yet sold, to obtain the value of closing inventory. The methods produce different closing inventory, hence they produce different profits

Illustration12.4
Flomo Limited purchases and sells identical articles. The table below shows the inventory movement in the store. The company's accounting period ends on December 31, each year.

Month	Quantity Purchased	Unit Price Le	Quantity issued
Brought forward	150	100	
February 2020	350	150	
April 2020			340
June 2020	440	180	
August 2020			420
October 2020	420	210	
December 2020			360

Required: Present a table of the inventory keeping from January to December 2020 and show the cost of inventory on December 31, 2020, Using first-in-first-out and weighted average method.

SOLUTION TO ILLUSTRATION 12.4

Flomo Limited

Date	Receipts			Issued			Balance		
2020	Qty	Unit Price	Value	Qty	Unit Price	Value	Qty	Unit Price	Value
		Le	Le		Le	Le		Le	Le
01/02	150	100	15,000	-	-	-	150	100	15,000
28/02(i)	350	150	52,500	-	-	-	500		67,500
31/04	-	-	-	150	100	15,000	150	100	15,000

3	-	-	-	190	150	28,500	190	150	28,500
(ii)				340		43,500	(340)		(43,500)
(i-ii)							160	150	24,000
31/06 (iii)	440	180	79,200	-	-	-	600		103,200
31/08	-	-	-	160	150	24,000	160	150	24,000
	-	-	-	260	180	46,800	260	180	46,800
(iv)							(420)		(70,800)
(iii-iv)							180	180	33,400
31/10 (v)	420	210	88,200	-	-	-	600		121,600
31/12	1,360	-	234,900	180	180	33,400	180	180	33,400
				180	210	43,200	180	210	43,200
(vi)							(360)		(76,600)
Closing inventory(v-vi)			-				240	210	50,400

Inventory ledger account, using weighted average cost

At 31 December 2020, the cost of goods available for sale is Le234,900 while the closing inventory is Le50,400, hence the cost of goods sold is Le184,500

Flomo Limited

Date	Receipts			Issued			Balance		
2020	Qty	Unit Price	Value	Qty	Unit Price	Value	Qty	Unit Price	Value
		Le	Le		Le	L$		Le	Le
01/02	150	100	15,000	-	-	-	150	100	15,000
28/02	350	150	52,500	-	-	-	350	150	52,500
	-	-	-	-	-	-	500	135	67,500
31/04	-	-	-	340	134	45,900	(340)	135	(45,900)
	-	-	-	-	-	-	160	135	21,600
31/06	440	180	79,200	-	-	-	440	180	79,200
	-	-	-	-	-	-	600	168	100,800
31/08	-	-	-	420	168	70,560	(420)	168	(70,560)
	-	-	-	-	-	-	180	168	30,240
31/10/	420	210	88,200	-	-	-	420	210	88,200
Purchases	1,210	-	219,900	-	-	-	600	197.4	118,440
31/12	-	-	-	360	197.4	71,064	(360)	197.4	(71,064)

Closing inventory	-				240	197.4	47,376

Inventory ledger account, using weighted average cost

At 31 December 2020, the cost of goods available for sale is Le234,900 while the closing inventory is Le47,376 hence the cost of goods sold is Le187,524 .

Conclusion: The closing inventory under FIFO is higher than that of weighted average because of rising prices.

12.9 Methods of recording inventory

After purchase, in order to prepare a statement of profit or loss, it is important to compute gross profit. This is done by comparing the sales revenue from items of inventory to the cost of those items. To arrive at the cost of the items sold, there is need to record opening inventory, purchases and closing inventory. There are two methods of recording inventory. They are periodic inventory method and perpetual inventory method.

i. Periodic Inventory methods

The periodic system uses end of period physical count to measure the level of inventory and the cost of goods sold (COGS). Goods purchased are recorded in the purchases account. The inventory account and the cost of goods sold account are updated at the end of the period. When cost of goods sold is subtracted from revenue, it shows a company's gross margin. Using the **Flomo Limited** example under average weighted approach, cost of goods sold under the periodic inventory system is calculated as follows:

	Le
Opening inventory	15,000
Purchases	219,900
	234,900
Closing inventory	(47,376)
Cost of Goods Sold	187,524

ii Perpetual Inventory methods

By contrast, the perpetual system keeps track of inventory balances continuously, with updates made automatically whenever a product is received or sold. Purchases and returns are immediately recorded in the inventory account. As long as there is no theft or damage, the inventory account balance should be accurate. The cost of goods sold account is also updated continuously as each sale is made. Perpetual inventory systems use digital technology to track inventory in real time using updates sent electronically to central data bases

Entries to link to statement of profit or loss

Two ledgers are involved; the purchases ledger to record purchases during the year and inventory ledger to record inventory at beginning and inventory at the end.
Purchases during the year

	Dr Le	Cr Le
Purchase account	219,900	
Cash or liability account		219,900

At the end of the period or year, the two accounts are closed to extract trial balance. The value in purchase account is transferred to cost of sales by these entries:

	Dr Le	Cr Le
Costs of sale account	219.900	
Purchase account		219,900

Physical inventory count takes place to establish the quantity of closing inventory; this is valued to know the amount to be included in financial statement. Closing inventory is brought to the ledger by the following entries:

	Dr Le	Cr Le
Inventory (statement of financial position)	47,375	
Cost of sales(statement of profit or loss)		47,375

Opening inventory will be brought forward balance from the previous period. This will be transferred to the statement of profit or loss by the following entries:

	Dr.	Cr.
Cost of sales (statement of profit or loss)		15,000
Inventory	15,000	

12.10 Accounting for loss of Inventory

The following procedures are normally followed in the determination of the inventory loss and the amount of claims from the insurance company.

a) Calculate the gross profit, % for the previous accounting period immediately before the period of the fire.

b) Prepare a trading account for the period of fire and insert the available data which are most likely to be:
   i. Opening inventory which is the closing inventory of the previous year brought forward
   ii Purchases made from the beginning of the year to the date of the incident
   iii Sales from the beginning of the period to the time of the fire

c) Apply the gross profit percentage calculated in (1) above to the sales figure in (2) To obtain gross profit made to the time of the incident.
d) Obtain cost of sales by deducting the gross profit from the sales
e) The inventory lost is equal to the amount obtained by this formula:

Inventory Lost= Opening Inventory +Purchases–Cost of Goods Sold.

Illustration 12.5
Gbago Enterprises sells artifacts. On 30 June 2021, the premises and the goods therein were destroyed by fire. Some artifacts valued at ₦30,000 and some financial records were removed through rescue efforts. The following information was extracted from the record:

Inventory: ₦'000

01/01/2020		1,750,000
31/12/2020		1,855,000
Purchases:		
For the	reporting	Dated 13,941,000
31/12/2020 Jan1 to 30June 2021		10,529,000
Sales:		
For the reporting dated 31/12/20		19,200,000

January–June 30,2021 14,356,000

The gross profit percentage in 2021 was the same as those disclosed for the reporting dated 31 December 2020. You are to compute the claims to be presented to the insurance company.

SOLUTION TO ILUSTRATION 12.5

Computation of Gross Profit Percentage for the reporting dated 31 December 2020

	₦'000	₦'000
Sales		19,200
Opening inventory	(1,750)	
Purchases	(13,941)	
	(15,691)	
Closing inventory	1,855	
Cost of goods sold		(13,836)
Gross Profit		5,364

Gross Profit % = $\frac{5364}{19,200} \times \frac{100\ \%}{1}$

=28%

Computation of Inventory on 30 June 2021

	N'000	N'000
Sales		14,356
Opening inventory	1,855	
Purchase	10,529	
Goods available for sale	12,384	
Closing inventory	2,048	
Cost of Goods Sold		(10,336)
Gross Profit (28% x 14.35m)		4,020

Insurance Claim

Inventory ar the time of fire 2,048
Inventory salvaged (300)
Claims 1,748

Note:
The gross profit is deducted from sales to obtain cost of sales.

	N'000
Sales	14,356
Cost of sales	10,336
Gross profit	2,048

2) Cost of goods available for sale 12,384
Cost of sales (10,336)
Close inventory 2,084

12.11 Inventory Adjustment

In order to get the normal gross-profit percentage of the previous period, the value and the sale proceed of inventory written down must be segregated from the normal inventory during the period.

a) The proceeds from the sales of inventory must be removed from the total sales figure.
b) The value of the inventory at its written down value must also be removed from the value of the opening inventory.

c) If any part of the inventory was sold in the previous accounting period, the proportion not yet sold is multiplied into the inventory at its written down value and the results is deducted from the closing inventory of that period.
d) The amount realized from the inventory written down in the year of fire incident is deducted from the sales proceed for the period.
e) The unsold part of the written down inventory is added to the inventory at the date of i incident
f) The other steps as in illustration would then be applied to arrive at the inventory cost.

Illustration 12.6
Bonjour Enterprises sells footwear and prepares accounts to 31 December annually.
The store was destroyed by fire on 30 June 2020. However, some records were saved from which the following information was obtained:

	₦'000
Valueofinventory 1/1/2019	19,200
Valueofinventory 31/12/2019	20,000
Purchasesforthey ear2019	164,665
From1/1/2020– 30/6/2020	107,125
Salesfortheyear20 19	233,965
From1/1/2020to30/6/2020	156,500

The value of inventory 1/1/2019 was inclusive of certain goods bought for ₦2,400,000 but were valued at half the purchase price because the expiry date was approaching. During the reporting dated 31 December 2019, one half of these goods were sold for ₦788,000 and further one-quarter sold during the period to June 2020 realizing ₦150,000. The proceeds have been included in the sales figure shown above. The remainders were yet to be sold when the fire incident occurred. The value of goods undamaged amounted to ₦4,875,000.

Required:

Calculate the value of the inventory consume by fire assuming the same profit percentage as that of the reporting dated 31 December 2019.

SOLUTIONTOILLUSTRATION 12.6

Computation of Gross Profit Percentage for the reporting dated 31 December 2019

	₦'000	₦'000
Sales(w1)		233,177
Opening inventory(w2)	18,600	
Purchases	164,665	
	183,265	
Closing inventory	19,700	
Cost of goods sold		(163,565)
Gross Profit		69,612

Gross Profit % = 69,612 x 100 % =29.9%
233,177 1

Determination of inventory on 30 June 2020

Sales		156,500
Opening inventory	19,700	
Purchases	107,125	
Goods available for sale	126,825	
Closing inventory	17,745	
Cost of goods sold		(109,080)
Gross Profit (28% x 14.356m)		47,420

Untold inventory written = ¼ x N1.2m

	N'000
Value of inventory on 30 June 2020	47,420
Add unsold inventory written down	300
Estimate value of stock lost	47,720
Less inventory sold	150
Value of inventory destroyed	47,570

Working Note:

1. Sales proceed of goods sold at normal selling price

	N'000
Total sales for the reporting date 31/12/19	233,965
Less value of inventory written down	
½ x ₦2.4m	(788)
Sales proceed at normal selling price	233,177

2. Opening inventory to be sold at normal price

	₦'000
Value of opening inventory	19,200
Less value of inventory w/Down	
½ x ₦1.2m	(600)
Goods to be sold at normal price	18,600

3. Total value of closing inventory	20,000
Less value of remaining inventory w/Down	
¼ x ₦1.2m	(300)

Goods to be sold at normal price	19,700	
Total sales 1/1/20– 30/6/20	156,500	
Less proceeds from sale of inventory w/Down	(150)	
Sales proceeds of goods at normal s/price	156,350	

12.11.1 Amount insured is less than Insurable Amount

We have assumed all along that the amount insured is equal to or greater than the insurable amount, therefore, the amount calculated represents the amount due from the insurance company. However, if the amount insured had been less, the claim would have been averaged.

Illustration 12.7

Assume that in the above illustration 9.6, Bonjour took insurance cover for loss of inventory for ₦40million, calculate the amount of claim from the insurance company.

Solution to 12.7

$$\text{Claim} = \frac{\text{Amount of Insurance}}{\text{Estimated Value of Inventory}} \times \frac{\text{Inventory Lost}}{1} = \frac{₦40{,}000}{₦47{,}720} \times \frac{₦47{,}570{,}000}{1} = ₦39{,}874{,}000$$

12.12 Effect of Cut-Off Point on Inventory Valuation

The cut-off point may not coincide with the accounting reporting date of an entity, but sales and purchases of inventory must continue.

a. The accounting issues are that the goods that were sold after the cut-off date but before the reporting date will be regarded as sales and they should be excluded from the inventory at the reporting date.

b. All goods that were purchased after the cut-off point but before the reporting date must be included in the valuation of inventory.

c. The returns of goods would also be affected. Returns inwards should be included as part of sales while returns outwards are excluded.

d. If the value of the closing inventory falls below the cost at the cut-off date, the net realizable value should be recorded. The difference between the net realizable value and the cost should be expensed in the income statement.

12.13 Chapter Summary

Inventory losses occur in an entity in a number if situations such as when goods are sent on consignment, on sale or return basis or even as a result of theft, fire incidence and adverse weather for stock items in the warehouse. Fire outbreak is the most disastrous of all the causes of stock loss and the risk is transfered to insurance companies by taking loss of stock insurance policy. The accounting issue involved is how to calculate the cost of stock destroyed by fire to be able to process necessary claim from the insurance company. It is important to ascertaining cut-off point to be able to determine what should constitute the components of stock loss valuation.

12.14 End of chapter questions

1) The following information appears in the inventory records of Lemon Plc on 31 March 2022.

Item	Quantity Units	Cost per unit ₦	NRV per unit ₦
P	150	300	420
Q	175	400	350

1. Under IAS 2 *Inventory*, what amount should be reported as inventory in current assets in the statement of financial position as at 31 March 2022?

   A. ₦97,500
   B. ₦106,250
   C. ₦113,750
   D. ₦125,125

2. How much should be charged to the statement of profit or loss during the reporting date 31 March, 2022?
   A. ₦8,750
   B. ₦9,250
   C. ₦18,000
   D. ₦26,750

3. Which of the following is NOT required to be disclosed under IAS2, Inventory?
   A. Accounting policies adopted for measurement of inventory
   B. Physical count of inventory at the end of the period
   C. Amount of inventories recognized as expense during the period
   D. Carrying amount of inventories pledged as security for liabilities
   E. Carrying amount of inventories carried at fair valueless cost of sell

4. In accordance with IAS-2 Inventories, which of the following costs should be included in the valuation of inventories of a manufacturing company?
   A. Carriage outwards
   B. Carriage inwards
   C. General administrative overheads
   D. Depreciation of land and buildings
   E. Discount allowed

Which of the following is NOT a component

5. In preparing the statement of profit or loss , which of the following is deducted from goods available for sale to arrive at cost of sales?
   i. Inventory sold
   ii. Closing inventory
   iii. Lost inventory
   iv. Inventory withdrawn by owner
   A. I and II
   B. II and III
   C. II and IV
   D. I, II and III
   E. II,III and IV

6. At the end of an accounting period, the cost of a company's inventory is ₦900,000. This Includes damaged items with a cost of ₦40,000 which are expected to be sold for only ₦20,000; At what amount should the inventory be recognised.

7. The inventory items which are sold or consumed are those acquired longest ago; which cost formula is described by this statement?

12.15 Solution to end of chapter questions

1. B
2. A
3. B
4. B
5. E
6. N900,000-N40000 +20000 = N880,000
7. First in first out method

12.16 Examination type question

Jayek Limited is a manufacturer of plastic buckets. On1 January,2018 Jayek Limited held 15,000 plastic buckets at ₦11,865,000. During the year ended 31 December 2018, Jayek Limited produced 120,000 plastic buckets, compared to a normal production level of 150,000 plastic buckets. 12,000 plastic buckets' inventories were held at 31 December 2018.

Production costs for the year were as follows:

	₦
Raw materials	42,000
Direct labour	2,000
Variable overheads	14,040
Fixed overheads	25,950

At the reporting date, net realizable value of the plastic buckets is higher than cost.

Required:
Using First-in-First-Out method within the context of IAS 2 Inventory, calculate the cost of plastic buckets sold during the period.

2. Overcome PLC applied the weighted average cost (WAC) method to inventory valuation up to the year ended 31 December 2019. The retained earnings on 31December 2019 and 31 December 2018 were ₦163million and ₦297million respectively.

During the year ended 31 December 2020, the company changed from WAC to FIFO method. The value of inventory under each method was as follows:

In the year ended 31December 2020 and the comparative figures for 2019 are as follows

	FIFO	WAC
	₦'m	₦'m
As at 31 December, 2018	120	108
As at 31 December,2019	152	144
As at 31 December,2020	161	152

The statement of profit or loss for the year ended 31December 2020 and the comparative figures for 2019 are as follows

	2020	2019
	₦'m	₦'m
Revenue	1,124	643
Cost of goods sold	(450)	(230)
Gross profit	674	413
Operating expenses	(300)	(120)
Profit before tax	374	293
Income tax expense	(135)	(59)
Profit for the period	239	234

Dividends paid	110	100

You are required to prepare

a. The adjusted statement of profit or loss for the year ended 31 December, 2020 and 2019 using FIFO method.
b. The movement in retained earnings as it would appear in the statement of changes in equity for the year ended 31 December 2020 and 2019; under WAC and FIFO.

12.17 Solution to examination type questions

1. Units	unit cost	Total cost
	₦	₦'000

Opening inventory	15,000	791	
	11,865		
Cost of goods produces	120,000	815	
	97,800		
Cost of goods available for sale	109, 665	135,000	
Closing inventory	(9,780)	(12,000)	815
Cost of goods sold	99,885	123,000	

Cost per unit of goods produced during the period

	₦
Raw materials (42,000,000/120,000)	350
Direct labour (21,000,000/120,000)	175
Variable overheads(14,040,000/120,000)	117
Fixed overheads(26,950,000/150,000)	173
Cost of plastic buckets produced during the period	815

i. Note that fixed overhead is absorbed into production at the normal units of output and not based on the actual units produced.

	₵	₵
Inventory at cost	971,040	
Cost of damaged inventory		31,620
NRV-selling priceless cost of sale 8,160-1,15		(7,004)
Amount written down on damaged inventory		(24,616)
Value of closing inventory		946,424

b. If the total cost has been recognized in the financial statements, then adjustment must be made for the amount written down

Dr .	Cost of goods sold	24,616
Cr.	Inventory	24,616

Conclusion: Cost of goods sold will increase by ₵24,616 while the inventory to be reported in the statement of financial position will reduce by the same amount.

1. Statement of profit or loss for the years ended 31 December 2020, using FIFO

	2020	2019
	₦'m	₦'m
Revenue	1,124	643
Cost of goods sold(Seenote1)	(441)	(222)
Gross profit	683	421
Operating expenses	(300)	(120)
Profit before tax	383	301
Income tax expense	(135)	(59)
Profit for the period	248	242

Statement of changes in equity(extract)for the period ended 31 December 2020, using WAC

	2020	2019
	₦'m	₦'m
Balance b/d	297	163
Profit for the year	239	234
Dividend paid	(110)	(100)
Retainedprofits31December	426	297

Statement of changes in equity (extract) for the year ended
31 December 2020, using FIFO

	2020	2019
	₦'m	₦'m
Balance b/d	317	163
Change in accounting policy(Seenote2)	----	12
Restated balance b/d	317	175
Profit for the year	248	242
Dividend paid	(110)	(100)
Retained profits 31 December	455	317

Tutorial Notes:

1. Higher closing inventory value under FIFO is a reduction in cost of sales. So, if the FIFO method had been used from year 2018 instead of the WAC method, then cost of sales could have reduced by the differences between the two valuations.
2. In year one (2018) the value of closing inventory increased by ₦12million;in the same vein, it increased by ₦8million and ₦9 million in years 2 (2019) and 3 (2020) respectively.
3. These differences would be adjusted retrospectively; that is with effect from year 2018. Financial statements are produced for the current year with the comparative statements for the preceeding year, hence all adjustments were made in the2019 and 2020.
4. The cumulative effect (₦12million) of the change in accounting policies before 2019, (that is 2018), was made on the retained earnings of 2019. The other changes were adjusted in the statements of profit or loss of the year in which they occur.
5. The change to FIFO method increased retained earnings by a total of ₦29million (₦455m-₦426m)

CHAPTER THIRTEEN
COMPANIES FINANCIAL STATEMENTS

Chapter contents
a. Introduction
b. basic principles required for preparing financial statements.
c. components of financial statements-
d. financial statement of sloe trader partnership and companies
e. statement of profit or loss and other comprehensive income
f. statement of changes in equity
g. statement of financial position
h. notes to the financial statements
i. statement of cash flows
J. differences between IAS 1 – presentation of financial statements and IFRS18- presentation
And disclosure of financial statements

13.0 Objectives

At the end of this chapter readers should be able to:

- State the components of financial statement in accordance with IAS1
- Explain the basic principles for preparing financial statements
- Describe the general features of financial statements in accordance with the provisions of IAS1.
- Define and explain current and non-current assets and liabilities
- Explain the main items that are disclosed in notes to the financial statements in accordance with the provisions of IFRS
- Identify and explain components of statements of cash flows and distinguish between direct and indirect methods of preparing cash flows
- Differentiate between IAS 1- Presentation of financial statements and IFRS18 (new standard) – Presentation
- And disclosure of financial statements.

13.1 Introduction

To achieve the objective of providing information useful for economic decision, an entity shall present fairly.
The financial position, financial performance and cash flows to ensure transparency and comparability.
Transparency means representing events and transactions faithfully, reporting volatilities as they may arise not when management choose to report them. Therefore elements of financial information are reported in the financial statements when they meet the definition of recognition criteria for assets, liabilities etc as set out in the conceptual frame work for financial reporting.

Comparability means representing similar events and transections in the same manner and reporting different events and transactions differently. Financial statements becomes comparable with consistent application of the same accounting policies. Also comparability does not mean that all entities in the same industry must apply the same accounting policies to an item, for example COST vs REVALUTION model. If an entity consistently applies the cost model it becomes comparable with any other entity that consistently applies a revaluation model.

13.2 Basic principles required for preparation of financial statements

The following are the principles required for preparing financial statements of companies:

i. **Going concern** - Financial statements are prepared with the assumption that the entity will continue in operations for the foreseeable future. The foreseeable future of an entity is a minimum of 12 months for which the entity's management must assess whether they have the intention to liquidate or cease operation.

ii. **Accrual basis**- The of events and transactions are recognized in the financial statements as they occurred not when cash is received or paid. An entity prepares its financial statements except statement of cash flows using the accrual basis of accounting.

iii. **Offsetting** – An entity shall not offset assets and liabilities or income and expenses, unless required or permitted by an International Financial Reporting Standards (IFRS) .

iv. **Materiality and aggregation**- An entity must present each material class of similar items separately in the financial statements. Items of dissimilar nature and functions should be presented separately, unless they are immaterial.

13.3 Components of financial statements

A company shall prepare with equal prominence a complete set of IFRS financial statements which comprise of the following:

i. Statement of profit or loss and other comprehensive income for the period;

ii. Statement of changes in equity for the period;

iii. Statement of financial position as the end of the period;

iv. Statement of cash flows for the period; and

v. Notes comprising. A summary of significant accounting policies and other explanatory information.

13.4 Financial statements of sole trader, partnership and companies

The same basic accounting approach is used in recording transactions of a sole trader, a partnership or a company. The preparation of financial statements of all the three used the same or similar process for preparation of their statements.

However, this chapter will only deal with the preparation of financial statements of companies while others will be dealt with in other chapters.

13.5 Statement of profit or loss and other comprehensive income

This statement provides information about the financial performance of an entity for the reporting period by presenting the income and expense of the entity. This statement is made up of two parts

a. Statement of profit or loss – this comprise list of expenses and income which results in a profit or loss for the period.

b. Statement of other comprehensive income- this comprise list of gains or losses that have arisen during the period

The statement represents non- owner changes in equity that is income and expenses for the period either in a single statement or inform of two separate statements as:

- Statement of Profit or Loss
- Statement of Other Comprehensive Income.

Entities are permitted under IFRS to present expenses either by NATURE or by FUNCTIONS, depending on whichever will provide more reliable or relevant information about the entity's financial performance.

NATURE OF EXPENSES PRESENTATION: expenses are classified according to their nature such as purchases of materials, depreciation and amortisation, employee benefits, marketing cots etc and are not reallocated to other functions within the entity.

Format of presentation by nature:

	N	N
Revenue		X
Other Income		X
Changes in. inventories of finished goods and WIP	X	
Raw materials and consumables used	X	
Employee benefits expenses	X	
Depreciation and amortization	X	
Other expenses	X	
Total expenses		(X)
Profit before tax		XX

FUNCTION OF EXPENSES PRESENTATION: expenses are classified according to their function such as cost of sales, if cost directly relates to generation of revenue, distribution or administrative expenses. A minimum classification should have costs of sales or direct costs and other operating expenses.

Format of presentation by functions:

	N
Revenue	X
Cost of sales	(X)
Gross profit	XX
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Profit before tax	XX

Income and expenses should be reported separately except where specifically permitted by another IFRS. For example
Finance costs should not be netted against finance income.

Other comprehensive income
Other comprehensive income presents items of income and expenses and reclassification adjustments that are not recognized in the profit or loss statements which include:

- Revaluation gains or losses from tangible and intangible assets
- Gains or losses on re- measuring of financial assets

Full format of statement of profit or loss and other comprehensive income

	N
Revenue	X
Cost of sales	(X)
Gross profit	XX
Other income	X
Distribution costs	(X)
Administrative costs	(X)
Other operational expenses	(X)
Finance costs	(X)
Profit before tax	XX
Income tax expense	(X)
Profit for the year	XXX
Other comprehensive income	
Gains /Loss on property revaluation	X/(X)
Fair value gain or loss on financial assets	X/(X)
Total comprehensive income	XXX
Total comprehensive income for the year	XXX

Illustration 13.1

The following is the extract of a trial balance of Lakuna Ltd prepared by a financial accountant and Management accountant of the company for the same period :

Trial balance extract prepared by the financial accountant

	DR (N'000)	CR(N'000)
Cost of sales	31,070	
Revenue		74,115
Distribution costs	18,465	
Other income		110
Other expenses	1,240	
Administrative expenses	19,505	

Trial balance extract prepared by the management accountant

	DR (N'000)	CR (N'000)
Revenue		74,115
Raw materials and consumables	27,825	
Increase in inventories of finished goods and WIP		430
Other income		110
Depreciation	7,665	
Staff costs	24,630	
Other operating expenses	10,590	

Required;

Prepare the statement of profit or loss of Lakuna Ltd analysing the expense by NATURE and by FUNCTION using the relevant trial balance for the period.

Solution to illustration 13.1

i) Statement of profit or loss analysing the expenses by FUNCTION

	N'000	
Revenue		74115
Cost of sales	(31070)	
Gross profit		43045
Other income	110	
Distribution costs		(18465)
Administrative expenses		(19505)

Other operating expenses	(1240)
Profit before taxation	3945

ii) Statement of profit or loss analyzing expenses by NATURE

	N'000
Revenue	74,115
Other income	110
Total income	**74,225**
Changes in inventories of finished goods and work in progress	430
Raw materials and consumables	(27,825)
Staff costs	(24,630)
Depreciation	(7,665)
Other operating expenses	(10,590)
Profit before taxation	3,945

N.B both accountant arrived at the same profit before taxation despite the fact that the basis of analysing their expense were different and they have some different figures in their trial balance extracts.

13.6 Statement of changes in equity

Statement of changes in equity is the link between statement of financial position and statement of profit or loss and other comprehensive income. Statement of changes in equity shows the component of equity the amount at the beginning of the period, changes during the period and amount at the end of the period.

The main components of equity include the following:

- Share capital
- Share premium
- Retained earnings
- Revaluation surplus

For each components of equity above the statement should also show changes resulting from:

- Profit or loss for the period
- Each item of other comprehensive income
- Transaction with owners in their capacity as owners

Transactions with owners of the business in their capacity as owner include the following:

- New issue of shares
- Payments of dividends
- Sale of entities own shares

These transactions are not gain or losses, hence they are not shown in the statement of profit or loss and other comprehensive income. They however affect the equity position hence the need to show their effects.

13.6.1 The effect of retrospective applications or retrospective restatements for changes in accounting policies and correction of errors

IAS 8- changes in Accounting Policies, Changes in Accounting Estimates and Corrections of errors requires that when an entity changes an accounting policies or restate amount in the financial statements to correct errors, the adjustments should be made retrospectively to the extent that it is practicable.

Retrospective adjustments are not changes in equity hence they are adjusted to the opening balance of the retained earnings or other components of equity. Where such adjustments are made the statement of changes in equity must show how it was deducted or added to the opening balance of the affected components of changes in equity. As illustrated in format of Statement of changes in equity below:

Format of statement of changes in equity

	capital	premium	ıed earnings	ıation reserve	
	N'000	N'000	ɴ'000	N'000	'000
ng balance					
due changes in accounting policies					
ed balance					
for the year					
comprehensive income for the year					
of shares					
end paid					
g balance					

13.7 Statement of financial position

This statement communicates the financial position or the net-worth of an entity by presenting the all assets liabilities and equity of an entity.

IAS 1- Presentation of Financial statements sets out the requirements for information that must be presented in the statement of financial position or notes to the financial statements. It also provides a pro-format as guidance for the presentation.

An entity is required to present current and non- current assets and liabilities as a separate classification on the face of the statement of financial position, except when a presentation based on liquidity provides information that is more reliable and relevant.

Current and non-current assets and liabilities

Current and non -current assets and liabilities should normally be presented separately as earlier stated above such that current and non -current assets are divided into separate classification , also current and non- current liabilities are also stated separately.

Current assets

Assets should be classified as current if it meets up with the following requirements:

i. if the entity expects to realise the assets or sell or consume the assets within its normal operating cycle

ii. The assets is held for trading purpose

iii. The entity expects to realise the assets within 12months after the reporting period.

iv. it is cash or cash equivalent (unless it is restricted from being used for at least 12 months after the reporting period).

Examples of current assets include inventories, trade receivables, cash and cash equivalent etc.

Non- current assets

All other assets that do not meet the definition of current assets should be regarded as non- current assets these are assets that have life span of more than 12 months after the reporting period. They can be tangible or non-tangible assets examples of non-current assets include property plant and equipment's, investment properties, intangible assets etc.

Current liabilities

An item should be classified as current liabilities, if it satisfies the following criteria:

i. The entity expects to settle the liability in its normal operating cycle.

ii. The liability is held primarily for the purpose of trading

iii. The liability is due to be settled within 12months after the end of the reporting period

iv. The entity does not have unconditional right to defer settlement of the liability for at least 12 months after the end of the reporting period.

Examples include trade payables, accrued expenses, tax payables etc

Non- current liabilities

All other liabilities that do not meet the definition of current liabilities should be classified as non-current liabilities.

Examples include Loan notes, deferred taxation, etc.

Format of statement of financial position in accordance with IAS 1

	N'000
Assets	
Property plant and equipment	X
Intangible assets and goodwill	X
Investment property	X
Financial assets	X
Investment accounted for using equity method	X
Biological assets	X
Deferred tax assets	X
Non- current assets	XX
Inventories	X
Trade and other receivables	X
Prepayments	X
Cash and cash equivalent	X
Assets held for sale	X
Current assets	XX
Total assets	XXX
Equity	
Share capital	X
Share premium	X
Reserves	X
Retained earnings	X
Total equity	XX
Liabilities	
Loan notes and borrowings	X
Employee benefits	X
Deferred tax liabilities	X
Non -current liabilities	XX
Bank overdraft	X
Trade and other payables	X
Income tax payable	X
Provisions	X
Current liabilities	XX
Total liabilities	XX
Total equity and liabilities	XXX

13.8 Notes to the financial statements

Notes to the financial statements are additional information presented in the financial statement to provide more details on information presented on the face of the financial statements. They provide narratives description of items in the financial statements and how total figures in the financial statements are also arrived at.

The notes to the financial statements of an entity must have the following structure

i. State the basis of preparation of the financial statements, identify and state significant accounting policies that affect the financial information and significant transactions and other events.

ii. To disclose the information required by International Financial Reporting Standards (IFRS) that is not disclosed elsewhere in the financial statements.

iii. To provide additional information that is not presented in the financial statements but relevant to the understanding of the financial information in the financial statements.

The notes normally that accompany financial statements in an annual report is usually arranged in this order:

- Statement of compliance with IFRS
- Summary of significant accounting policies applied in preparing financial statements
- Providing details for most information presented on the face of the financial statements
- Other narratives and disclosures that relates to non- financial information.

13.9 Statement of cash flows

This communicates information about how entity generate and uses cash during a reporting period. This
Statement is a good indicator of a company's liquidity and solvency.

IFRS 7 – Statement of cash flows
The focus of IFRS 7 is to report changes in cash and cash equivalents during the reporting period. The standard sets out cash flows should be classified and reported under operating, investing and financing activities.

Entities are required to report cash flow in a manner most appropriate to their business. In practice, most entities cash flows in order of operating, investing and financing activities.

Only transactions involving cash flows are reported in the statement of cash flows. Cash flows are defined as Inflows and out flows of cash and cash equivalent

Cash is defined as cash in hand and demand deposits. Demand deposit is generally accepted to be deposit with financial institution that is repayable on demand and available within a short period.

Bank overdraft.

That are repayable on demand and that are integral to the entity's cash management can be included as a component of cash and cash equivalents.

To assist users of financial statements in making assessment about liquidity, viability and financial adaptability entities are required to present cash flows in three broad heading s classifications earlier stated above.

Operating activities: Simply put, these are the principal revenue generating activities of the entity and other activities that are not investing or financing.

Operating cash flows are reported in the cashflow statements using either **direct or indirect methods**

Direct method: Operating cash flows are reported from major classes of gross receipts and payments are aggregated to arrive at net operating cash flows; such as cash received from customers, cash paid to suppliers payments to employees and income tax paid as illustrated in the format below:

Operating cash flows- Direct method	N'000
Cash flows from operating activities:	
Cash received from customers	X
Cash payments to suppliers	(X)
Cash paid to employees	(X)
Other operating cash payments	(X)
Cash generated from operations	XX
Interest paid	(X)
Income tax paid	(X)
Net cash flows from operating activities	XXX

Indirect method: the net operating cash flows for the period is arrived at by adjusting the profit or loss before to remove the effects of non-cash items such as depreciation, provisions etc, changes in working capital that is movement on inventories, receivables and payables as well as interest and income tax paid.

This is illustrated in the pro format below:

Operating cash flows- Indirect method	N'000	N'000
Cash flows from operating activities:		
Profit/(loss) before taxation		XX/(XX)
Adjustment for:		
Depreciation/Amortisation	X	
Impairments	X	
Interest expense	X	
(Profit)/Loss on disposal of assets	(X)/X	X/(X)
Changes in working capital:		
Increase in inventories	(X)	
Increase in receivables	(X)	
Increase /(decrease)in trade payables	X (X)	X /(X)
Cash generated from operations		XXX/(XXX)
Interest paid		(X)
Income tax paid		(X)
Net cash flow from operating activities		XXXX

Investing activities are the acquisition and disposal of non- current assets and other investment not included in cash equivalent. Examples include:

- Payments for acquisition and disposal of property plant and equipment.
- Receipts from sale of non-current assets
- Payment for acquisition of intangible assets and self constructed assets
- Receipt from sale of equity investments or debt instruments of other entities
- Payments to acquire equity and debt instruments of other entities.

Financing activities: are the activities that results in changes in size and composition of the contributed equity and borrowings of the entity. Examples include:

- Receipts from issue of shares or other equity instruments
- Payment to acquire or redeem the entity's own share
- Receipts from issued bonds
- Repayments of amount borrowed

When preparing cash flow statements items should be presented in the most appropriate activity to ensure compliance with IAS 7 – statement of cash flows.

However, IAS 7 also permits the presentation of the following items as follows:

- Interest and dividend received can be treated in operating or investing activities
- Interest and dividend paid can be treated as operating and financing activities.
- Non- cash transactions from investing and financing activities such as bonus issues, debt conversion to equity, acquisition of assets through finance lease etc should be excluded from the cash flow statement but presented in notes form to the cash flow statements.

Full format of statement of cash flows

	N'000	N'000
Cash flows from operating activities		
Net cash flow from operating activities (using either direct or indirect methods)		XX
Cash flows from financing activities		
Proceeds from sale of property, plant and equipment	X	
Proceeds from sale of investments	X	
Acquisition of property plant and equipment	(X)	
Acquisition of other investments	(X)	
Dividend / interest received	X	
Net cash inflow/outflow from investing activities		XX/(XX)
Cash flow from financing activities:		
Proceeds from issue of shares	X	
Proceeds from sale of own shares	X	
Repayment of borrowings	(X)	
Dividend paid	(X)	
Net cash inflow/outflow from financing activities		XX/(XX)
Net increase/decrease in cash and cash equivalent		XXX
Cash and cash equivalent 1 Jan.		XX
Cash and cash equivalent 31. Dec		XXX

13.10 IFRS 18- Presentation and disclosure in financial statements

This is a new standard issued by International Accounting Standards Board. (IASB). It was issued to replace

IAS1 – Presentation of financial statements. The effective date of the standard is January 2027, however the Standard permits earlier adoption by the users.

The aim of the standard is to standardize financial reporting, improve comparability and reduce diversity in practice. The key changes focus on income statement structure, management performance measure (MPMs) and disclosure requirements

Differences between IAS1 and IFRS 18

i. Income structure

IAS 1 permits flexible structure with discretion in defining operating profit. However, IFRS 18 requires mandatory categories which include:

a) Operating (core business activities)

b) Investing (acquisition/disposal of long-term investments

c) Financing (transactions with providers of capital)

therefore IFRS 18 makes it mandatory for income statement to be prepared with the above mandatory subtotals.

ii. Management performance measures

IAS 1- Allowed non- GAAP measures (e.g. EBITDA) in primary statements with minimal restrictions, However, IFRS 18 emphasis restriction and strict disclosures

iii. Grouping and labeling

IAS 1 permits broad discretion in aggregating / labeling of line items on the statement of profit or loss. However, IFRS 18 prefers standardization label and aggregation rules hence it is more rigid in terms of presentation of the Income statements.

iv. Disclosure

IAS 1- disclosure requirements is not too extensive while IFRS 18 disclosure requirements are more elaborate.

Merit of IFRS 18 OVER IAS 1

IFRS 18 addresses key criticisms of IAS 1**.**

- **Consistency** it reduces variability in operating profit definition.

- **Transparency** it limits misleading non- GAAP measures

- **Comparability** it standardized labels and structure and cross - entity analysis.

Simplified format of statement of profit or loss – under IFRS 18

	N'000
Operating:	
Revenue	X
Cost of sales	(X)
Other operating expenses	(X)
Operating profit	XX
Investing:	
Share of profit or loss from investment	X
Other investment	X
Profit before financing and income tax	XX
Financing:	
Interest expense on borrowing	X
Profit before income tax	XX
Income tax expense	(X)
Profit for the year	

13.11 Chapter summary

The chapter dealt with presentation of financial statements in accordance with IAS1 It describes basic principles for preparing financial statement of a limited liability company. It also explains the components of financial statement in an annual report and in accordance with the provisions of IFRS. The structure of each financial statements e.g. statement of profit or loss, statement of changes in equity Statement of financial position and statement of cash flows were exhaustively discussed. Emphasis was however placed on presentation while the computational aspects were dealt with in other chapters.

The chapter also highlighted the new IFRS 18 which will become effective from January 2027, although the standard permits earlier adoption by users.

13.12 End of chapter questions

Multiple choice questions

1. The following are components of financial statement of limited liability companies in accordance with the provisions of IAS 1 **EXCEPT**

   A. Statement of changes in equity
   B. Statement of value added
   C. Statement of financial position
   D. Statement of cash flows
   E Statement of significant accounting policies

2. Which of the following information is disclosed on the face of statement of profit or loss of an entity which is prepared analyzing the expenses by nature ?

   A. Distribution expenses
   B. Administrative expenses
   C. Depreciation and amortisation
   D. Dividend
   E. Interest expense

3. Which of the following is a component of statement of changes in equity that can be classified as part of transaction attributable to owners of equity?
   A. Retained earning
   B. Revaluation surplus
   C. Dividend
   D. Other comprehensive income
   E. Retrospective adjustments.

4. The financial performance and position of a company can be measured by the following financial statements
   A. Statement of cash flows/Statement of affairs
   B. Statement of financial position/statement of value added
   C. Statement of changes in equity/statement of financial position
   D. Statement of profit or loss/ State of changes in equity
   E. Statement of profit or loss/ statement of financial position.

5. IFRS 18 is a new accounting standard introduced to replace which of the following standards?

A. IAS 1

B. IAS 2

C. IAS 7

D. IAS 8

E. 1AS 16.

13.13 Solution to multiple choice questions

1. B

2. C

3. C

4. E

5. A

13.14. End of chapter questions and answers

1. Panseke Nig Ltd made a loss of on sale of its plant and machinery of N400,000. The machine originally cost N2.5 million and at the date of disposal the accumulated depreciation of the machine was N1million

Required:

a) What amount will be disclosed as adjustments under operating activity of statement of cash follow?

b) Which portion of the transaction above should be disclosed under investing activities in a statement of cashflows?

Solution 1

a) N400,000 should be disclosed under adjustments in operating activities.

b) Sales proceed of the machine should show under investing activities and calculated as shown below:

	N'000
Cost of the machine	2500
Accumulated depreciation	(1000)
Carrying amount at time of sale of the machine	1500
Loss on disposal of the machine	(400)
Proceeds on sale of the machine	1100

CHAPTER FOURTEEN
PREPARATION OF FINANCIAL STATEMENT FOR CORPORATE ENTRIES

Chapter contents

a. Introduction
b. Type of financial instruments a company can issue
c. Share premium account
d. Bonus issues and right issues
e. Differences between current and non-current
f. Components of financial statements
g. Preparation of simple financial statements in alliance with IAS1
h. Statements of cash flows
i. Statements of changes in equity

14.0 Objectives:

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

- Explain the types of financial instruments a company can issue
- Explain and illustrate the share premium account
- Explain rights issue and it advantages and disadvantages
- Define and record bonus shares in the financial statement
- Explain the differences between current and non-current items
- Identify the line-items in the statement in each of the following components of financial statement
- Prepare simple financial statement in accordance with IAS 1
- Explain and account for treatment of current tax

14.1 Capital structure of a company.

The capital structures of a company are in two broad categories, equity, in particular, ordinary share capital and debt instruments.

Types of shares

There are two main types of share capital; ordinary share capital and preference share capital

Ordinary shares. These are the shares issued to members of the company who have rights to vote and receive variable returns from the company. Dividends vary according to the profits earned by the company vis-à-vis their dividend policy. Ordinary shareholders are entitled to dividends only after preference dividends have been settled. Dividends paid to ordinary shareholders are treated in the statement of changes in equity.

Preference shares: These are shares that earn a fixed rate of dividends. The holders have prior claim over ordinary shareholders, to any company's profits available for dividends and the capital of the company in the event of liquidation. Preference shares are mainly classified as non-current liabilities, except in rare occasions when companies issue irredeemable preference shares. Some countries do not permit companies to issue irredeemable preference share capital. Dividends due on preference shares are treated as finance cost in the statement of profit or loss preference shares.

Types of preference share capital

Some categories of preference shares are participating preference shares, redeemable preference shares, irredeemable preference shares and convertible preference shares.

i. Participating Preference Shares: These are preference shares that are given the right to share out of surplus income of the company.
ii. Cumulative Preference Shares: These are preference shares that are given the right to make claims in future for dividend not paid due to insufficient profit.
iv. Redeemable Preference Shares: These are preference shares that are redeemable in future
iii. Convertible Preference Shares: These are preference shares in which the holder has the option of converting to equity or ordinary shares in future terminologies

Nominal Value

Shares are normally stated at their nominal value or par value. Nominal value is used as a means of calculating dividends to shareholders; dividends are paid as a percentage of nominal value. The nominal value is also the minimum price at which shares can be issued to shareholders. Companies are prohibited by law to issue shares at a discount (that is, price that is lower than the nominal value) but they can issue shares at a premium.

Share Premium

Definition

Share premium is a situation where the shares of a company are issued at a price, higher than the nominal price. Simply, share premium is the excess of the issued price of a share over the nominal price. The total excess amount arising on the shares issued is credited to a share premium account. The balance in the share premium account is not distributable as dividends to shareholders.

For instance if an entity issued 1000 shares of ₦1 each at ₦2.50 per share; ₦1000 (₦1 x 1000 shares) would be credited to ordinary share capital account while ₦1,500 (₦1.50 x 1000) would be credited to share premium account. The cash received of ₦2,500 would be debited to cash account.

14.1.1 Uses of the balance in the share premium account.

The share premium can be used by the entity as follows

i. To issue bonus shares as fully paid to existing shareholders.
ii. Writing off preliminary expenses of a newly incorporated company
iii. Writing off the expenses of, or the commission paid on any issue of shares of the company.
iv. Providing for the premium payable on redemption of any redeemable share of the company.
v. To purchase its own shares and other type of securities
vi. To provide for premium payable on redemption of redeemable preferences share/debentures

14.1.2 Share Capital

a) Minimum share capital:
This is the concept used in company law to stipulate the nominal value of share capital a company must hold as a minimum requirement. For instance, in the CAMA 2020 (as amended) Nigeria's companies must have a minimum issued share capital of ₦100,000 for private companies and ₦2,000,000 for public companies.

b) **Authorized Share Capital:** This is the amount approved by the Memorandum and Articles of Association
of a company which the company can legally raise by issue of shares (usually in the form of

ordinary or preference shares). Some countries have removed the lid on the number of shares a company may legally raise; in such countries, the concept of authorized share capital does not apply. In Nigeria, CAMA 2020 (as amended) has replaced authorized share capital with minimum share capital**.**

c) **Issued Share Capital**: This is the part of the authorised shares that have been issued and allotted whether or not they have been fully paid for. Issued share capital cannot exceed the authorized capital.

d) **Called- Up Share Capital**: This is the cumulative portion of the nominal value of shares called-up for payment within a specified period. This is usually including the amount which was due on application, allotment and any subsequent calls that have not been made.

e) Paid- Up Share Capital: This is the portion of called up share capital which has been received from the subscribers

14.1.3 Accounting for Issue of Shares.

When shareholders pay cash to subscribe for shares of a company, the company will debit cash account and credit deposit for shares account. When the company issue shares, usually at a premium, the company will transfer the amount in the deposit for shares account to both ordinary share capital account, at nominal value and share premium account, being the excess of the issued price over the nominal value. Issue cost will be deducted from share premium. In effect, the relevant entries are;

Debit cash account, Credit ordinary share capital account, with the nominal value Credit share premium account, with the premium

Illustration 14 .1 Owen PLC issued 140,000 shares of ₦20 each at a price of ₦120 per share. Show journal entries for the transaction.

Solution to illustration 14.1

Cash received ₦120 x 140,0000 = 16, 800,000

Nominal value = 140,000 x ₦20 = 2,800,000

Share premium = 140,000 x ₦100 = 14,000,000

Journal:

	DR N'000	CR. ₦'000
Cash account	16,800	
Ord. share capital		2,800
Share premium		14,000

Where shares are issued with transaction cost, the cost is deducted from the share premium balance.

Illustration 14.2

Assume that the transaction cost in the Owen example above is ₦2,000,000, then the entries will be reflected as follows:

Journal

	DR. ₦'000	CR. ₦'000
Cash account.	16,800	
Ordinary share capital	2,800	
Share premium	12,000	
Debit share premium account (share issue cost)		2,000

Effectively, the balance in the share premium account is. ₦12,000,000

14.1.4 Bonus Issue

This is also referred to as capitalization issue or scrip issue. It is simply capitalization of reserves. These are shares issued to existing shareholders on a pro-rata basis without the shareholders making any payment for shares issued, hence there is no cash received in respect of bonus shares but there may be administrative costs.

Advantages of issuing bonus share.

i. Bonus share increases the liquidity of the company
ii. It a is a positive sign that the company committed to long-term growth
iii. It increases the issued share capital of the company, making it attractive to investors

Disadvantages of issuing bonus share.

i. The administration cost of making bonus issue is higher than the cost of paying cash dividends
ii. The company does not receive cash; hence overall investment of the company remains the same.

Bonus shares are funded from reserves, first from share premium and then other reserves.
Example: A company with 10 million ordinary capital of ₦1 each made a 1 for 4 bonus shares. At that date, the balance in the share premium account was ₦1,700,000 while the retained earnings were ₦7,800,000.Show the accounting journal for the transaction.

Solution
Value of bonus shares issued = (10m/4 x ₦1) = ₦2,500,000

Entries
Debit share premium account with ₦1,700,000

Debit retained earnings with ₦800,000 Credit Ordinary share capital with ₦2,500,000

14.1.5 Rights Issue

These are shares issued to existing shareholders at a price which is usually lower than the market price of the shares: The shareholders therefore have the following options,

- To take up the rights;
- To sell/take up part of the rights;
- Not to do anything at all.

Rights are also issued on pro rata basis to existing shareholders. For example; rights issue of 1 for 2 means that for every two shares held by existing shareholders one share would be issued to them.

Therefore, a shareholder that has 50,000 ordinary shares would be entitled to 25,000 ordinary shares as rights.

Advantages of rights issue

i. Rights issue is the cheapest and fastest source of raising capital for a company; the shareholders will likely take up the right because it is offered at cheaper than the market price.
ii. There are less rigorous rules for their issue compare with outright public issues.
iii. Companies can make right issue to reduce debt/equity ratio and may help companies to avoid breaching of contracts.

Disadvantages of rights issue

i. If the existing shareholders do not exercise their rights or sold their rights to the public, their shareholding percentage may be diluted.
ii. Rights issue is always an indication that the entity is facing liquidity crisis, this impression may affect the entity negatively.

Accounting treatment of rights issue:
Rights issue is accounted for the same way issue of ordinary share capital to the public is accounted for.

14.2 Loan notes

A company can raise fund by issuing debt instruments other than preference shares. A typical example is loan notes or loan stock. A loan is not a financial instrument. When loan is issued by a company, it is a contract that specify that a loan is owed by the company to be paid at a specified period in the future. Annual amount of interest would be paid or payable on the principal. The interest due whether paid or not would be recognised in the statement of profit or loss part of the statement of comprehensive income. In the statement of financial position, the amount of interest due but not yet paid is recognised as current liability while the principal is treated as non-current liability.

14.3 Company Income Tax

Only corporate entities pay tax on their profits. At the end of each year, the entity will estimate its tax liability after adjusting for certain items, in its accounting profits, to arrive at the taxable profit. The adjustments are done according to the tax laws of the jurisdiction. This taxable profit is multiplied by the tax rate to arrive at the current tax estimate for the period.

Adjustment for tax underestimate or overestimate.
When the tax estimate is agreed with the relevant tax authority, in the following year, the tax payable may not agree with the tax estimate, hence the need to adjust for under- or over- estimate in respect of the previous year.

Income tax expense
The tax expense to be recognised for each year in the statement of profit or loss is made up of:

i. Tax estimate for the current year minus previous year's underestimate; or
ii. Tax estimate for the current year minus previous year's overestimate.

In the trial balance, underestimate is on the debit side while overestimate is on the credit side.

Treatment of tax in the statement of financial position
The current tax year's estimate is reported in the statement of financial position as current liability. Last year's estimate, including any adjustment made for under or over-estimate would have been settled in the current year if the company pay its tax as at when due.

14.4. Preparation of Financial statements

Preparation of financial statements must comply strictly to the laid down laws and relevant International Financial Reporting Standards (IFRS). The financial statements are general purpose financial statements; hence they are not prepared for specific users.
IAS 1- Presentation of Financial Statements prescribes the contents and presentation of financial statements. We shall discuss some of the requirements at this level of the examinations.

Components of Financial Statements
The components of financial statements are:

1. Statement of financial position at the end of the period
2. Statement of comprehensive income (presented as a single statement) or a statement of profit or loss and other comprehensive income for the period (made up of a separate statement of profit or loss and of other comprehensive income)
3. Statement of changes in equity for the period
4. Statement of cash flows for the period
5. Notes, comprising a summary of significant accounting policies and other explanatory notes

The first three components' statements are prepared using the accrual basis of accounting, while the statement of cash flows in prepared on cash basis.

14.4.1 Additional requirements of IAS 1

IAS 1 requires the following details to be stated in respect of every component of financial statements

1. The name of the reporting entity or other means of identification and any change in that information from the end of the preceding period;
2. Whether the financial statements are of an individual entity or a group of entities:
3. The date of the end of the reporting period or the period covered by the set of financial statements or notes;
4. The presentation currency, as defined in IAS 21 The effects of Changes in Exchange Rates; and

5. The level of rounding used in presenting amounts in the financial statements.

An entity may round up or round down amounts contained in its financial statements to the nearest whole number, thousands or millions etc.

14.4.2 Other requirements of IAS 1 are the disclosure of:

i. The domicile and legal form of an entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office),
ii. A description of the nature of the entity's operations and its principal activities
iii. Comparative information must generally be disclosed in respect of the preceding accounting period.

14.4.3 Contents of Financial Statements

IAS 1 prescribes the structure and contents of the following financial statements:

Contents of the Statement of Financial Position

It is statement which shows all the components of equity, assets and liabilities of an entity as at a particular date or as at the end of a particular period. The items listed below are generally presented as line items in the statement of financial position.

i. Property, plant and equipment
ii. Investment property
iii. Intangible assets
iv. Financial assets or investments
v. Trade and other receivables, and
vi. cash and cash equivalents
vii. Inventories
viii. Trade and other payables
ix. Current tax liability
x. Provisions
xi. Financial liabilities such as loan notes

Current and non-current assets and liabilities

It is necessary to know the distinction between current and non-current where assets and liabilities in statement of financial position are classified into their current or non- current nature.

Current Assets

Assets are classified as current if they meet any of the following criteria A current asset is one which satisfies any of the following criteria:

i. It is expected to be realized, sold or consumed within the entity's normal operating cycle.
ii. It is held primarily for the purpose of being traded
iii. It is expected to be realized within 12 months after the reporting period
iv. It is cash or a cash equivalent.

An asset which satisfies none of these criteria is a non-current asset.

Operating Cycle
This is the time between the acquisition of assets for processing and their realisation in cash or cash equivalent. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve (12) months.

Current assets include inventories and trade receivables that are sold, consumed or realised as part of the normal operating cycle, even when they are not expected to be realised within twelve (12) months after the end of the financial year.

Examples of current assets are
- Inventories
- Accounts receivables
- Cash and cash equivalents
- short-term and highly liquid investments that are readily convertible into specific sum of cash
- Income tax asset

Examples of non-current assets
- Motor vehicles
- Plant and equipment
- Furniture and fittings
- Computer
- Land and building
- Motorcycle
- Development cost
- Brand name
- Goodwill
- Deferred tax asset

Current Liabilities:
i. It expects to settle the liability in its normal operating cycle;
ii. It holds the liability primarily for the purpose of trading;
iii. The liability is due to be settled within twelve months after the reporting period; or
iv. It does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period

Any liability that does not meet any of the four criteria above for current liability is classified as a non-current liability.

Examples of current liabilities are
- Trade payables
- Other payables
- Accruals
- Provisions
- Current tax payable
- Bank overdraft/short-term bank borrowing; and
- Current portion of long-term loan payable.

14.5 Presentation of Statement of Profit or Loss and Other Comprehensive income

IAS 1 stipulates that statement of profit or loss can be prepared using the following methods:

- Single statement method: that is where the profit or loss part in merged with the other comprehensive income section
- Two statement method: where the profit or loss part is prepared as a separate part and the other comprehensive income part is also prepared separately

The statement of profit or loss part is made up of income and expenses which would finally result in a profit or loss for the year while other comprehensive income part lists other gains or losses that have arisen in the period.

The only **Other Comprehensive Income (OCI)** we shall deal with at this level is the revaluation reserves on property, plant and equipment.

Total comprehensive income, comprising the profit or loss for the period and other comprehensive income, is transferred to statement of changes in equity.

14.5.1 Content of Statement of Profit or Loss

IAS 1, however permits the classification of expenses in the statement of profit or loss using **two** methods:

1. **Analysis of expenses by functions**: when expenses are analysed according to their function, the f unctions are

i Cost of sales: They include purchases, for a merchandising company or production cost for manufacturing company. Cost of sales is calculated the same way for a sole trader.

ii. Distribution costs: These costs relate to advertisement, marketing and promotion as well as depreciation of distribution vehicles and salesman salary and commission.

iii.Administrative expenses: These are expenses that are neither cost of sales nor distribution cost. They relate to general office administration.

This method of classifying expenses is more common with most entities.

Format of function of expenses method

	₦	₦
Revenue		X
Cost of goods sold		(X)
Gross profit		X
Other operating income		X
Distribution costs	X	
Administrative expenses	X	
Total operating expenses		(X)
Profit from operating activities		X

2. **Analysis of expenses by their nature:** when expenses are analysed according to their nature the categories of expenses will vary according to the nature of the business.

i. Cost of raw materials and consumables used;
ii. Changes in inventory
iii. Personnel cost
iv. Depreciation and amortisation cost
v. Other expenses

Cost of goods sold is calculated by adding opening inventory and cost of goods purchased less closing inventory. For a manufacturing company, cost of good purchased will be replaced with cost of goods produced. The format of the statement of profit or loss, using the nature of expenses method is as follows:

	₦
Revenue	X
Other operating income	X
Cost of raw materials and consumable used	X
Changes in the inventory of finished goods and work in progress	X
Personnel or staff costs	X
Depreciation and amortisation charges	X
Other operating expenses	X
Total operating expenses	(X)
Profit from operating activities	X

- Under the nature of expenses method, if the closing inventory is greater than the opening inventory of finished goods and work in progress the difference is an increase in income or a reduction in operating expenses.
- Raw materials and consumable used is obtained by adding opening inventory of raw materials to purchases of raw materials less closing inventory of raw materials.

14.6 Statement of Changes in Equity

Purpose of Statement of Changes in Equity (SOCIE) The main purpose of a SOCIE is to show how each component of equity has changed during an accounting period. The statement contains the following:

i. Balances at the beginning of the period in respect of components of equity;
ii. Adjustment for the effect of changes in accounting policies and prior year error;
iii. The profit earned during the period
iv. The other comprehensive income for the year
v. Additional funds raised during the year, through issue of ordinary shares
vi. Dividends paid to holders of equity shares
vii. Balances at the end of the accounting period.

In the case of a company, these components are share capital and the company's reserves; such as share premium, revaluation reserves and retained earnings.

Illustration 14.3.

You have been asked to prepare the financial statements of Brima Limited for the year ended 31 December 2021.

The trial balance as at that date is shown below.

	DR.	CR
	Le 000	Le'000
Revenue Purchases		66,000
	32,200	
Property, plant and equipment (PPE) - cost	72,000	
PPE-accumulated depreciation, 1 January 2021		25,000
Inventories as at 1 January 2021	7,800	
Interest expense	200	
Income tax		400
Distribution expenses	8,900	
Administrative expenses	7,000	
Retained earnings Dividend paid		27,700
	1,200	
Trade receivables	9,000	
Cash at bank	3,200	
8% bank loan repayable in 2021		5,000
10 million ordinary share capital at N1 each		10,000
Share premium		5,000
Trade payables		2,400
	141,500	141,500

The following information is also available:

i. The revenue figure in the trial balance includes sales made on credit to Mr. Alusine amounting to Le3,100,000 on 30 October 2020.
ii. Closing inventory value was Le8,400,000. Included in this figure are inventories that cost Le500,000 but which can be sold for only Le250,000.
iii. Interest on bank loan for the past six months remained unpaid as at 31 December 2018. This was not included in the trial balance.
iv. Depreciation of property, plant and equipment, for the year was charged at 10% using straight line method.
v. Accrued distribution expenses amounted to Le 150,000 at 31 December 2021.
vi. Included in the ordinary share capital is additional 1 million shares of Le1 that were issue for Le2,500,000.
vii. Income tax represents overestimate in respect of current tax in the previous year. Income tax estimate for the current year is Le1800,000.

You are required to prepare:

a) Statement of profit or loss and other comprehensive income for the year ended 31 December 2021.
b) Statement of changes in equity for the year ended 31 December 2021.
c) Statement of financial position as at 31 December 2021.

Solution to illustration 14.3

Brima LIMITED

Statement of profit or loss and other comprehensive income for the year ended 31 December 2021

	Le'000	Le'000
Revenue	9,050	62,900
Cost of sales	14,200	(31,850)
Gross profit Distribution costs		31,050
Administrative expenses		(23,250)
Loss from operations		7,800
Finance costs (		(400)
Profit before tax		7,400
Tax expense		(1,400)
Profit for the year		6,000

Brima LTD

Statement of financial position as at 31 December 2021

Assets	Le'000		Le'000
Non-current Asset			
Property, plant and equipment			39,
Current Assets:			800
Inventories		8,150	
Trade receivables		9,000	
Cash at bank		3,200	20,350
			60,150
Equity Share capital			
		10,000	
Share premium		5,000	
Retained earnings (23,500-4,457 + 3,100)		35,600	50,600
Liabilities			
Non-current liabilities			
8% bank loan **Current liabilities**: Income tax payable			5,000
		1,800	
Trade payables		2,400	
Other payables (200+150)		350	4,550

60,150

Brima LTD
Statement of changes in equity for the year ended 31 December 2021

	Ordinary shares	Share premium	Retained earnings	Total
	Le'000	Le'000	Le'000	Le'000
Balance Jan 1, 2021	4,000	8,500	27,700	40,200
Prior year gain			3,100	3,100
Profit for the period			6,000	6,000
Dividend paid			(1,200)	(1,200)
Issue of shares	1,000	1,500		2,500
Balance Dec 31, 2021	5,000	10,000	35,600	50,600

Working notes:

	Le'000	Le'000
1. Revenue		66,000
Prior year gain		(3,100)
Recognised in profit or loss		62,900
2. Cost of goods sold		
Opening inventory	7,800	
Purchases		32,200
Closing inventory at cost	8,400	
Amount written off (500-250)	(250)	
Net realisable value		(8,150)
Recognised in profit or loss		31,850

3. Distribution costs

As per trial balance	8,900	
Accrued expenses	150	
Recognised in profit or loss		9,050

4. Administration expenses

As per trial balance	7,000	
Depreciation charge on PPE	7,200	
Recognised in profit or loss		14,200

5. Income tax

Income tax estimate	1,800	
Over-estimate in previous year		(400)
		1,400

6. Other payables

Accrued interest on loan	200	
Accrued distribution expenses		150
		350

7. Property, plant and equipment

Cost		72,000
Depreciation		
Accumulated depreciation January 1, 2021	(25,000)	
Charge for the year		(7,200)
Balance December 31,2021		32,200

Tutorials:

The illustration examines your ability to prepare financial statements in accordance with IAS 1, the relevant adjustments as prescribed by the relevant standards included in the notes, such as:

- Revenue of Le3,100,000 not recognised in 2020, now adjusted as prior year item in 2021 by debiting current year revenue and crediting prior year retained earnings.
- Adjustment for tax overestimate in previous year to arrive at tax expense for the year.
- The amounts in ordinary shares and share premium are the balances at the end of the year In order to obtain the balances at January 1, 2021, the amount raised from issue of shares during the year must be deducted.

Ordinary shares (Le5,000,000 – Le1,000,000) = Le4,000,000 Share premium (10,000,000 – Le1,500,000) = Le8,500,000 Le'000

Total amount realised 1,000,000 shares **x** Le2.50	2,500
Credit to ordinary shares	1,000
Credit to share premium	1,500
	2,500

14.7. Statement of Cash Flows

IAS 1 states that a complete set of financial statements should include a **statement of cash flows**. IAS 7- Statements of Cash Flows sets out the requirements for the format and content of the statement. The aim of IAS 7 is to provide information to users of financial statements about an entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents

A statement of cash flows categorizes inflows and outflows of cash, under three main headings namely:

- Cash flows from operating activities
- Cash used in or obtained from investing activities
- Cash paid or received in financing activities.

Statement of cash flows can be prepared using two methods, these are:

- Indirect method
- Direct method.

The statement of cash flows provides users with a basis to:

a) Assess the ability of the enterprise to meet its debt obligations as they fall due.
b) Assess the entity's ability to generate and utilize cash
c) Assess the ability of the enterprise to finance its current operations using its own cash or external sources of cash
d) Analyze the relationship between profit and cash flows overtime, in order to control costs by controlling cash flows
e) Estimate future cash flows.

14.7.1 Limitations of the Statement of Cash Flows

a) The statement may not be able to provide the required information for the future because it uses historical data.
b) Some non-cash transactions that are not disclosed on the face of the statement are of interest to users because they will impact on future cash flows.

14.7.2 Differences between Statement of Cash Flows and Statement of Profits or loss.

a) The statement of comprehensive income is prepared on accrual basis; hence profit is only an indicator of performance. On the other hand, the statement of cash flows is prepared on cash basis, which is a useful indicator of a company's liquidity and solvency.
b) Cash flows is a better measure of the ability of the entity to meet its debt obligation, as they fall due, than the profit generated.

14.7.3 CLASSIFICATION OF CASH FLOWS- IAS7

The Statement of cash flows is prepare using standard headings as explained below:

1. Cash flows from operating activities: These are principal revenue-producing activities of the entity and other activities that are not investing or financing activities:

Common examples are:

a. Cash inflows

- Cash receipts from customers from sales of goods or rendering of service
- Royalties fees, commission and other revenue received in cash
- Income tax refunds received,

b. Cash outflows:

- Cash payments made to suppliers of goods and services
- Cash payments made to and on behalf of employees"
- Income tax paid, unless the payments can be specifically identified with financing or investing activities

2. Cash flows from investing activities: These are cash flows of the entity that relate relate to acquisition and disposal of property, plant and equipment, financial assets and investment Properties and any other current er assets. Examples of inflows from investing activities are

- A proceed from sale of property, plant and equipment
- Proceed from sale of investments
- Collection of cash advances
- Dividend received
- Interest received

Examples of cash outflows from investing activities are:

- Purchase of property, plant and equipment
- Purchase of investment
- Cash advances made to third parties

3. Cash flows from financing activities: These are cash flows of the entity that relate to changes in the size and composition of the equity and borrowing of an entity.

Example of cash inflows from financing activities are

- Cash received on issue of shares
- Cash received from issuing debt instruments
- Proceeds from bank borrowings

Examples of cash outflows from financing activities are:

- Payment of dividends to shareholders
- Repayment of principal portion of debt, including lease obligations
- Repayment of bank borrowings

4. Cash and Cash Equivalents: Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value. Cash equivalents include bank overdrafts and cash equivalents with short-term maturity; usually not more than three months maturity date.

5. Net increase or decrease in cash and cash equivalents is the overall increase or decrease in cash and cash equivalents during the period. The balance of cash and cash equivalents at the end of the year is obtained by adding the cash and cash equivalent at the beginning of the period to the net increase or decrease in cash equivalent for the period. The net increase in cash and cash equivalent for the period is the sum of the cash flows from operating activities, investing activities and financing activities.

14.7.4 Presentation of the Statement of Cash Flows

Cash flows are divided into three parts, namely:

- Cash flows from operating activities.
- Cash flows from investing activities; and
- Cash flows from financing activities.

There are two methods for the preparation of cash flows from operating activities,

1. **Direct Method:** Direct Method shows all the receipts and payments for each class.
   - Cash receipts from customers
   - Cash paid to suppliers
   - Cash paid to employees
   - Cash paid for other operating expenses
   - Interest paid
   - Income taxes paid
   - Net cash from operating activities

2. **Indirect Method**

Under this method the profits or loss is adjusted for the effects of transactions of non-cash nature. It derives net cash flows from operating activities from the net operating results for the year as reported in the statement of profit or loss. ***Indirect Method Cash Flow Statement comprises of***

- Profit before interest and income taxes

Add or deduct items not involving movement in cash

- Add back depreciation charged during the year
- Add back loss on sale of non-current assets
- Add back impairment loss of assets during the year
- Add back interest expense
- Deduct gains on sale of non-current assets

Adjust for changes in working capital items

- Deduct increase or add decrease in receivables
- Deduct increase or add decrease in inventories
- Add increase or deduct decrease in trade payables

Obtain a sub-total of all the above items, then

- Deduct interest paid
- Deduct tax paid

The result is, net cash from operating activities
Note that an increase in inventories or receivables means that it takes longer time to collect cash in respect of it, hence it is a deduction from cash from operating activities. An increase in payables means that it takes a longer time to pay cash to suppliers, hence it is an addition to cash flows from operating activities.

Working capital items.
Working capital items are current assets and current liabilities but for the purpose of cash flows, increase or decrease in the following working capital items are not adjusted under cash flows from operating activities, using indirect method.

- Tax: Tax paid is treated as a deduction from gross cash flows from operating activities
- Interest: Interest paid is treated as either cash outflows on operating activities or from financing activities. Interest received is treated as cash inflows from investing activities
- Dividend: Dividend paid is treated as cash flows from financing activities and interest receive is treated as cash inflows from investing activities
- Cash: Cash and cash equivalent
- Bank overdraft: Cash and cash equivalent
- Demand deposits: Cash and cash equivalent if it is easily convertible to cash

Illustration 14.4

Chuks Ltd is preparing it statement of cash flows using the direct method and has provided this information.
₦'m

Credit sale	20,000
Trade and other receivable at year end	3,000
Trade and other receivable at beginning of the year	5,000
Purchase on credit	8,000
Trade payable at year end	3,800
Trade payable at beginning of year	4,000
Operating expenses incurred	6,000
Accrued expenses, beginning of the year	1,000
Accrued expenses, end of the year	800
Depreciation of property, plant and equipment	1,200
Tax paid	3,200

Required:
Prepare the cash flows from operating activities using the direct method.

Solution to illustration 14.4
Cash flows from operating activities

₦''m

Cash received from customers (w1)	22,000
Cash paid to suppliers (w2)	(8,200)
Cash paid towards operating expenses (w3)	(5,000)
Tax paid	(3,200)
Net cash flows from operating activities	6,000

Working Receivables Account

	Nm		Nm
Bal b/f	5,000	Bank received	22,000
Credit Sales	20,000	Bal c/f	3,000
	25,000		25,000
Bal b/d	3,000		

Suppliers Account

Nm			Nm
Bank-paid	8,200	Bal b/f purchase	4,000
Bal c/f	3,800		8,000
	12,000	Balance b/d	12,000
		Balance b/d	3,800

Operation Expenses Account

Nm		Nm	
Bank-paid	5,000	Bal b/f	1,000
Depr. On PPE	1,200	Income statement	6,000
Bal c/f	800		
Balance b/d	800		

Indirect method

Under this method the profits or loss is adjusted for the effects of transactions of non-cash nature. It derives net cash flows from operating activities from the net operating results for the year as reported in the statement of profit or loss.

Example:

Statement of cash flows using indirect method (Cash flows from operating activities)		
	₦'m	₦'m
Profit before taxation		800
Adjustment for:		
Depreciation on PPE	400	
Loss on sale of building	200	
Interest expense	300	900
Movement in working capital:		
Increase in account receivable	(700)	
Increase in account payables	600	
Decrease in inventory	200	100
Cash from operation		1,800
Interest paid	200	
Tax paid	100	(300)
Net cash flows from operating activities		1,500

Illustration 14.5

The statement of financial position of Alade Ltd as at 31 December 2020 and 2021 are given below:

	2021	2020
	₦'000	₦'000
Non-current assets		
Land and buildings	7,170	6,940

Plant and equipments	5,404	6,214
	12,574	13,154
Intangible assets		
Patents	1,704	1,570
Current assets		
Inventory	11,434	11,470
Receivables and prepayments	9,870	9,394
Cash and bank balances	930	230
	36,512	35,818
Current liabilities		
Trade and other payable	(5,590)	(5,344)
Current taxation	(1,790)	(1,970)
Bank overdraft	(544)	(1,410)
	28,588	27,094
Non-Current Assets:		
Deferred taxation	(3,110)	(3,090)
	25,478	24,004
Equity and Liabilities:		
Ordinary share capital	8,800	8,800
Share premium	1,034	1,034
Accumulated profits	15,644	14,170
	25,478	24,004

Notes

a) Depreciation has been charged for the year ended 31 December 2021 as follows

	₦'000
Land and building	174
Plant & machinery	1,200
Patents	46

b) Plants sold during the year realized ₦80, 000. The cost of the plant when it was acquired was ₦304, 000, accumulated depreciation at date of disposal amounted to ₦264, 000.
c) The tax charge was ₦2,080,000
d) Dividend paid in the year amount to ₦1,854,000
e) The profit for the year before tax was ₦5,428,000

Required:
Prepare the statement of cash flows using the indirect method for the year ended 31 December 2021

Solution illustration 14.5 Alade LTD

Statement of cash flows for the year ended 31 December 2021

	₦'000	₦'000
Cash flow from operation activities:		
Profit before tax		5,428
Adjustment for:		
Depreciation	1,374	
Amortization of patents	46	
Profit on disposal of plant	(40)	1,380
Change in working capital		
Decrease in inventory	36	
Increase in receivables	(476)	
Increase in payables	246	(194)
Cash flow from operating activities		6,614
Tax paid		(2,260)
Net cash from operating activities		4,354
Cash flow from investing activities:		
Purchase of land and buildings	(404)	
Purchase of plant & machinery	(430)	
Purchase of patents	(180)	
Proceed from disposal of plant & machinery	80	
Net cash used in investing activities		(934)
Cash flow financial activities:		
Dividend paid	(1,854)	
Net cash flow used in financing activities		(1,854)
Net increase in cash and cash equivalents		1,566
Net cash and cash equivalents Jan 1	(230-1,410)	(1,180)
Net cash and cash equivalents 31 December	386	

Workings

Land and Building Account

	₦'000		₦'000
Opening balance	6,940	Depreciation charged	174
Bank purchase	404	Bal c/d	7,170
	7,344		7,344

Plant disposal

	₦'000		₦'000
Plant account cost	304	Plant account depreciation	264
Income statement	40	Bank sale proceed	80
344			344

Taxation Account

₦'000			₦'000		
Bank (Paid)	2,260	Closing balance c/d	1,790	Opening balance b/d	1,970
				Statement of profit or loss	2,080
4,050					4,050

14.8 End of Chapter Questions and answers

Multiple choice questions

1. Which of the following cash transactions will result in cash outflow?
   - A. Sale of a machine
   - B. Increase in trade receivables
   - C. Increase in trade payables
   - D. Proceed from issue of debenture
   - E. Receipts from customers

2. Which of the following is NOT a cash flow from operating activities?
   A. Cash payment of an insurance entity for premiums on claims, annuities and other policy benefits
   B. Cash advances and loans made to other parties
   C. Cash payments or payments from contracts held for dealing or trading purposes.
   D. Cash receipts from the sale of goods and rendering of services
   E. Cash receipts from royalties, fees, commissions and other revenue

3. Which of the following is/are correct?
   I. A statement of cash flow prepared using the direct method produces same figure for operating cash flow
   from that produced if the indirect method is used
   II. Rights issue of shares do not feature in the statement of cash flow
   III. Revaluation surplus of a non-current asset is not recognised as an item in statement of cash flow
   IV. A profit on the sale of a non-current asset is recognised as an item under cash flows from investing activities in a cash flow statement
      A. I and IV
      B. II and III
      C. II and IV
      D. I and III
      E. I and III

4.

5. When preparing statement of cash flows, which of the following items may NOT be classified as investing activities?

A. Proceeds from the issue of shares, debentures and loan stock
B. Dividends and interest received on investments
C. Purchase of non - current assets
D. Proceeds from sale of non-current Assets
E. Purchase of investments

Use the following information to answer questions 5 and 6:
Opa Limited has the following capital structure:-
Ordinary share capital of 50k ₦100,000
Share Premium Account - ₦150,000

The company made a rights issue of 1 for 5 at N1.50 which were fully subscribed.

6. Determine the value of the rights issue

A. ₦40,000
B. ₦50,000
C. ₦60,000
D. ₦70,000
E. ₦75,000

7. What is the balance on the share premium account following the rights issue?

A. ₦140,000
B. ₦150,000
C. ₦160,000
D. ₦190,000
E. ₦200,000

8. Ale Limited has a gross profit of 11% and its sales are ₦150,000. What is the cost of sales?

₦131,460
₦133,135
₦133,500
₦142,500
₦160,000

14.8.1 Solution to end of chapter questions – multiple choice question.

1. B
2. B
3. D
4. A
5. C
6. D
7. C

Question 1

The trial balance of Kakanfo Ltd for the year ended 31 December 2024 is as follows:

	Dr	**Cr**
	(N'm)	**(N'm)**
Patent rights	60	
Work – in progress 1 January 2024	125	
Lease hold building at costs	300	
Ordinary share capital		600
Revenue		1740
Staff costs	260	
Accumulated deptn on building 1 Jan 2024		60
Inventory of finished goods- 1 Jan 2024	155	
Consultancy fees	44	
Director's remumneration	360	
Computer at costs	50	
Accumulated depre on computer – 1 January 2024		20
Dividend paid	125	
Cash and cash equivalent	440	
Trade receivables	420	
Trade payables		92
Sundry expenses	294	
Retained earnings – 1 January 2024		121

Total	2633	2633

The following information is relevant :

i. Closing inventories of finished goods are valued at N180million. Work -in-progress. Has increased to N140million .

ii. The patent right relates to computer program with a life span of three years.

iii. On 1 January 2024, buildings were revalued to N360million. This has not yet been reflected in the accounts Computers are depreciated over five (5) years. Buildings are now depreciated over thirty (30) years.

iv. An allowance for bad debts (irrecoverable debts) of 5% is to be created.

v. There is an estimated bill for current tax of N120million which has not yet been recognized.

Required:

a) Prepare statement of profit or loss (analyzing the expenses by nature) for the year ended 31 December 2024.

b) Statement of changes in equity for the year ended 31 December 2024

c) Statement of financial position as at that date.

Solution 1

a) kakanfo Ltd

Statement of profit or loss for the year ended 31 December 2024

	N'000
Revenue	1740
Changes in inventories of goods and WIP (W3)	40
Staff costs (W3)	(620)
Depreciation and amortization expenses (W3)	(42)
Other expenses (W3)	(359)
Profit before taxation	759
Income tax expense	(120)
Profit for the year	639

Kakanfo Ltd

Statement of changes in equity for the year ended 31 December 2024

	Share Capital	Revaluation Reserve	Retained Earnings	Total
		N'm	N'm	N'm
	N'm			
Opening bal	620	-	121	721
Divided paid			(125)	(125)
Revaluation (360-(300-60)		120		120
Profit or loss for the year			639	639
Bal as at 31 Dec.	620	120	635	1355

Kakanfo Ltd
Statement of financial position as at 31 December 2024

	N'm
Non- current assets	
Property plant and equipment (W1)	368
Intangible assets (w2)	40
Total non-current assets	408
Current assets	
Inventories (180+ 140)	320
Trade and other receivables (420x 95%)	390
Cash and cash equivalent	440
Total current assets	1159
Total assets	1567
Equity and liabilities	
Equity	
Share capital	600
Other reserves	120
Retained earnings	635
Total equity	1355
Current liabilities	
Trade and other payables	92
Current tax payable	120
Total liabilities	212
Total equity and liabilities	1567

Working notes :

W1 Property plant and equipment

	N'm
Leasehold building	300
Computer	50
Revaluation	60
Total cost/value	410
Accumulated depreciatn b/fwd (60+20)	80
Revaluation	(60)
Charged for the year:	
Leasehold building (360/30)	12
Computer (50/5)	10
Total accumulated depreciation	42
Carrying amount	368

W2 Intangible assets

	N'm
Cost	60
Amotisation (60/3)	(20)
Carrying amount	40

W3 – Cost allocation

	Change in inv	Staff costs	Deprectn	Other Exp
	N'm	N'm	N'm	N'm
WIP(140- 125)	(15)			
Finished goods (18	(25)			
Staff costs		260		
Consultancy fee				44
Directors. Remuneration		360		
Doubtful receivable				21
Sundry exp				294
Amortisation of patent (W2)			20	
Depreciation (12 +10)			22	
Total	(40)	620	42	359

CHAPTER FIFTEEN
INTERPRETATION OF FINANCIAL STATEMENTS

Chapter content

a. Users of financial statements and their information needs
b. Financial analysis
c. Tools of financial analysis
d. Summary of basic accounting ratios
e. Calculation of basic ratios and their interpretations
f. Limitations of ratio analysis
g. Effects of manipulated financial statement on ratios

15.0 Objectives

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

a. Distinguish vertical and horizontal financial analysis
b. Identify different tools of financial analysis
c. Calculate basic financial ratios.
d. Analyse results over time or between entities.
e. Interpret such results
f. Produce reports based on the interpretation
g. Understand basic limitations inherent in such analysis.
h. Discuss manipulation of financial statements and its effect on ratio analysis.

15.1 Users of Financial Statements and Their Information Needs

Financial statements are produced not for their own sake but for different uses to which they can be put by various groups interested in different aspects of the report. These users and their information needs are considered below:

Employees (existing and potential, including management): They are interested in the overall profitability, financial soundness, growth and efficiency of the company.

Investors (existing and potential, including shareholders, takeover bidders, predator companies): These are interested in profitability, earnings potential, dividend policy, yields on investment, financial stability and risk exposure of the firm where they have committed or are intending to commit their fund.

Creditors (existing and potential, including debenture holders, loan providers, bankers, trade creditors, lessors): These are concerned about the company's solvency and ability to pay debt and interest as at when they fall due, asset backing for liability, their position vis-à- vis other stakeholders, etc.

Analysts and Advisors (including credit rating agencies, stockbrokers, investment advisors, insurance brokers, etc.): These are professionals interested in the overall performance of the firm relative to the industry or the whole market.

Government and Its Agencies (including VAT Service, CEPS, IRS and Local Government, Central bank, etc.): This group of users are interested in the profitability and growth prospects of companies within the economy, their ability to meet their tax liability, their ability to generate employment and fulfil their statutory obligation and corporate responsibilities, etc.

Business Contacts (including suppliers, bankers, insurance companies, consumers): This group of people are interested in different things. Suppliers are interested in the continued existence of their client company and its growth. Consumers are interested in quality of goods and/or service delivery, reasonableness of pricing and trade terms, etc. Bankers are interested in the cash flow and performance efficiency of the client. Insurance companies are also interested in the continued operation of the client, risk management policies and safety measures.

The General Public: would like to see corporate bodies living up to their social responsibilities.

15.2 Financial Analysis

The process of reviewing and evaluating the financial statements of companies, thereby gaining an understanding of the financial health of the company and enabling more effective decision making is what is referred to as

Financial Statements Analysis or simply **Financial Analysis**.

Financial Analysis is usually performed by professionals who prepare reports using ratios that make use of information taken from financial statements and other sources. Financial analysis is required for many financial managerial decisions such as:

- How to manage the finances to achieve the strategic goals of the institution
- How to increase profitability
- How to reach self-sufficiency/breakeven point
- How to increase efficiency especially reducing the cost per client
- How to manage the costs of human resources as part of overall human resource management
- How to deal with the effect of inflation
- How to manage liquidity
- How to manage the fixed assets, i.e. what should the asset structure be? How to finance them, are they insured and are they safe, what should be the depreciation policy?
- What is the best financing structure, i.e., how much debt?
- What is the optimum level of each different operational expense including the cost of funds?

15.2.1. Tools of Financial Analysis

Analyzing the financial statement could be done in several ways; through horizontal, vertical or intercompany and ratio analysis.

Horizontal Analysis

Horizontal analysis is the comparison of financial information over a series of reporting periods; it is a form of inter-temporal analysis i.e. a comparison between accounting periods. Horizontal analysis compares two or more years of financial data in both monetary and percentage terms, which is the most straight forward method of analysing financial statements. The current year figures and information are

compared with the previous year(s) to note and rationalize any significant changes. A variation of horizontal analysis is **Trend Analysis** where percentage changes are calculated for several successive years thus having a long run view of the analysis. In trend analysis a firm's present performance figure is compared with its past and expected future performance figure to determine whether the company's financial condition is improving or deteriorating over time.

Vertical Analysis

Vertical Analysis also known as common size financial statement is the proportional analysis of a financial statement, where each line item on a financial statement is listed as a percentage of another item. Typically, this means that every line item on an income statement is stated as a percentage of gross sales, while every line item on a statement of financial position is stated as a percentage of total assets. It is the review of the proportion of accounts to each other within a single period.

Intercompany Analysis

This relates to comparison of performance figure of two or more similar companies. In intercompany analysis, the performance figures of a firm are compared with those of similar firms or with industry averages or norms to determine how the company is faring relative to its competitors. Ideally the `benchmarked companies` should be operating under similar business and economic conditions and applying similar accounting policies. If these are lacking, then adjustments should be made to ensure fair and comparable bases.

Ratio Analysis

Ratio analysis provides relative measures of the firm's conditions and performance. It identifies meaningful statistical relationships between different components of the financial statements. Ratios are useful in evaluating a company's financial position and operations and in comparing financial data for several years or for many companies.

15.2.2 Comparisons and Basis of Comparisons in Financial Analysis

Our discussion of tools of financial analysis enumerated above reveals that comparisons are being made; either inter-temporal and/or intra or intercompany. A single performance indicator or ratio is not sufficient on its own but becomes more meaningful if a benchmark or yardstick is available against which to set the indicator. This call for benchmarking and possible yardsticks to use as a basis for comparisons includes the following:

- Company's own budgeted or targeted performance
- Company's own previous year(s) performance (trend analysis or intra-company analysis)
- Performance figures of similar entities
- Industrial average performance figures
- National economic targets

15.3 Ratio Analysis as a Tool of Financial Analysis

Ratio analysis is the most common form of financial analysis. There are different categories and types of ratios with each of them focusing and evaluating different areas of performance. Therefore, it is important to restrict the calculation by being selective. The ratios chosen should be the key ones relevant to the requirements of the situation. The main point is that there is no single group of ratios suitable for all purposes; specific ratios are required for specific purposes and the analysis must be developed accordingly.

15.3.1 Categories of Ratios

Different users of financial statements are interested in different ratios since their information needs and areas of interest in the company differ. Ratios can be grouped into categories such as:

a) Profitability,
b) Activity or Efficiency,
c) Liquidity (short-term financial stability),
d) Gearing (Long-term financial stability) and
e) Investment and Market Value Ratios.

a. Profitability Ratios

Profitability is the ratio that measures the ability to earn income and sustain growth in both short and long run. A company's degree of profitability is usually based on the income statement, which reports on the company's results of operations. These ratios measure the entity's potential to earn income /revenue in excess of its operating costs.

The absolute figure of profit earned is not in itself significant since the size of the business earnings and profit may vary enormously. It is significant to consider the size of the profit relative to the size of the business; size being expressed in terms of the quantity of capital employed. This is why these ratios are of two types; those showing profitability in relation to sales and those showing profitability in relation to investment. Measures of profitability include the following:

i. Gross Profit Margin
ii. Net Profit Margin
iii. Return on Equity (ROE)
iv. Return on Assets (ROA)
v. Return on Capital Employed

Gross Profit Margin

Gross profit ratio expresses the relationship between gross profit and net sales. Gross profit is the difference between sales and cost of sales. Normally, a higher ratio is considered good. Gross profit ratio is a reliable guide to the adequacy of the selling prices and efficiency of trading activities.

Gross Profit x 100
Total Sale

This is the margin that the enterprise makes on its sales. Normally, this ratio is expected to remain reasonably constant. A change in this ratio over various accounting periods may be traced to a change in:

- Selling price – normally deliberate though sometimes unavoidable, for example, because of increased competition
- Sales mix (often deliberate)
- Purchase cost including carriage or discounts
- Production cost (material, labour, production overhead)
- Inventory (error in counting, valuing or cut off, inventory shortages)

Low margins usually suggest poor performance but may be due to expansion cost (e.g. launching a new product) or trying to increase market share. Above average margins are

usually a sign of good management although unusually high margins may make the competition keen, whereby many will be willing to join the industry and enjoy the rich pickings.

Generally, industries with high volumes of sales and quick turnover rates like food retailing are able to support and sustain low margins while manufacturing industries with high operating overheads would normally have high margins.

Net Profit Margin

This ratio establishes the relationship between net profit and net sales. Net profit ratio indicates the overall efficiency of the business. The higher the net profit ratio, better the business.

$$\frac{\textit{Net}\text{ Profit after tax}}{\textit{Total}\text{ sales}} \times 100$$

Rate of Return on Equity (ROE)
This is the required rate of return on investment in shares. It varies from investor to investor, but should reflect the fact that investment in shares is having a higher level of risk than leaving the money in the bank.

Net Profit after tax - Preferred Dividend
Shareholders' Equity

Return on Assets
This is an indication of how profitable a company is relative to its total **assets**. **It** gives an idea as to how efficient management is at using its **assets** to generate earnings.
Net Profits after Tax x 100
Total Assets
Return on Capital Employed (ROCE)

Return on Capital Employed or Return on Investment judges the overall performance of the enterprise. It measures how efficiently the sources entrusted to the business are being used. The return on capital employed is a fair measure of the profitability of any concern. This ratio also helps in judging performance of different departments as well. In practice, this ratio can be calculated in various ways depending on how capital employed is defined and which of the earnings figure is used, whether earnings before interest and tax (EBIT) or profit after tax (PAT).
In its simple form, this ratio is = Earnings x 100%
Capital Employed

Other versions of ROCE are as follows:

EBIT (Net Profit before interest on long term loan and taxation) x 100 Shareholders Fund + Long term loan

EBIT means Earnings Before Interest and Tax

Profit after Interest and Tax – preference dividends Ordinary share capital + reserves

b. Activity or Efficiency Ratios
These ratios show how well management have been able to utilize the resources of the business to generate income. They include:
i. Sales to Assets Ratio

Sales to Assets Ratio = Sales
Assets
The denominator (Assets) can be defined as Non-current Assets, total assets or various categories of assets; the choice of the appropriate base depends on the user of the information and the purpose of the analysis. The perceived performance of the company is good with a high figure from this ratio; therefore the higher this ratio, the better the performance.

ii. Sales to Capital Employed
This ratio suffers similar challenges like the ROCE because of the different ways of measuring capital employed by the business. Its interpretation is not different from that of Sales to Asset ratio.
Sales Capital Employed

iii. Inventory Turnover Ratio/Period

Inventory turnover ratio establishes the relationship between the cost of goods sold during a given period and the average amount of inventory carried during that period. Higher ratio indicates that more sales are being produced by a unit of investment in inventory. The objective of computing inventory turnover ratio is to ascertain whether investment in stock has been efficiently used or not. A low inventory turnover may reflect dull business, over investment in stock or accumulation of inventory.

Average Inventory x 365 days/52 weeks/12 months
Cost of Sales

Receivables Turnover Ratio/period

This ratio is computed to establish the relationship between net credit sales and average Receivables. This ratio indicates the number of times the receivables are
turned over in a year in relation to sales. It shows how quickly receivables are converted into cash. It indicates the efficiency of the staff entrusted with collection of debts. A high ratio is better since it would indicate that debtors are being collected more quickly.

Debt Collection Period = Average Receivables x 365 days/52 weeks/12 months
Credit Sales

iv. Payable Payment Period

This ratio shows the relationship between net credit purchases and average Trade payables. The objective of computing this ratio is to determine the efficiency with which the creditors are managed and paid. A high ratio indicates that creditors are not paid in time while a low ratio gives an idea that the business is not taking full advantage of Trade payables period allowed by the creditors. A long payment period may be good. It represents a source of free finance. It may however indicate that the company is unable to pay more quickly because of liquidity problems. Note that if the payment period is long, then:

i. The company may develop a poor reputation as slow payer and may not be able to attract new suppliers.
ii. Existing suppliers may decide to discontinue supplies
iii. The company may be losing out worthwhile cash discounts.

Trade payable Payment Period = Average Trade payables x 365 days/52 weeks/12 months
Credit Purchases

It is usual to find the last three ratios 'iii' to' v' listed under liquidity or short-term financial stability ratios as well. This is because they are part of working capital components and determinants of cash operating cycle.

c). Liquidity or Short-term financial stability Ratio

Liquidity or short-term financial stability ratios measure the ability of a firm to maintain positive cash flow, while satisfying immediate obligations. The common ones are:

Current Ratio

Current Ratio = $\frac{\textit{Current}\ \text{Assets}}{\text{Current liabilities}}$

The current ratio measures the adequacy of current assets to meet short term liabilities. It reflects whether the entity is in a position to meet its liabilities as they fall due. Traditionally, a current ratio of 2 or higher was regarded as appropriate for most businesses to maintain credit worthiness. However in recent times, a figure of 1.5 may be regarded as the norm (In practice, what is an ideal ratio depends on the industry and the particular circumstance of the entity involved). A higher figure should be perceived with some suspicion as it may be due to high level of inventory and receivable or high cash levels which could be put to better use. The current ratio should be looked at in the light of what is normal for the business. For example, supermarkets tend to have low current ratio because there are no trade receivables and there is usually very tight cash control.

Quick Ratio or Acid Test Ratio

Quick ratio is also known as the acid test ratio because by eliminating inventories from current assets, it provides the acid test of whether the enterprise has sufficient resources (in terms of receivables and cash) to settle its current liabilities. The Norm is for the quick ratio to be between 1 and 0.7 (even though in practice what is an ideal ratio depends on the industry and the circumstance of the entity).

$$\text{Quick Ratio or Acid Test Ratio} = \frac{\textit{Current}\ \text{Assets less Inventory}}{\textit{Current}\ \text{Liabilities}}$$

Inventory Turnover Period

Stock Turnover Period= Average Inventory x 365 days/52 weeks/12 months
Cost of Sales

Receivables Collection Period

Debt Collection Period =Average Trade Debtors x 365 days/52 weeks/12 months
Credit Sales

Payables Payment Period

Creditors Payment Period = Average Trade creditors x 365 days/52 weeks/12 months
Credit Purchases

Cash Operating Cycle/Working Capital Cycle

This indicates the length of times it takes a business to convert its Inventory into sales (stock turnover period), converts receivables into cash (receivable collection period) and mobilizes cash to pay its trade payables (payable payment period).

Inventory turnover period	xx
Receivable Collection Period	xx
	xx
Less payables payment period	xx
Cash operating cycle	xx

The longer the period, the worse it is for the business because the longer the period, the higher the working capital requirement. It is therefore essential that under normal circumstances, a company works towards reduction of the Inventor turnover period and the Trade receivable collection period and expansion of the Trade payables payment period.

15.4 The Concept of Overtrading

Overtrading arises when a company expands its sales revenue fairly rapidly without securing additional long term capital adequate for its needs. The symptoms of overtrading are:

i. Inventory increasing, possibly more than proportionately to revenue

ii. Receivables increasing, possibly more than proportionately to revenue

iii. Cash and liquid assets declining at a fairly alarming rate

iv. Payables increasing rapidly

The symptoms imply that the company has expanded without giving proper thought to the necessity to expand its capital base. It has consequently continued to rely on its suppliers and probably its bank overdraft to provide the additional finance required. It will reach a stage where suppliers will withhold further goods and bankers will refuse to honour further cheques until borrowings are reduced. The problem is that borrowings cannot be reduced until sales revenue is earned which in turn cannot be achieved until production is completed which in turn dependent upon materials being available and wages is paid. Overall result is deadlock and rapid financial collapse.

15.5 Gearing or Long- term Financial Stability Ratios

These ratios assess the ability of the entity to fulfill its obligation to creditors and other third parties in the long-run.

They measure the relationship between equity capital and debt capital of the company and also indicate financial risk and stability of the company.

Ratios computed under this sub-heading include the following:

i. Total Debts to Shareholders Fund = $\frac{\textit{Total debts}}{\text{Shareholders' equity}}$

ii. Long Term Debts to Shareholders Fund

This ratio measures the relationship between equity fund and debt capital. Within this context, preference shares are considered as debt capital (probably because they normally attract fixed rate of dividends and also they are cumulative). It is also known as the gearing or leverage ratio.
Gearing is the relationship between fixed interest bearing long term loans plus fixed dividend bearing shares on one hand and equity share capital or equity fund on the other. The objective of companies is to obtain favourable or positive leverage. This means that the business raises fund at a relatively low fixed servicing cost (in terms of interest and dividends) and uses these funds to earn a much higher returns than their servicing cost. This strategy is known as trading on the equity and is evidenced by improvement in earnings per share.

Long Term Debt to Shareholders Fund =
Long Term Loan + Preference Shares Shareholders Fund

The Concept of Financial Balance

The capital leverage of a company brings into focus the concept of *'financial balance'* It is the balance between the various forms of available funds. A business must have a sufficient level of long term capital to finance its long term investments in non-current assets. Part of the investment in current assets will also be financed by relatively permanent capital with the balance being provided by credit from suppliers and other short- term borrowings.

Any expansion in activity will normally require a broadening of the long capital base, without which overtrading may develop.

Suitability of finance is also a key factor. A permanent expansion of a company's activities should not be financed by temporary, short term borrowings. On the other hand a short term increase in activity such as the ***December Christmas Sales'*** for a company retailing children's wear would ideally be financed by short-term borrowing e.g. bank overdraft.
A major addition to Property Plant & Equipment fixed assets such as the construction of a new factory would not normally be financed on a long term basis.

iii. Proprietary Ratio

Proprietary ratio is also known as Equity Ratio or Net worth to total assets. It establishes relationship between proprietor's funds to total resources of the firm. It is the inverse of debt ratio and is not very widely used.

Proprietary Ratio = $\frac{\text{Shareholders Fund}}{\text{Total Tangible Assets}}$

iv. Fixed Interest Cover

Interest cover shows how many times interest payments are covered by operating profits, or the ability of a company to pay for the cost of its long term borrowing out of profit is measured by its interest cover. A low interest cover is a warning to ordinary shareholders that their dividend may be endangered if profits are not maintained.

Fixed Interest Cover =Net Profit before Interest and Tax
Fixed Interest paid or payable

v. Fixed Dividend Cover

This is the relationship between available profits and the ordinary dividends payable out of those profits, reflecting how sustainable the dividend level is likely to be in the future

Fixed Dividend Cover =Net Profit before Interest and Tax
Preference Dividend paid or payable

Investment or Market Value Ratios

These are ratios that measure potential and actual growth of a shareholder's investment

The Earnings Per Share (EPS)

The EPS is used primarily as a measure of profitability and so an increasing EPS is a good sign.

Earnings per Share i.e. EPS = $\frac{\textit{Earnings}\text{ after Taxes}}{\textit{Total}\text{ Number Shares}}$

The limitations of EPS are as follows:

i. In times of rising prices, EPS will increase as profits increase. Thus any improvement in EPS should be viewed in the context of the effect of the price level changes on the company's profits
ii. Earnings Per Share is dependent on an earnings figure, which is a subjective measure. Some elements of the earnings figure are particularly subjective such as depreciation charges.
iii. EPS is a historical figure based on historical accounts. This is a disadvantage where it is used for a forward-looking figure such as the price earnings ratio
iv. EPS cannot be used as a basis of comparison between companies, as the number of share in issue in any particular company is not related to the amount of capital employed.

Dividend Per Share (DPS)

This indicates the amount payable as dividend per ordinary share. It is usually recommended by the directors and approved by the shareholders. When compared with EPS, it indicates the retention policy of the Company.

Dividend per Share = Dividend \

Total Number of Shares

Earnings Yield

This measure relates EPS to the market price per share and it is a very important stock market performance indicator.

Earnings yield = Earnings per share x 100 Market price per share

Price Earnings Ratio

This ratio is the reciprocal of earnings yield and it indicates the payback period of the investment made in the shares. It is the most widely referred to stock market ratio. It is also commonly referred to as *Earnings Multiple* and it represents the market`s consensus of the future prospects of that share. The higher the P/E ratio, the faster the growth the market is expecting in the company`s future EPS; and the lower the P/E ratio, the lower the expected future growth.

Price/Earnings Ratio = *Share* Price
Earning per Share

Dividend Yield

This is the percentage of the gross dividend to the market price. The dividends are grossed up to show the amount including tax where applicable**.**

Dividend yield= *Dividend* Per Share
Share Price x 100

Dividend Pay-Out Rate

This ratio indicates the percentage of the earnings for the year (available to equity shareholders) that is actually declared as dividend.

$$\text{Dividend Pay-Out Ratio} = \frac{\text{Dividend per share}}{\text{1. Earnings per share}} \times 100$$

15.6 Calculation of Basic Ratios and Their Interpretation

A number of worked examples showing how basic accounting ratios are calculated are given below.

ILLUSTRATION 15.1

The capitals employed by two different companies operating in the same industry are as follows

		Glory Ltd ¢	Praise Ltd ¢
Equity Shares (issued at ¢2)		600,000	1,800,000
Preferences Shares (issued at ¢2)		600,000	--
		1,200,000	1,800,000
Retained earnings		800,000	1,200,000
Total equity	2,000,000		3,000,000
18% Debentures	2,000,000		1,000,000
Capital Employed	4,000,000		4,000,000

The preference shares is irredeemable

Required

i. Calculate the gearing ratios of each company, stating in each case whether the gearing is high or low.

ii. Calculate the maximum dividend per share on equity dividend which each company could declare, without utilizing, or adding to, surplus. if net profits before interest and tax for 2021 were Glory ¢1,000,000 and Praise ¢1,000,000. The preference shares attract a fixed dividend of 24 pesewas per share per annum. Assume company income tax to be at the rate of 30%.

iii. What conclusions can you draw from your calculation in (ii) above?

Solution 15.1

b) (i) Gearing = Long Term Loan + Preference Shares
Total equity

	Glory Ltd	Praise Ltd
	¢2,600,000 =185% ¢1,400,000	¢1,000,000 ¢3,000,000 =33.3%
	Highly geared	Lowly geared
	=	
b) ii	Glory Ltd	Praise Ltd
Net Profit before Interest and Tax	₵1,000,000	₵1,000,000
Less Interest	360,000	180,000

Net Profit before tax	640,000	820,000
Less Tax	192,000	246,000
Net Profit after tax	448,000	574,000
Preference dividend (600,000 x 24p)	144,000	-
Profit available for equity shareholders	304,000	574,000

Maximum dividend per share ₵304,000 = ₵0.51 ₵600,000
₵574,000 ₵1,800,000
=₵0.31

iii. It can be seen that in Glory Ltd, the highly geared company, EPS is substantially better than in Praise Ltd which is lowly geared, although both companies have the same net profit before interest and tax. This is due to the fact that the return on capital employed earned was higher than the fixed interest rate and fixed dividend rate.

Illustration 15.2
The figures below relates to QRS Ltd For the year ended 31 December 2024

Gross profit	3,985,000
Net Profit	1,275,000
Turnover	13,715,000
As at 31 December 2024	D
Shareholders' Fund	6,675,000
Total Tangible Assets	10,040,000
Total Current Assets	160,000
Current Liabilities	125,000
Long term loans	3,240,000
Inventories	95,000

Required:
Using the above figures and what can be derived there from, calculate profitability and financial stability ratios discussed above.

Solution 15.2

Some ratios that can be used to measure profitability are

- Net Profit to Total asset % (Return On Assets or ROA)
- Net Profit to Non-current assets %
- Net Profit to capital Employed (ROCE)
- Gross Profit to Sales %
- Net Profit to sales %

Some ratios that can be used to measure financial stability are

- Shareholders‟ funds to total tangible assets (Proprietary ratio)
- Long term external finance to shareholders funds
- Total external finance to shareholders‟ funds
- Current ratio
- Quick ratio or acid test ratio

b) Profitability

i)	Net profit on Total Assets %	= 1,275,000/D10,040	=12.7%
ii)	Net Profit to Noncurrent Assets %	=1,275,000/(D10,040,000 – D160,000)	=12.9%
iii)	Net Profit to Capital Employed	=1,275,000/ (D6,675,000 +D3,240,000)	= 12.86%
iv)	Gross Profit to sale%	= 3,985,000/D13,715,000	= 29.1%
v)	Net Profit to Sales %	=1,275,000/D13,715,000	= 9.3%

Financial Stability

Proprietary Ratio	=6,675,000/D10,040,000	= 66.5%
Long Term External Finance to SF	=3,240,00/D6,675,000	= 48.5%
Total External Finance to SF	= 3,240,000+D125,000) D6,675,000	= 50.4%
Current Ratio	= 160,000/D125,000 :1	= 1.28:1
Quick A Ratio	= 160,000 – D95,000) /D125,000	= 0.52 :1

Illustration 15.3

The summarized final accounts for the year ended 31 December, 2006 for two retailing companies in the same industry are as follows:

Income statement for the year ended 31 December 2016

	Adom Ltd	Grace Ltd
	L$	L$
Sales	400,000	400,000
Cost of sales	(280,000)	(292,000)
Gross profit	120,000	108,000
Expenses	(94,800)	(84,960)
Net Profit	25,200	23,040

Statement of Financial Positions as at 31 December , 2024

		Adom Ltd (L$)	Grace Ltd (L$)
Non-Current Assets		260,000	160,000
Current Assets:			
Inventory		96,000	24,000
Receivables		34,000	8,500
Cash		10,000	39,500
		140,000	72,000
Current Liabilities		(40,000)	(4,000)
Net Current Liabilities		100,000	32,000
		360,000	192,000
Financed by			
Stated Capital		160,000	160,000
Income Surplus		200,000	32,000
		360,000	192,000

Notes:			
Opening Inventory were as follows		64,000	16,000

Required:

a) Calculate the following ratios for the respective companies:

- Current Ratio
- Acid Test Ratio
- Rate of Inventory Turnover
- Gross Profit to Turnover %
- Net Profit to Turnover %
- Net Profit to Capital Employed %

b) One of the companies had adopted the policy of selling goods as cheaply as possible to increase the volume of sales. The other company gives special attention to customer service and charges top prices for its goods.

Required

State with reasons, which of these companies, Adom Ltd or Grace Ltd, is better using ratios in part (a) of the question

Solution 15.3

	Adom Ltd	**Grace Ltd**
a) Current Ratio	L$140,000	L$72,000
	L$40,000 =3.5:1	L$40,000 =1.8:1

Acid Test	L$44,000 / L$40,000	=1.1:1	L$48,000 / L$40,000	= 1.8 : 1
Rate of Inventory Turnover	L$280,000 / 80,000	=3.5times	L$292,000 / 20,000	=14.6

Gross Profit % = L$120,000 / L$400,000 = 30%

L$108,000 / L$400,000 = 27%

Net Profit % L$25,200 / L$400,000 =6.3%

L$23,040 / L$400,000 = 5.8%

Net Profit to Capital Employed L$25,200 / L$360,000 =7.0%

L$23,040 / L$192,000 = 12%

Adom Ltd carries a wider range of expensive Inventory, consequently inventory turnover is slower. More substantial investment in non-current assets, stemming from ownership of a prime prestigious site and luxurious premises has accounted for a relatively low return on capital employed.

Grace Ltd charges lower prices which encourage sales. The faster Inventory turnover is the result of the company operating on a Inventory figure of about one quarter of that of its competitor.

Illustration 15.4

The financial information provided below is for two companies which operate in similar retail fields, using the same business and accounting policies.

Statement of financial position at 30 June , 2024

	GODSON LTD	ALLASON LTD
	¢	¢
Assets		
Non-current	11,260	15,700

Current Assets		
Inventories	2,440	1,940
Trade Receivables	2,480	3,320
Cash	120	160
	5,040	5,420
Total assets	16,300	21,120
Share Capital	7,000	9,400
Capital reserves	1,300	700
Retained earning	3,700	5,740
Equity	12,000	15,840
10% loan notes	1,100	1,280
Current Liabilities		
Bank overdraft	420	400
Trade payables	1,940	2,640
Other payables	840	960
	3,200	4,000
Total equity and liabilities	16300	21,120

Statement of income for the year ended 30 June 2024

	GODSON LTD	**ALLASON LTD**
Sales	¢ 14,940	¢ 11,400
Cost of sales	11,360	7,540
Gross Profit	3,580	3,860
Less: Expenses		
Selling and Distribution	1,280	1,200

Administration and General	620	580
Financial	180	160
	2,080	1,940
Net Profit before	1,500	1,920
Taxation	740	900
Net Profit after tax	760	1,020
Dividends	480	740
Retained Profit	28	280

You are required to:

a. Calculate for each company six ratios which you consider to be most appropriate for indicating the efficiency of operation and short term financial strength of the two firms showing the figures you have used and pointing out any weakness in the figures, and alternatives that might be taken had more information been available.

b. Using the financial information provided above and the ratios you have calculated, prepare a report which analyses and compares the efficiency of operations and short-term financial strength of the two companies.

Solution 15.4

The question requires only six ratios to be calculated out of the many which can be calculated. The main feature of the question is that there should be a judicious selection of ratios. Different accountants would make different choices.

	Godson Ltd	**Allason Ltd**
Efficiency of Operation		
Sales/non-current assets	¢14,940	¢11,400
	¢11,260	¢15,700
	= 1.33 times	=0.73times

Profit before Tax/Capital employed	¢1,500 =11.45% ¢13,100	¢1,920 = 1.33 times ¢17,120
Sale/Capital employed.	¢14,940 11,420 =1.4 times	11,400 17,120 =0.67 times
Debts collection period	2480 x 365days =61days 14,940	3320 x 365days = 106days 11,400

The main weakness in the figures is that the ratios have been calculated on the figures prepared under historic cost convention. Consequently, if one of the companies is much older than the other, it will have better efficiency ratios, all other things being equal, by reason of its total assets and capital employed being less than those of other company since a greater number of years" depreciation would have been accumulated.

If more information had been available, figure on current cost accounting basis could have been used. This would not only have taken inflation into account, but also would have the effect of making the two companies" figures time comparable.

b. Report on Inter-Company Performance Comparison Efficiency of Operation

In absolute terms, Allason has achieved a greater net profit (¢1,920) on a lower turnover figure of ¢11,400) compared with ¢14,940m for Godson Ltd. This represents net profit to sales of 16.85% for Allason Ltd as against 10% for Godson Ltd.

This situation is mainly attributable to the Gross Profit Ratio of 33.86% and 23.96% for Allason and Godson respectively. Bearing in mind that these are similar businesses, this disparity is remarkable. From the evidence which follows, there might be good reasons for saying that Godson Ltd is under-pricing its goods and that Allason Ltd is over-pricing them and that both companies might improve profits and profitability by remedying this situation.

Godson's lower Gross profit margin of 33.86% seems to be responsible for its faster Inventory turnover of 5.07 times compared with Allison's rate of Inventory turnover of 4 times. The lower turnover (¢11,400) and slower Inventory turnover (4 times) of Allason are reflected in its poor sales to capital employed ratio of 0.67 times or 67% compared with 1.14% for Godson Ltd. Overall profitability

(ROCE) is consistent with the above findings.

Short-term Financial Strength

At both 1.56:1 and 1.36:1, the working capital positions of both companies seem weak. The Receivable collection and Payable settlement periods of Godson are evenly balanced (about 61/62 days) while those for Allason are about 106 days and 128 days respectively.

If those for Godson are on the high side, Allason's figures are incredibly high. Considering the similarity of the businesses, the disparities between the two companies is surprising. The liquidity problem could be overcome by issuing share capital or debentures.

15.7 Limitations of Ratio Analysis

Ratios are meaningless on their own unless they are interpreted to bring out their intended meaning and

to tell the intended stories to aid management decisions. The following points should serve as a checklist

i. What does the ratio literally mean?
ii. What does a change in the ratio mean?
iii. What is the norm?
iv. What are the limitations of the ratio?

Computing financial ratios are merely one way of conducting financial analysis and financial ratios face several theoretical challenges among which are:

1. Financial statements themselves have limitations, e.g. they contain arbitrary estimates and figures which are based on personal decisions. Another limitation of financial statement is window dressing. To give a better picture of the company, accounting figures may be manipulated.
2. The application of accounting policies in the preparation of financial statements must be understood when attempting to interpret financial ratios. Inter firm comparison is possible provided these firms follow the same accounting policies regarding the method of depreciation, valuation of stock, etc. But this is very rare to see.
3. The effect of inflation: The problem of interpreting data in a period of changing prices is can only be catered for if prior year(s) figures are adjusted to constant values. The interpretation and comparison of ratios are rendered invalid by the changing value of money.
4. A few simple ratios do not provide an automatic means of evaluating a company. Business problems usually involve complex patterns which cannot be solved by the use of ratios.
5. Ratios must not be used as the sole test of efficiency. Concentration of ratios may inhibit the incentive to grow and expand, to the detriment of the long-term interests of the company.

6. The earning power of a business may well be affected by factors which are not reflected in the financial statements. Thus, these do not necessarily represent a complete picture of a business, but only a collection of those parts which can be translated into money terms e.g. the size of the order book and the existence of a highly trained workforce are normally ignored in financial statements.
7. Ratios say little about the firm's prospects in an absolute sense. Their insights about relative performance require a reference point from other time periods or similar firms.
8. One ratio holds little meaning. As indicators, ratios can be logically interpreted in at least two ways. One can partially overcome this problem by combining several related ratios to paint a more comprehensive picture of the firm's performance.
9. Seasonal factors may prevent year-end values from being representative. A ratio's values may be distorted as account balances change from the beginning to the end of an accounting period. Use average values for such accounts whenever possible.
10. Financial ratios are no more objective than the accounting methods employed. Changes in accounting policies or choices can yield drastically different ratio values.
11. They fail to account for exogenous factors like investor behaviour that are not based upon economic fundamentals of the firm or the general economy (fundamental analysis).
12. Many large companies actually operate a number of different divisions in quite different industries making it difficult to develop a meaningful set of industry averages for comparison purposes.
13. At times, even for those companies operating in one industry it is difficult to decide on a proper basis for comparison. Ratios of a company have meaning only when they are compared with some standards. Generally there is no standard ratio for the purpose of the comparison, because conditions of one concern differ significantly from another concern. For example, an ideal current ratio is 2: 1. But if a firm is able to procure additional funds easily and immediately, in that case current ratio of less than 2 may be considered good.
14. The differences in definitions of items in the statement of financial position and income statements make the interpretation of ratio difficult. In practice, differences exist as to the meaning of certain term e.g. capital employed. Terms used to calculate accounting ratios have no standard and precise.
15. Definition. For example, net profit ratio is calculated by different ways like net profit before tax or net profit after tax.
16. Ratios calculated at a point in time are less informative and effective as they suffer short-term changes and qualitative factors like skill of employees, quality of product/ service, competitions, industrial relations, etc. are ignored.
17. Life cycle of the business, such as type of firm, stage of development, objectives of owners are not considered. For example low profitability ratios may be accepted during early stages of growth.
18. Ratios indicate past performance only. Ratios are calculated on the basis of past figures. Thus, ratios indicate past performance and not expected future performance. Since past is quite different from what is likely to happen in future, it is difficult to use ratios for forecasting purposes. The financial analyst is more interested in what will happen in future. The management of a company has information about the company's future plans and, policies and is, therefore, able to predict future to a certain extent. But an outsider analyst has to rely only on the past ratios.

19. Unless ratios are calculated in a uniform manner, from uniform data, comparisons can be very misleading.
    The accounting periods covered by the financial statements may not reflect representative financial positions. Many businesses produce financial statements to a date on which there are relatively low amounts of trading activities. If trade is seasonal, the items in the statement of Financial Position may not be representative of values throughout the accounting period.

15.8. Manipulations of financial statements

Entities may manoeuvre their way through in order to produce a desired effect on the decisions of users of financial statements. In sophisticated scenarios, the accounting practice/policy adopted may be acceptable or compliant to standards but is not fair to all parties who will use such accounting information. This is termed creative accounting.
Window dressing would mean an unethical practice of distorting financial statements to sway users of the information therein. Creative accounting is pre-meditated and planned from outset while window dressing is often reactionary.
Some examples of financial statements manipulation include:

a) inconsistent revaluation of items of property, plant and equipment- intended to boost the assets of an entity; and

b) attributing high amount as cost for uniquely made or invented product or intangible asset where there is no market to ascertain its fair value and only the inventing entity can reasonably assign a value to it.

(i) Window dressing or misleading tendencies of related transactions
The International Accounting Standard 24 details provisions on who related parties are. It covers all those relationships between companies and their parents, subsidiaries, associates, joint ventures and even entities with common management. It also includes key management personnel and staff with significant shareholding in any company.

Companies in the above relationship may provide misleading financial statements to sway decision in a preconceived manner. Examples are:

a) directors of company A who are also directors of company B may decide to forfeit their allowances and remuneration for company B to reduce their reported expenses in like sum;

b) over-invoicing by one company to another so as to show boosted earnings in the invoicing company's financial statements;

c) intercompany discounted transactions to achieve reduced purchasing cost in the financial statements of the buying company; and

d) classifying a subsidiary in a massive loss-making swing as a discontinued operation so as to avoid consolidating same in the financials of the group, to show an impressive result where it should be far from that.

(ii) Window dressing/ creative accounting in financial statements
Figures or amounts in the statement of financial position represent the position as on a particular date; the date on the statement. It does not reveal the pattern of the accumulation or reduction of the income and expense items, assets, liabilities and equity over the period.
It is important to factor in the possibility of mid-year or quarterly transactions which give rise to the figure seen on the date of the statement of financial position. The following transactions may have occurred:

a) seasonal trading e.g. in a yuletide boosting the profit margin reported in the reserves;

b) pay down on a loan/debenture at year end, which was used in generating income during the year for the business; and

c) year-end acquisition of item of property, plant and equipment which may not have been actively used at all, whereas analysis of the financial statements may be looking at the efficiency of use of operating capacities.

The emphasis is to appropriately capture the particular period of an accounting year when items contained in the Statement of Financial Position were transacted and to sensitise them for effective and value adding analysis.

Impact of window dressing on Calculated Ratios

Window dressing and creative accounting can distort financial ratios, making it difficult to accurately analyze a company's financial performance. Some examples include:

a. Window dressing can temporarily improve the current ratio by reducing accounts payable or increasing accounts receivable.
b. Creative accounting can reduce the debt-to-equity ratio by keeping debt off the balance sheet or revaluing assets to increase equity.
c. Aggressive revenue recognition or asset revaluation can artificially inflate ROA.
d. Creative accounting can manipulate EPS by recognizing revenue prematurely or using complex accounting standards to obscure the true financial performance of a company.

Consequences of window dressing and creative accounting

The consequences of window dressing and creative accounting can be severe, including:

a. If investors discover that a company has engaged in window dressing or creative accounting, they may lose confidence in the company's financial reporting and management.
b. Companies that engage in window dressing or creative accounting may face regulatory scrutiny, fines, or other penalties.
c. Window dressing and creative accounting can create financial instability by hiding a company's true financial performance and creating unrealistic expectations among investors and other stakeholders.

15.9 Chapter Summary

Users of financial statements can best appreciate the contents if they can interpret the statements and make meaning out of them. Horizontal or intra-company analysis involves comparing the current year with the previous year(s) and noting any significant changes. Intercompany analysis involves comparing an entity's performance with another entity of comparable standard ratios are one means of analyzing financial statements. Ratios can be grouped into categories such as Profitability, Liquidity (short term financial stability), Efficiency, Gearing (Long term financial stability) and Investor ratios. Different users of financial statements are interested in different ratios. Ratios are only as good as the underlying information and this must therefore be considered as to its reliability and the degree to which it may have been manipulated.

15.10 END OF CHAPTER QUESTION

1. During a year, a business sold inventory which had cost N120,000. The inventory held at the beginning of the year was N12, 000 and at the end of the year was N20,000. What was the annual rate of inventory turnover?
   A. 12times
   B. 10 times
   C. 7.5 times
   D. 7 times
   E. 6 times

2. Given a selling price of Le350, 000 and a gross profit mark up of 40%, the cost price would be
   A. Le300,000
   B. Le250,00
   C. Le210,000
   D. Le140,000

E. Le100,000

3. A business operates on a gross profit margin of $33^1/3\%$. Gross profit on sale Was L$1,600 and expenses were L$1,360. The net profit percentage is
   A. 22.67%
   B. 11.25%
   C. 18.5%
   D. 5.0%
   E. 3,75%

4. In 2006, a company's current ratio was 2.5:1 and its acid test ratio was 0.8:1. By year 2007, the ratios are expected to be 3:1 and 0.6:1 respectively. These changes are most likely to be due to which ONE of the following
   A. Increased bank balance
   B. Decreased bank balance
   C. Increased Inventories
   D. Increased receivable and payable
   E. Decreased Inventories

SHORT ANSWER QUESTIONS

1. State the formulae for computing inventory turnover ratio
2. State how to compute quick asset ratio.
3. State the formulae for debt collection period
4. (Long term loan + Preference shares)/Equity is equal to
5. Which user group would be most interested in the gearing ratio?

SOLUTION TO MULTIPLE CHOICE QUESTIONS

1. C
2. B
3. D
4. D

SOLUTION TO SHORT ANSWER QUESTIONS

1. Inventory turnover ratio= $\frac{\text{Average Inventory x 365 days}}{\text{Cost of Sales}}$ / 52 weeks /12 months

2. Quick Ratio or Acid Test Ratio = $\frac{\textit{Current}\text{ Assets less Inventory}}{\textit{Current}\text{ Liabilities}}$

Debt Collection Period = $\frac{\text{Average Receivables}}{\text{Credit Sales}}$ x 365 days /52 weeks/ 12 months

Examination Type Question

a) It is widely believed that in order for a business to succeed it must pay attention not only to its profitability but also to its financial stability.

Required

i. State briefly what you understand to be the meaning of the terms `Profitability" and "financial stability"

ii. Name three ratios which can be used for measuring profitability and three ratios for measuring financial stability.

SOLUTION a (i)

Profitability

This is the measure of relationship between profit and the resources employed in earning it: the resultant figure is usually expressed as a percentage. The resources aspect of the relationship may comprise total assets or fixed assets plus working capital or equity fund.

For other businesses which are not asset reliant, an alternative suitable measure might be adopted.

Thus in a profession such as that of an accountant or a solicitor, profit would be more appropriately related to fee income. A subsidiary measure of profitability is in the relationship between gross profit and net profit to sales.

Financial Stability

This measures the degree of safety of a business from failure due to inability to pay its way. It is necessary to consider stability in both the long and short term. Thus, in assessing financial stability, important relationships include e.g. those subsisting between total resources owned and external obligations (that is, solvency) and between short term resources owned and external obligations which have to be met in the near future (that is, liquidity). Stability is the firm's ability to remain in business in the long run, without having to sustain significant losses in the conduct of its business. Assessing a company's stability requires the use of both the income statement and the statement of financial position, as well as other financial and non-financial indicators.

a.(ii) Ratios that can be used to measure profitability are

- Net Profit to Total asset % (Return On Assets or ROA)
- Net Profit to Non-current assets %
- Net Profit to capital Employed (ROCE)
- Gross Profit to Sales %
- Net Profit to sales %

Ratios that can be used to measure financial stability are

- Shareholders" funds to total tangible assets (Proprietary ratio)
- Long term external finance to shareholders funds
- Total external finance to shareholders" funds
- Current ratio
- Quick ratio

CHAPTER SIXTEEN

Professional Ethics and Applications of Basic Information Technology

Chapter contents

a) Introduction
b) Explanation of professional ethics
c) Importance of ethics
d) Fundamental principles of professional code ethic
e) Threats that may affect professional accountants' behaviour
f) Safeguards that may reduce or eliminate ethical threats
g) Ways by which financial information may be compromise
h) Consequences of unethical financial behaviour
i) Explanation of digitization of financial accounting
j) Computerised accounting system
k) Internal controls in a computerised environment.
l) Specialised areas of information technology and its application to financial accounting.

16.0 Objectives

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

- Explain the need for professional ethics
- Identify the principles of honesty and integrity sets out in the professional codes of ethics
- Explain the various way by which financial reports can be manipulated
- Explain the motivation for unethical behaviours in financial reporting
- Identify and explain threats that may affect professional accountants from compliance with ethical behaviour
- Explain how to resolve ethical issues
- State consequences of unethical financial behaviors
- Identify and explain digitization of financial accounting
- Explain and describe computerized accounting system and its internal controls
- Identify and explain the types of accounting software packages
- Explain the application of information technology to financial accounting.

16.1 Introduction

In general terms ethics is a set of moral principles and standards of correct behaviour. They are essential for any society to operate and function effectively. Put simply they help to differentiate between right and wrong, although their application often involves complex issues, judgement and decisions. While ethical principles can be incorporated into law, in many cases their application must depend on the self-discipline of the individual. This principle can be said to apply to society, the business community and the accountancy profession.

16.2 Professional Ethics

The Need for Professional Ethics in Financial Reporting

Professional accountants are faced with a series of ethical pressures and influences from employers, individual clients, chief executives and politicians in the course of their duties. The professional accountant’s responsibility is not to satisfy the needs of their client or employer only but to act in the public interest.

Existing and potential shareholders need financial reports for decision making on the

investment and financial aspects of the organisation. The financial reports produced by the accountant should be based on certain fundamental qualities for various users to understand the content of the report. Accountants have obligations to shareholders, creditors, employees, suppliers, the government, the accounting profession and the public at large. In other words, their obligations go beyond their immediate client, hence behaving ethically is essential and expected from accountants and those that deal with financial reporting in general.

Ethics and ethical behavior refer more to general principles such as honesty, integrity, and morals. The code of professional conduct, however, is a specific set of rules set by the governing board of professional accounting bodies. The rules set out by different bodies around the world are unique, but some rules are universal.

16.3 Importance of ethics

Ethics in business- business life is a fruitful source of ethical dilemma because the whole purpose of business is material gain, that is, the making of profit in business
People are under pressure to do whatever yields such an advantage. In view of this organisations have become increasingly under pressure to act and be seen as acting ethically and therefore in recent times many businesses have demonstrated it by publishing their ethical codes

Ethics and accounting profession- a distinguishing feature of accountancy profession is its acceptance of responsibility to act in the public interest. Therefore, professional accountants must act to protect the interest of the following; clients, lenders government, employer's employees, investors, business and the financial community as well as others who rely on the work of professional accountants

Ethics and the individual – while legislation and professional bodies have their part to play through the issue ethical guidance; however, the importance of the integrity of the individual is also very important its ethical consequences are potentially very significant. For example, an individual must know when to 'whistle blow' on questionable practice at work.

16.4 Fundamental principles of Professional code of ethics

i. Integrity Professional accountants should be honest and straightforward in their professional and business dealings. They must be seen to be honest. Integrity implies not just honesty but also fair dealings and truthfulness;
ii. Objectivity ICAN members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgments;
iii. Professional competence and due care Members have a duty to maintain their professional knowledge and skills at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques. They should act diligently and in accordance with applicable technical and professional standards;
iv. Professional behavior Members must comply with relevant laws and regulations, always behave with courtesy and should avoid any action which can put the profession to disrepute; and
v. Confidentiality Members should not disclose any information about their clients or employers to third parties without the consent of such or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

16.5. Threats that may affect professional accountants from compliance with ethical behaviour

The following five threats have been identified by the International Federation of Accountants (IFAC).

i. Self-interest threats or conflicts of interest: These occur when the financial and other interests of the professional accountant, or a close family member, inappropriately affect the accountant's decisions or actions.

ii. Self-review threats: This is the threat that a professional may not review appropriately some work done previously by him or by another individual within the same firm. A typical example is a situation where a professional accountant prepares the annual financial statements for a client and then is appointed to do the audit.

iii. Advocacy threats: This type of threat can occur when an accountant promotes the point of view of a client, for example by acting as a professional witness in a legal dispute.
This may impair the objectivity of the accountant

iv. Familiarity threats: The is the threat that results from a long or close relationship with the client such that an accountant might become too sympathetic to the client and more willing to accept the client's point of view.

vi. Intimidation threats: A professional accountant might find that his objectivity and independence is threatened

16.6 Safeguards to reduce or eliminate ethical threats

There are two broad categories of safeguards which may reduce or eliminate ethical threats to an acceptable level.

a. Safeguards created by the profession, legislation or regulation

Examples are:

i. Educational, training and experience requirements for entry into a profession
ii. Corporate governance regulations
iii. Professional standards
iv. Professional or regulatory monitoring and disciplinary procedures
vi. External review of reports or returns by external third parties
vii. A mandatory rule or duty to report breaches of ethical requirements
viii. Regulations that empower members of the public to draw attention of government and regulatory authorities to unethical behavoiurs

b. Safeguards in the work environment

Examples of these safeguards include:

i. Employing organisational systems of corporate oversight or other oversight supervision
ii. Employing organisation's ethics and conduct programmes
iii. Having good recruitment procedure in place to employ competent and qualified staff
vi. Having strong internal control system
v. Having appropriate disciplinary process in place
vi. Having policies and procedures in place to monitor the quality of employee performance.
vii. Consultation with other appropriate professional accountants.
viii. Timely communication of the organisation's policies and procedures to employees

16.7 Ways by which financial statements information can be compromised

i. Keeping liabilities off the statement of financial position or classification of liability as equity.
Keeping liabilities off the financial statement of financial position has the impact of increasing the net

assets and reducing gearing. This could be done by the company to avoid breaching debt covenants on borrowings that require the maintenance of certain ratios such as gearing or interest cover. A typical example is when preference share is treated as equity, instead of being classified as debt instrument, according to its substance.

ii. Manipulating revenue: Companies may lower their revenue by not recognising all invoices received for goods sold towards the end of the year in order to reduce tax liability. They may also recognise fictitious revenue in order to attract investor or retain existing investors
iii. The company may raise invoices before the end of the accounting year to inflate its sales figures and, but the actual transaction occurs after the reporting date. It is an example where the company attempts to boost revenue figures.
iv. A company may record amount received from loan as revenue.
v. Manipulate depreciation rates and methods: The management may set an arbitrary life span, usually more than expected or may increase the salvage of a depreciable asset, it thus can have a less deprecation calculated on the asset.
vi. Arbitrary revaluation of non-current assets in order to reduce debt/equity ratio.
vii. Selling off assets that is not yet fully depreciated in order to earn one-off high gain
viii. Capitalising operating costs in order to reduce expenses.
ix. Failing to recognise impairment losses or failing to write down inventory to its net realisable value when it is expected that the net realisable value is lower than the cost.
x. Inadequate disclosure in order to hide some information that may affect the credibility of the financial information.
xi. Failure to write-off undoubtful receivables to avoid reporting losses.

16.8 What are the motivations for unethical financial reporting by companies?

Management has the tendency to focus on short-term gains in order to achieve the following objectives:

i. Bonuses for management are often tied to performance level hence they violate generally accepted accounting principles in the preparation of financial statements, in order to meet earnings target and receive an annual bonus.
ii. Increase the market indicators in order to increase the market capitalisation of the company, thereby attracting investors.
iii. In order to achieve reduction in tax liabilities
iv. As a result of increasing pressure from the company's competitors.
v. By employees to cover up assets misappropriated
vi. Self -review threats, which relate to attempts by management to depict a healthy financial picture in order to conceal material losses.
vii. Lack of strong and efficient internal control system in place

16.9 How to resolve issues of ethical conflict

Professional accountants responsible for the preparation of financial reports need to adhere to the codes of ethical accounting standards to produce reliable, relevant, timely, accurate, understandable and comprehensive financial reports.

Therefore, the professional accountant should consider the following steps in the resolution of ethical conflicts with client or employer.

i. State the relevant facts of the case and examine the ethical issues involved;
ii. Explain the fundamental principles relating to the matter;
iii. Explain the GAAP and standards that is appropriate in the circumstance and the consequences of adopting the unethical approach;

iv. Establish internal procedure to resolve the issue;
v. Where this fails, the accountant should explore alternative course of action, which should be consistent with the fundamental principles identified;
vi. The professional accountant may consider consulting with the governing board of the company or the audit committee;
vii. The professional accountant should document the substance of the issue and details of discussions held or decision taken in respect of the issue
viii. If the conflict cannot be resolved internally, the accountant may wish to obtain advice from professional body or seek legal advice without breaching confidentiality; and
ix. In the final analysis, if all these steps failed, the accountant may wish to disengage from the assignment or resign.

16.10 Consequences of unethical financial reporting:

The following are some of the consequences of unethical financial reporting:

i. Lack of investors' confidence and low participation in the stock market leading to substantial fall in stock market price of shares;
ii. The company may face lawsuit from lenders and other creditors;
iii. Integrity and reliability of financial statements will be in doubt;
iv. The going concern of the company may be threatened, leading to liquidation of the company, consequently stakeholders will suffer; such as
- Loss of investment by shareholders,
- Loss of revenue to the government,
- Loss of jobs by employees, and
- Loss source of patronage by suppliers

v. The general economic climate of the country's economy will be depressed if the unethical practices are pervasive.
vi. High cost of obtaining capital

16.11 How accountancy profession ensures quality financial reporting

i. The conceptual framework for financial reporting: The IASB Conceptual Framework clearly defines and sets out guidance for measurement, recognition, de-recognition, presentation and disclosure of elements of financial statements. These definitions and guidance, if properly applied may reduce the cases of poor-quality financial reporting.
ii. Issue of principle-based accounting standards rather than rule based: The adoption of International Financial Reporting Standards is believed to be principled based as against the previous accounting standards. IFRSs also require more disclosures
iii. The professional accountants' codes of ethics
iv. Companies codes of ethics: Companies now have codes of ethics stating their commitment to integrity, healthy and safe business environment, employees' welfare etc

Illustration 16.1

Bola Adetutu AAT holder, worked as an accounting officer in the final accounts department of kalala Ltd. She was asked by her boss to falsify the accounts in order to increase profit. This was achieved primarily by capitalising some costs rather than treating them as operating expenses. While Bola considered resignation due to pressure she was put under to falsify results, she continued to work for the company, and she was subsequently promoted to managerial post with higher salary.

Required:

i. List the factors which might have affected Bola to make the fraudulent entries
ii. What other course of action could she have taken?

Solution to illustration 16.1

i. factors that might have affected Bola
- The request was made by her boss
- Financially she might have felt pressure to keep her job
- Potential prospect of being rewarded through promotion and pay rise
- Inability to decide how to deal with the situation

ii. Other course of action that she could have taken

She could have:
- Refused to make the adjustments;
- Brought the matter to the attention of other senior staff such as the internal auditor of the company;
- Resigned;
- Sought advice from her relevant professional body;
- Sought legal advice; or
- Report the matter to relevant regulatory authorities if any.

16.12 Information Technology

16.12.1 Digitisation of financial accounting

Digital accounting is a way of managing financial information electronically. This means that all transactions, records and other financial information a.re stored and managed using the computer and other digital devices.
With digital accounting, there is no need to worry about paper records getting lost or damaged, and it is much easier to track every financial information in one place.

Digital accounting permits the use of software and online tools to automate tasks, store financial data electronically and generate financial reports on-line and realtime.

Main processes of digital accounting – the main process of digital accounting are as follows:

-Transaction entry: software may facilitate transaction entry through linkage of relevant accounts and aiding of reconciliation of transactions.

Categorisation and automation: software can also help to categorise transactions according to the chat of accounts to facilitate generation of reports

Reporting and analysis: software can also assist to generate insightful reports on income, expenses, assets and liabilities cash flows and overall financial health of an entity. This report may assist in identifying trends, aid decision making and in providing plans for the future.

16.12.2 Advantages of digital accounting
Digital accounting has multitude of advantages some of which include:

i. Efficiency and accuracy Digital software automates tedious tasks and reduces the risk of errors in calculations and data entry. This will free up time and ensure the accuracy of financial records.
ii. Accessibility and mobility. It permits access to financial information anytime, anywhere with an internet connection. This allows for real-time monitoring of finances and real-time management.
iii. Data security and back-up. Digital accounting software offers robust security features to protect financial data. Additionally, automatic backups ensure that information is not lost.
iv. Improved insight and reporting. It assists in generating insightful reports and tracking financial trends. This aid decision making processes plan for future growth.
v. Simplifies financial management. Digital accounting aid easy management of financial information and thereby aids overall financial management of an entity.

16.13 Opportunities for accountants as result of information technology development
The following are some the opportunities available to the accountancy profession as result of information technology developments:
i. Cloud computing and collaborative tools: cloud computing has allowed access to financial data from anywhere and at any time. This facilitates real time collaboration and communication enabling seamless document sharing and efficient teamwork whether accountants are working on financial statements or providing advisory services.
Collaborative tools are also put in place to further enhance the benefit of cloud computing with tools such as software and virtual meeting platforms which enable real -time communication fostering quick decision making and efficient project management.

ii. Automation and artificial intelligence (AI): Robotics Process Automation (RPA) and AI - powered software are also being used to automate repetitive and manual tasks, such as data entry, bank reconciliations and financial statement preparation. By automating these processes accountants can allocate more time to decision making.
AI-based tools can assist accountants in data extraction and categorization. They can scan and extract relevant information from large volumes of financial data thereby helping accountants to identify risks and opportunities and thereby aids decision making process.

iii. Data analytics and business insights: Data analytics has become indispensable tools for accountants with the increasing availability of financial data. Accountants can make use of data analytics to identify trends and detect potential risks etc.
Data analytics can help. Identify key performance indicators (KPI) and therefore access the financial health of a company.

16.14 Computerised Accounting System

Computerised accounting system refers to the processing of accounting transaction through the use of hardware and software in order to produce accounting records and reports.

Components of Computerised Accounting System

The components of computerised accounting system comprise computer hardware and software while the software comprises mainly system and application software.

Workings of the Computerised Accounting System

The computerised accounting system works under the Generally Accepted Accounting Principles (GAAP) to process accounting transactions as inputs through Accounting Software to generate reports. The following reports may be generated through the processing;

- Day books or journals
- Ledger

- Trial balance
- Statement of financial position
- Statement of profit or loss and other comprehensive income.
- Statement of changes in equity
- Statement of cash flows

Computerised accounting system is based on the concept of database. A database is implemented using a database management system, which is a set of computer software that may be organised effectively and provide access to data by the application software. The user operates on such a database using the required and desired interface and also takes the desired reports by suitable transformation of stored data into information.

Basic requirements of computer database application

The phases of computer database application are:

i. Front-end interface: This refers to the user interface. The user enters a request through the interface. It is then verified and communicated to the server, which pulls the data from the database and sends it to the user
ii. Back-end database: It is the data storage system that is hidden from the user and responds to the requirement of the user to the extent the user is authorised to access.
iii. Data processing: It is the sequence of actions that are taken to transform the data into decision useful information
iv. Reporting system: It is an integrated set of objects that constitute the report

Coding and grouping of accounts

After classification of accounts into various groups and allotting codes to each account these are programmed into the computer system.

A proper codification requires a systematic grouping of accounts. The major groups or heads could be assets, liabilities, income and expenses. Each major group may be divided further to the line-items required to be presented in the financial statements under IAS 1; Presentation of

Financial Statements. For instance, assets may be divided further as follows:

Non-current assets

i. Property, plant and equipment;
ii. Investment property;
iii. Intangible assets;
iv. Financial assets or investments

Current assets

v. Inventories
vi. Trade receivables
Vii. other receivables
viii. cash and cash equivalents

There is a hierarchical relationship between the groups and their sub-groups. In order to maintain the hierarchical relationships between a group and its sub-groups, proper codification is required to ensure correct application of the codes. For instance, unique code should be assigned to assets, liabilities, income, expenses and equity and each subgroup of these major groups should also be assigned different codes that are unique to each sub-group. Modern accounting software systems use a generic system of accounting codes to codify the various ledgers that make up your full accounts.

16.14.1. Type of coding

Sequential codes

A common application of numeric sequential codes is the pre-numbering of source documents. These codes are applied primarily to source documents such as purchase orders, cheques, invoices, etc. A sequential code can facilitate document searches. Errors can easily be detected and corrected.

Block-coding: Assigned to

Features of computerised accounting system.

i. Recording: Data content is recorded in customised database
ii. Calculation: Only data input is required, the calculations are performed by computer system
iii. Correction of errors: No ratification of errors if input data are done correctly
iv. Backup: Entries of transactions can be saved and backed up
v. Instant trial balance and financial statements provided, when required. Reports can be generated based on codes.

It is to be noted that the fundamentals of accounting do not change whether books of accounts are maintained manually or computerised. The same principles of debit and credit are equally applicable in a computerised environment

Accounting software

There are three types of software, namely,

i. Readymade software,

ii. Customised software and
iii. Tailormade software

i. Readymade software (off- the -shelf software)

These packages are standardised or readymade packages which can be used by the business enterprises immediately on procurement. (Off- the shelf software). These software packages are used by those enterprises where financial transactions are simple, uniform and routine in nature. Few examples of such type of software are **Tally, Busy, Marg, Profit books, Quick books**

ii. Customised packages

Customised packages can be modified according to the needs of the enterprise. These packages are used by medium or large business enterprises. Cost of installation, maintenance and training is relatively higher than that of ready-to-use packages. These software packages are used by those enterprises where financial transactions are somewhat peculiar in nature.

Tailor-made packages: These are used by large companies to process large information frequently to meet the company's needs. They are usually expensive, and users will require training to use them.

Advantages of Computerised Accounting System

The advantages of Computerised Accounting System are:

i. Timely generation of reports and information in desired format.
ii. Efficient record keeping.
iii. Ensures effective control over the system.
iv. Economy in the processing of accounting data.
v. Confidentiality of data is maintained.

The limitations of Computerised Accounting System are:

i. Faster obsolescence of technology necessitates investment in a shorter period of time.
ii. Data may be lost or corrupted due to power interruptions.
iii. . Data are prone to hacking.
iv. Un-programmed and un-specified reports cannot be generated.:

16.15 Internal control in a computerised accounting information system

The internal control of a computerised accounting information system is generally divided into two, namely:

a. Management (general) control

b. Application control

a. Management control

Management control refers to a series of control methods, procedures and instrument applied to the entire computerised accounting information system. They include:

i. Organisational control: this refers to the control in form of departmental set up, division of labour, formulation of job duties, division of authorities etc. Its basic goal is to establish an appropriate organizational structure and division of labour to achieve the purpose of mutual control, preventing or reducing the occurrence of errors and malpractices.

ii. Security controls: This refers mainly to security and confidentiality controls on the use of the software. it involves the following, system document control, system operational control, software quality control etc.

b. Application control

This is a control that relates to one phase of application processing it includes input, processing and output controls.

Inputs controls assist in:
- Ensuring that data is transferred successfully from source documents into the system
- Detect obvious errors before the data is processed

Processing control helps in:
- Detecting errors during processing of transactions
- Carrying out edict checks
- Determining default values

Output controls goals are detecting errors in output and deliver output to correct person hence its assist in the following areas:
- Data control groups
- End user review
- Aid reconciliation
- Checks users' identification
- Ascertain password used.

16.16 Specialised areas of information technology and its application to financial accounting

16.16.1 Block-chain technology

Blockchain technology is a decentralized, digital ledger that records transactions across a network of computers in a secure and transparent manner. It is the underlying technology behind crypto currencies such as Bitcoin and Ethereum, but it has a broader range of applications beyond digital currency.

Key Features of Block-chain Technology

1. Block-chain technology is decentralized, meaning that it is not controlled by a single entity or institution.
2. Block-chain technology is a digital ledger that records transactions across a network of computers.
3. Block-chain technology uses advanced cryptography to secure transactions and control the creation of new units.
4. Block-chain technology is transparent, meaning that all transactions are recorded publicly and can be viewed by anyone.
5. Block-chain technology is immutable, meaning that once a transaction is recorded, it cannot be altered or deleted.

How Block-chain Technology Works

1. A network of computers is established, each with a copy of the block-chain.
2. Transactions occur and are broadcast to the network of computers.
3. Transactions are verified by special nodes on the network called miners.
4. A group of verified transactions is combined into a block.
5. Each node on the network updates its copy of the block-chain with the new block.
6. The block-chain is updated on each node, and the process starts again.

Applications of Block-chain Technology

1. Block-chain technology is the underlying technology behind cryptocurrencies such as Bitcoin and Ethereum.
2. Block-chain technology can be used to track the movement of goods and materials through a supply chain.
3. Block-chain technology can be used to create and execute smart contracts, which are self-executing contracts with the terms of the agreement written directly into lines of code.
4. Block-chain technology can be used to create secure digital identities.
5. Block-chain technology can be used to securely store and manage medical records.

Block-chain, machine learning, and artificial intelligence, and their potential impact on accounting functions:

Block-chain and Accounting Functions

Block-chain technology has the potential to significantly impact accounting functions in several ways:

a) Maintaining and Reconciling Ledgers

- Block-chain technology allows for the creation of a decentralized and distributed ledger, which can be shared among multiple parties.
- With block-chain, ledger reconciliation can be automated, reducing the need for manual intervention and minimizing errors.
- Block-chain enables real-time updates, allowing accountants to have access to the most up-to-date financial information.

b) Certainty over Ownership and Management of Assets

- Block-chain technology creates immutable records, ensuring that transactions are tamper-proof and cannot be altered.
- Smart contracts can be used to automate asset management, ensuring that assets are transferred and managed according to predetermined rules.
- Block-chain provides transparent ownership records, making it easier to track asset ownership and management.

16.16.2 Machine Learning and Artificial Intelligence in Accounting Functions

Machine learning and artificial intelligence (AI) have the potential to significantly impact accounting functions in several ways:

a) Automated Accounting Processes

- Machine learning and AI can automate data entry, reducing manual errors and increasing efficiency.
- AI can automate accounting processes such as invoicing, reconciliations, and journal entries.

b) Predictive Analytics and Financial Forecasting

- Machine learning and AI can analyze financial data to predict future trends and patterns.
- AI can help accountants create more accurate financial forecasts, enabling businesses to make informed decisions.

c) Risk Management and Internal Controls

- Machine learning and AI can help identify potential risks and anomalies in financial data.
- AI can help automate internal controls, ensuring that financial transactions are accurate and compliant with regulations.

Applications of Machine Learning and Artificial Intelligence in Accounting

Some potential applications of machine learning and AI in accounting include:

- AI can help automate auditing processes, identifying potential risks and anomalies in financial data.
- Machine learning and AI can help analyze tax data, identifying potential tax savings, and optimizing tax strategies.
- AI can help create more accurate financial forecasts, enabling businesses to make informed decisions.

In conclusion, block-chain, machine learning, and artificial intelligence have the potential to significantly impact accounting functions, enabling greater efficiency, accuracy, and transparency. As these technologies continue to evolve, it's essential for accountants to stay up to date with the latest developments and applications.

16.16.3 Data structure

A data structure is a specialised format for organizing, processing, retrieving and storing data. There are several basic and advanced types of data structures, all designed to arrange data to suit specific purposes. Data structure makes it possible for users to access and work with data that they need. Most importantly data structures frame the organisation of information so that machines and humans can better understand it.

Importance of data structure

i. Data structure brings together the data elements in a logical way to facilitate its use.
ii. They provide a formal model. That describes the way data elements are organized.
iii. Data structure aids computer programing language that is sometimes insufficient to capture the logical intent for data processing use.
iv. Data structures are the building blocks for more sophisticated applications
In conclusion it is not just important to choose the proper data structure to use, it is also vital to avoid ill-suited data structure as this might result in slow run time or unresponsive computer code.

Factors to consider when selecting data structure
i. what kind of information will be stored?
ii. how will that information be used?
iii. where should data persist or be kept after it is created?
iv. what is the best way to organize the data?
v. what aspects of computer memory and storage reservation management should be considered?

Uses of data structures

i. storing data: Data structures are used for efficient data persistence, such as specifying the collection of attributes and corresponding structures used to store records in a database management system.
ii. Managing resources and services: Core operating system resources are enabled using data structure such as linked lists of memory allocation.
iii. Data exchange: Data structure that are effective, aid efficient data exchange.
iv. Ordering and sorting: Data structures known as ordered or sorted binary trees provide efficient methods of sorting objects.
v. Indexing: sophisticated data structures are. Also used for indexing.
vi. Searching: Data structure also aids searching in a specified way e.g. alphabetically, date etc.
vii.Scalability: Big data applications use data structure for allocating and managing data storage across distributed locations ensuring scalability and performance.

Characteristics of data structures

Data structures are often classified based on their characteristics

i. Linear and non – linear: this describes whether the data items can be arranged in sequential order, such as array, or in an unordered sequence such as graphically.
ii. Homogeneous or heterogeneous: this describes whether data items in a particular repository are the same type or different from one another.
iii. Static or dynamic: this describes how data structures are compiled. Static data structure has fixed size while dynamic data structure has varying size.

Types of data structures

The various common data structures are as follows:
i. Array
ii Stack
iii. Queue
iv. Linked list
v. Tree.
vi. Heap
vii.Graph
viii. Trie
ix. Hash table, etc.

16.17 Principle and practice of virtual accounting

Virtual accounting
This refers to using technology, specifically digital tools and cloud-based systems, to manage and process financial records and transactions instead of relying on the traditional paper- based method of accounting. It essentially involved outsourcing or managing accounting functions remotely, leveraging software and the internet for task of book-keeping, invoicing, payroll management and reporting.

Characteristics of virtual accounting
The main features of virtual accounting include the following:

i. Remote access: financial information and accounting tasks can be accessed and managed from anywhere with an internet connection
ii. Reduced costs: virtual accounting can help business reduce expenses associated with office space personnel and paper -based processes
iii. Digital focus: virtual accounting heavily relies on software and digital platforms for recording and managing financial data and information.
iv. Cloud-based system: Virtual accounting relies on cloud-based accounting thereby facilitating remote work and easy access to financial information
v. flexibility and scalability: it offers flexibility in terms of work hours and location and can be scaled up or down as needed.

Advantages of virtual accounting
The advantages of virtual accounting include the following:

i. It reduces the cost of bookkeeping. Services

ii. it facilitates having complete access to books of accounts and accounting software
iii. it aid prompt reconciliation of accounting records
iv. it facilitates and assists small businesses in terms of financial support.
v. aids quick preparation of payroll by providing supplementary payroll services
vi. Assist in ensuring that business transactions and basic book-keeping and business process go through easily
vii. It facilitates online real-time monitoring of bank and cash transactions and also aid quick reconciliation process.

Typical services rendered by virtual book-keeping service provider

i. Regular, customized updates
ii. Bank reconciliation
iii. Data entry and catch-up services
iv. Accounts payable updates / billing management
v. Account receivables/invoicing management
vi. Tax preparation
vii. Tax filing
viii. Payroll processing
ix. Financial reporting
x. Transactions coding and categorization

16.18 Fraud opportunities when working remotely
Remote work may introduce new vulnerabilities for fraud particularly those related cyber -crimes. These opportunities include the following:

a. Cyber- related crimes

i. Business Email Compromise (BEC): Fraudsters may impersonate legitimate entities like managing directors/CEO, or customers/clients to request for sensitive information or changes to payments or receipts details

ii. Fake tech support: scammers impersonate IT support teams, asking for remote access to steal information or demand ransom for accessing files

iii. Phishing: Remote workers receive emails or text from unknown sources, often disguised as urgent requests or containing malware-laden links.

b. Other fraudulent activities

i. Employee fraud: Some remote workers may use software or devices to stimulate activity to avoid detection by monitoring tools and thereby perpetrate fraudulent activities.

ii. Client fraud: clients may disappear without paying for services rendered

iii. Fake job offer: Scammers offer fake job positions requiring upfront payments thereby defrauding the affected individual

iv. Impersonation: Fraudsters might impersonate remote workers on social media and websites to gain trust or access information.

v. Ransomware attack: Remote workers' system can be targeted by ransomware, holding files] until a ransom is paid

Remote fraud mitigation strategies

To combat the risks of remote frauds, companies must implement stringent verification and security measures, some of which include:

i. Enhanced background checks: Use of advanced technique to verify users' identities and credentials

ii. Multi-factor authentication: Implementation of multifactor authentication process is necessary to ensure that the person accessing the system is who they claim to be

iv. Regular security audit: Conducting frequent security audits to identify and address potential vulnerability in hiring and operational process

v. Training and awareness: frequent education of HR and IT teams about emerging fraud schemes and the importance of robust security practices.

vi. Vigilant screening: There may be a need to conduct face-to-face interviews with all employees in the company's network. It may sound obvious but not all companies do this. However, it is necessary to mitigate remote frauds.

16.19 Chapter summary

Professional ethics and application of information technology to financial accounting is an important aspect of financial accounting. Professional ethics exposes candidates to the ability to behave in an ethical manner when carrying out financial functions in particular. Ethics is about being honest and being able to behave responsibly in accordance with laid down rules and regulations of the accounting profession which is usually in form of code of professional ethics

Information technology is a vital aspect of financial accounting and reporting. The application of information technology is not to replace accountants or to take over the work of an accountant rather it is meant to facilitate and make the work of an account more efficient, through the use of virtual accounting, application of block-chain, use of artificial intelligence (AI) etc.

16.20 End of chapter questions

Multiple choice questions (MCQ)

1) The main areas covered by of code of professional conduct for members are as follows except:

A Integrity

B Confidentiality

C Cooperation

D Objectivity

E Competence

2) The type of threats that occur when an accountant promotes the point of view of a client unduly is called?

A Self-interest threats

B Advocacy threats

C Familiarity threats

D Self review threats

E Intimidation threats

3) A block-chain can be defined as

A a centralized digital ledger consisting of records called blocks

B digital data base consisting of records called class

C a private ledger that no one can inspect

D a decentralized, distributed digital ledger, consisting of records called blocks

E a merkel tree that stores all transactions

4) A weak Artificial Intelligence (AI) is

A. the embodiment of human intellectual capabilities within a computer

B. set of computer programs that produce output that would be considered to reflect intelligence as if it was generated by human

C. the study of mental faculties through the use of metal models implemented on a computer

D is making use of data structure to aid accounting functions

E is simply the combination of the use of blockchain and virtual accounting.

Solution to MCQ

1) C

2) B

3) D

4) C

Examination type questions

1 a. Identify possible ethical issues that an accountant may likely encounter in the process of carrying out his duties

b. Discuss the role of accountant as it relates to issue of ethics and highlights five possible safeguards of ethical threats