

FINANCIAL ACCOUNTING (FA)

STUDY TEXT

THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF NIGERIA

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Foreword

FOREWORD

As the global economy continues to evolve, the importance of accounting professionals with strong technical skills, professional competence and ethical awareness cannot be overstated. The swift transformation in the business world, driven by globalisation, technological advancements and sustainability considerations, have significantly impacted the finance function and the skills required by professional accountants.

To remain relevant, the Institute's syllabus and training curriculum are designed to equip students with the knowledge and competencies required to succeed in the dynamic fields of accounting and finance. These are regularly reviewed and updated to reflect current trends and future needs of users of accounting and related services.

The Institute of Chartered Accountants of Nigeria (ICAN) is committed to ensuring that its syllabus and training curriculum remain current and relevant. To achieve this, ICAN undertakes a comprehensive review of these documents every three years, supplemented by annual updates to reflect emerging trends and developments in the national and global accountancy profession.

Following a rigorous process, the Syllabus Review, Professional Examinations, and Students' Affairs Committees have developed a new 3-level, 15-subject syllabus. As approved by the Council, the new syllabus will be implemented starting with the November 2025 examination diet.

The publication of the Study Texts has consistently accompanied syllabus reviews, yielding notable improvements in the performance of professional examination candidates. To further enhance student success rates, the Council has approved the development of new learning materials (Study Texts) for all the subjects. This sixth edition, incorporates significant updates, including IT and soft skills, thereby enhancing the contents, innovation, and quality. This edition has taken into consideration all requirements of the International Panel on Accountancy Education (IPAE).

The Institute engaged renowned writers and reviewers, comprising esteemed scholars and practitioners with extensive experience in their areas of specialisation, to develop high-quality learning materials. The 15 subjects include:

Foundation Level		
1.	Business Environment	A1
2.	Financial Accounting	A2
3.	Management Accounting	A3
4.	Corporate and Business Law	A4

Skills Level		
5.	Financial Reporting	B1
6.	Audit, Assurance and Forensics	B2
7.	Taxation	B3
8.	Performance Management	B4
9.	Financial Management	B5
10.	Public Sector Accounting and Finance	B6

Professional Level		
11.	Strategic Business Reporting	C1
12.	Advanced Audit, Assurance and Forensics	C2
13.	Strategic Financial Management	C3
14.	Advanced Taxation	C4
15.	Case Study	C5

A rigorous quality control process was implemented, featuring a detailed and comprehensive review of the materials developed by the writers and reviewers by the Study Texts Review Technical Subcommittee.

These Study Texts will be valuable resources, not only for our candidates but also for students of other professional bodies, tertiary institutions, and finance and management practitioners, providing valuable resources for their studies and practices.

Chibuzor Noel Anyanechi, (Chief) BSc, MBA, FCA
Chairman, Syllabus Review Committee



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Syllabus

SYLLABUS

FINANCIAL ACCOUNTING

Aim

To equip students with the essential framework and assumptions necessary for reliable recording and summarising all financial transactions that will enable them compile accurate and reliable financial statements for sole traders, partnerships, companies, and not-for-profit entities.

Linkage with other subjects

The diagram below depicts the relationship between this subject and other related subjects.



Main competencies

On successful completion of this paper, candidates should be able to:

a)	explain the scope and purposes of accounting;
b)	identify the users of accounting information and their needs;
c)	understand the fundamental accounting concepts and demonstrate the bases of accounting;
d)	record financial transactions, articulate procedures for banking money received and associated documentation;
e)	record and account for transactions and events related to revenue, expenses, assets, liabilities, and equity in accordance with the relevant IFRS Accounting Standards and generally accepted accounting principles (GAAP);
f)	demonstrate the understanding and application of double-entry principles;
g)	discuss the usefulness and limitations of a trial balance;
h)	identify and correct errors;
i)	explain the use of control accounts and reconciliations;

Main competencies

j)	understand the accounting treatment for bad and doubtful debts
k)	state the accounting treatment for accruals and prepayments;
l)	explain ethical considerations for preparers of financial statements;
m)	state accountants' roles in business, and recognise the duties and responsibilities of those in governance;
n)	understand the regulatory environment and the IASB Conceptual Framework for Financial Reporting;
o)	record and account for property, plant and equipment (PPE), intangible assets and impairment of asset:
p)	explain management and accounting for inventory:
q)	compile financial accounts for partnerships, not-for-profit entities, and in cases of incomplete records, demonstrate the ability to generate precise financial statements:
r)	prepare basic financial statements of companies according to IFRS accounting standards, document the issue of shares, record income tax (including under/over-estimates from the prior year) in the statements of comprehensive income, changes in equity, cash flows and financial position;
s)	explain the interrelationship between the components of financial statements, and offer a clear interpretation of the financial statements; and
t)	explain computerised accounting systems, demonstrate knowledge of digitisation in financial accounting, and explain the application of key concepts relating to virtual accounting.

Syllabus

Syllabus overview		
Grid		Weighting
A	Accounting framework	10
B	Recording financial transactions	15
C	Reconciliation in financial accounting	15
D	Accounting for transactions in the financial statements	20
E	Accounting for partnership, not-for-profit entities and incomplete records	15
F	Financial statements	15
G	Virtual accounting	10
Total		100

Detailed syllabus			Chapter
A	Accounting framework		10%
	1	Scope and purpose of accounting	1
	a	Define accounting and state the objectives of accounting.	1
	b	Differentiate between accounting and bookkeeping.	1
	c	Discuss the different types of accounting.	1
	2	Identify the users of accounting information and their information needs.	2
	3	Explain IASB conceptual framework for financial reporting in relation to:	2
	a	objectives of general purpose financial reporting;	2
	b	qualitative characteristics of useful financial information;	2
	c	financial statements and the reporting entity; and	2
	d	elements of financial statements, including:	2
		i. recognition and derecognition;	2
		ii. measurement; and	2
		iii. presentation and disclosure	2
	4	Explain the following accounting concepts and conventions:	2,3,7

Detailed syllabus				Chapter
		A	Going concern;	2
		B	Accruals;	2, 7
		C	Duality;	3
		D	Historical cost and current cost conventions;	2
		E	Materiality and aggregation;	2
		F	Substance over form;	2
		G	Business entity concept;	2
		H	Fair presentation;	2
		I	Offsetting;	2
		J	Consistency of presentation; and	2
		K	Prudence.	2
	5	Bases of accounting		1
		A	Explain accrual, cash and break-up bases of accounting.	1
	6	The regulatory environment of accounting		1
		A	Explain the need for regulation of accounting practice.	1
		B	Identify the regulator of regulation of accounting practice in Nigeria – Financial Reporting Council (FRC) of Nigeria.	1
	7	Explain the ethical considerations for preparers of financial statements		1
	8	State the roles of accountants in business and the economy.		1
	9	State the duties and responsibilities of those charged with governance		1
B	Recording financial transactions			15%
	1	Identify source documents of accounting data and information such as invoices, receipts, credit notes, debit notes, purchase orders, goods received notes, cheque counterfoils, deposit slips, bank statements and payment vouchers.		4
	2	Procedures and documentation for banking of monies received		4
		A	Explain the methods of funds transfer, including handling, storing and security of monies.	4
		B	Explain the uses of debit and credit cards	4
	3	Record and account for transactions and events relating to revenue/incomes, expenses, assets, liabilities and equity in accordance with Generally Accepted Accounting Principles (GAAP) using:		4
		a	Books of prime entry; and	4

Detailed syllabus			Chapter
	b	Cash books including internal control over cash.	4
4	The double entry principles		3, 4
	a	Explain the double entry principle.	3
	b	Explain the accounting equation.	3
	c	Explain the basic classifications of the ledger.	3
	d	Post transactions into the Ledger using the double entry principle.	3
	e	Explain the general principles of the operations of the value added tax.	4
	F	Calculate value added tax and post to the ledger, transactions with elements of VAT.	4
	g	Balance ledger accounts and extract trial balance	3
5	State the usefulness and limitations of trial balance.		3
C	Reconciliation in financial accounting		15%
1	Errors		11
	a	Identify errors in the double entry system.	11
	b	Identify errors not highlighted/detected by the extraction of the trial balance.	11
	c	Correct book-keeping errors for given transactions.	11
	d	Determine the effect of errors on profit or loss/surplus or deficit.	11
	e	Explain the use of suspense account.	11
2	Control accounts and reconciliations		9
	a	Explain control account and its uses.	9
	b	Prepare receivables control account and reconcile with individual ledger balances.	9
	c	Prepare payables control account and reconcile with individual ledger balances.	9
	d	Explain the purpose of suppliers' statements and their reconciliation with the ledgers.	9
3	Bank reconciliation		10
	a	State the purpose of bank reconciliation statement.	10
	b	Identify the causes of difference between cash book and bank statement balances.	10
	c	Prepare bank reconciliation statement.	10
	d	Identify and correct cash book errors.	10

Detailed syllabus			Chapter
	e	Explain the use of adjusted cash book to determine the cash position in the financial statements.	10
4	Accounting treatment for bad and doubtful debts		6
	a	Account for the write-off of bad debts.	6
	b	Account for the recovery of bad debts.	6
	c	Determine the balance on the allowance for doubtful debts accounts.	6
	d	Account for the movement on the allowance for doubtful debts accounts.	6
	e	Account for movements in receivables.	6
5	Accounting treatment for accruals and prepayments		7
	a	Explain the meaning of an accrual.	7
	b	Account for accruals.	7
	c	Explain the meaning of a prepayment.	7
	d	Account for prepayments.	7
	e	Explain the meaning of accrued and unearned incomes.	7
	f	Account for accrued and unearned incomes.	7
D	Accounting for transactions in financial statements		20%
1	Accounting for Property, Plant and Equipment (PPE) in accordance with IAS 16		5
	a	Identify the elements of PPE cost.	5
	b	Explain the differences between capital and revenue expenditure.	5
	c	Code assets.	5
	d	Explain the functions and purposes of assets register.	5
	e	State how cost of non-current assets is initially recorded and measured.	5
	f	Compute, explain and record depreciation, using the straight line and reducing balance methods.	5
	g	Account for depreciation in the statement of profit or loss and other comprehensive income.	5
	h	Account for disposal of PPE.	5
	i	Calculate depreciation on an item of PPE that is revalued.	5
	j	Calculate and adjust for gain or loss on revaluation of PPE in the financial statements.	5

Detailed syllabus			Chapter
	k	Prepare simple schedules to account for movements in PPE.	5
2	Accounting for intangible assets (IAS 38)		5
	a	State the difference between PPE and intangible assets.	5
	b	State the different the types of intangible assets.	5
	c	Explain the difference between research and development expenditure.	5
	d	Determine the amount of research and development expenditure to be expensed or capitalised.	5
	e	Calculate and account for amortisation in financial statements.	5
3	Accounting for impairment of assets (IAS 36) – excluding impairment of assets in a cash generating unit		5
	a	Define impairment loss, recoverable amount, fair value and value in use.	5
	b	Explain indicators of impairment	5
4	Accounting for inventories (IAS 2)		8
	a	Explain the requirements of IAS 2 for valuation of inventories.	8
	b	Explain the elements of cost of inventories.	8
	c	Explain the valuation and recognition of inventories.	8
	d	Measure inventories at cost, and lower of cost and net realisable value.	8
	e	Determine the cost of inventory using first-in-first-out (FIFO) and weighted average cost (WAC).	8
	f	Explain the impact of various valuation methods on the profit or loss for a period.	8
	g	Explain the nature of inventories.	8
	h	Reconcile inventories and pass appropriate adjustments to opening and closing values of inventories in the financial statements.	8
	i	Explain the use of periodic and perpetual inventory methods.	8
5	Accounting for provisions, contingent liabilities and contingent assets (IAS 37)		11
	a	Define provisions, contingent liabilities and contingent assets.	11
	b	Explain the recognition criteria for provisions, contingent liabilities and contingent assets.	11

Detailed syllabus			Chapter
	c	Explain the measurement basis.	11
	d	Explain the disclosure requirements.	11
E	Accounting for partnership, not-for-profit entities and incomplete records		15%
	1	Partnership accounts	14
	a	Discuss partnership business.	14
	b	Prepare partners' current and capital accounts.	14
	c	Determine partners' share of profits.	14
	d	Account for changes in partnership (excluding amalgamation and piecemeal realization).	14
	2	Not-for-profit entities' accounts	16
	a	Prepare receipts and payments account.	16
	b	Prepare statement of income and expenditure.	16
	c	Prepare statement of financial position.	16
	3	Incomplete records	15
	a	State the need for preparation of accounts from incomplete records.	15
	b	Determine profit from the opening and closing capital balances.	15
	c	Explain the use of accounting equation, gross profit percentage, cash book summaries, memoranda and control accounts to determine missing figures for financial statements.	15
F	Financial statements		15%
	1	State and explain the purpose, nature and relationships among the main components of financial statements.	1, 12
	2	Accounting policies, change in accounting estimates and errors (IAS 8)	13
	a	Define accounting policies.	13
	b	Explain the guidance on the selection of accounting policies.	13
	c	Account for changes in accounting policies.	13
	d	Differentiate between accounting policies and accounting estimates.	13
	e	Explain how to account for changes in estimates.	13
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Detailed syllabus			Chapter
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AN INTRODUCTION TO BUSINESS AND ACCOUNTING

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1. An Introduction to Business and Accounting

1.0 Learning objective

This chapter explains the nature and forms of business entities, the various bases of accounting, the importance of financial information, and the structure and components of key financial statements. It also covers the classifications of business transactions.

1.1 Learning outcomes

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

- a. clearly define and explain the key characteristics of a business;
- b. identify and compare the features of sole proprietorships, partnerships, and limited companies;
- c. differentiate amongst accrual, cash, and break-up accounting bases, and determine when each is appropriate;
- d. evaluate the importance of financial information for various users;
- e. analyse the purpose and structure of the statement of financial position and the statement of comprehensive income;
- f. list and describe the essential components of a set of financial statements and explain their relevance
- g. apply the correct presentation format for the statement of financial position and the statement of profit or loss and other comprehensive income; and
- h. classify and record transactions that meet the definition of business transactions Detailed syllabus.

1.2 Business

The term "business" is used in various contexts. It can refer to an economic process as well as the entities that engage in that process.

There is no universally accepted definition of a business, but some possible definitions include the following:

Definitions: Business

Business is an economic system in which goods and services are exchanged for one another or for money.

A **business entity** is a commercial organisation that operates with the goal of making a profit.

A business is an **integrated set of activities and assets** that can be conducted and managed to provide returns to investors or other owners.

A business is an **organisation or enterprising entity** engaged in commercial, industrial, or professional activities.

1.2.2 Characteristics of business

All businesses share certain fundamental characteristics:

- i. Businesses exist primarily to make profits.
- ii. Businesses earn profits by supplying goods or services to customers.
- iii. Businesses that supply goods may either produce them or purchase them from suppliers (for example, food retailers buy food from producers and sell it to customers).
- iv. Profit is the reward for taking risks. For example, a food retailer who purchases 100

kg of bananas faces the risk of unsold stock, which may lead to losses. However, taking this risk provides the opportunity to earn a profit.

- v. The profits of a business belong to its owners, who may receive a share of the profits periodically.

1.2.3 Types of business entities

There are three main types of business entities:

- a. sole proprietorship;
- b. partnership; and
- c. company (limited liability company).

1.2.4 Sole proprietor (or sole trader)

A sole proprietorship is a business owned and managed by one person. Any individual who starts a business without forming a company is considered a sole trader.

Key Features of a Sole Proprietorship:

- a. The owner and the business are legally the same entity.
- b. The owner is personally liable for all debts and obligations of the business.
- c. Business profits are treated as personal income for tax purposes.
- d. The business ceases to exist upon the owner's death, as there is no perpetual succession.
- e. The sole proprietor owns all business profits and assets.
- f. The owner can withdraw cash and other assets from the business (known as drawings).
- g. The business is financed through a combination of the owner's capital (including retained earnings) and loans.
- h. The sole proprietor owns all business profits and assets.
- i. The owner can withdraw cash and other assets from the business (known as drawings).
- j. The business is financed through a combination of the owner's capital (including retained earnings) and loans.
- k. Although the business may employ multiple people, the owner typically plays an active role in daily operations and maintains a high level of control.

The sole proprietor has the option to sell the business as a going concern.

Example:

If a business owes a supplier ₦1,000 for purchased goods but lacks the funds to pay, the owner is personally responsible for covering the debt using their personal assets.

1.2.5 Partnership

A business partnership is an entity where two or more individuals (partners) share ownership of a business. Each partner contributes funds ("capital") to establish the business.

Important features of a partnership:

Definition: Partnership

Partnership is the relationship between individuals who have agreed to share the profits of a business conducted by all or any of them, acting on behalf of all partners.

- a. There must be an association of two or more persons to carry on a business.

- b. The owners (partners) are personally liable for the unpaid debts and other obligations of the business.
- c. The profits of the partnership are shared between the partners according to an agreed-upon ratio. Each partner's share of the profits is treated as personal income for tax purposes.
- d. When a partner dies, the partnership comes to an end, as there is no perpetual succession.
- e. The profits and assets of the business belong to the partners in an agreed ratio.
- f. Partners can withdraw cash and other assets from the business (referred to as drawings).
- g. The business may be financed through a combination of partners' capital (including retained earnings) and loans.
- h. While a partnership may employ many people, it is common for the partners to take an active role in the business and exercise a high degree of control.
- i. A partnership can be sold as a going concern by its owners.

Example:

If a partnership owes a supplier ₦1,000 for purchased goods but lacks the funds to pay, the partners are personally responsible for settling the debt.

1.2.7 Company (limited liability company)

A company is a distinct form of business entity. Nearly all companies in business are limited liability companies, meaning the liability of their owners (shareholders) is limited by shares.

a) Ownership and shares

- i. Ownership of a company is represented by shares.
- ii. The number of shares a company issue depends on its size. A small company may have just one share of ₦1, while a large publicly traded company may have millions of shares in circulation.
- iii. If a company has issued 100 shares, an individual holding 40 shares owns 40% of the company.
- iv. Large companies typically have numerous shareholders and shares in circulation. As a result, shareholders do not manage the business directly. Instead, executive directors are employed to run the company on behalf of the shareholders. This structure is referred to as the separation of ownership from control.

b) Legal status and liability

- i. Unlike sole proprietorships and partnerships, a company is recognised as a legal entity under the law.
- ii. A company can own business assets, enter contracts, and sue or be sued in its own name
- iii. A company is taxed separately from its owners. In contrast, sole traders and partners are taxed on their business profits as personal income.
- iv. A company is solely responsible for its debts. If a company owes a supplier ₦1,000 for purchased goods but cannot make the payment, the company itself remains liable, not the shareholders.
- v. Shareholders' liability is limited to the amount of capital they have invested or agreed to invest in the company.

c) Financial Reporting and Accountability

- i. When shareholders are not actively managing a company, it is essential for management to regularly report financial information on the company's position and performance. This is the primary purpose of financial reporting.
- ii. There is a risk that managers may present misleading financial reports to shareholders. To mitigate this risk, financial reporting and auditing regulations for companies are generally stricter than those for other business entities.

1.2.8 Advantages and disadvantages of different types of business entities

The advantages and disadvantages of operating under each type of business entity can be summarised as follows:

Business structure	Sole trader	Partnership	Company
Owned by...	One person	Several individuals working together	Shareholders
Liability for debts and obligations	Owner has personal liability	Partners have personal liability	Limited liability for shareholders
Management	Managed by its owner	Managed by the owners	Larger companies are managed by professional managers
Raising capital	Capital is provided by the sole owner and is often limited.	Capital is provided by the partners and is likely to be limited.	Capital is provided by shareholders; public companies can raise funds from investors in the stock market
Financial Accounting and Auditing	Financial accounts required for tax purposes	Financial accounts required for the benefit of partners and tax purposes	Financial reporting is strictly regulated, with legal requirements for auditing

Most very large businesses operate as companies due to their ability to raise substantial capital and limit personal liability.

1.3 Introduction to Financial Accounting by Business Entities

1.3.1 Introduction to Accounting

There are many definitions of accounting

Definitions: Accounting

- a. Accounting is the systematic and comprehensive recording of financial transactions related to a business, including the processes of summarising, analysing, and reporting these transactions.
- b. It is a systematic process of identifying, recording, measuring, classifying, verifying, summarising, interpreting, and communicating financial information.
- c. Accounting involves identifying, measuring, and communicating economic information to enable users to make informed judgments and decisions.

The main purposes of accounting are to:

- a. maintain a record of the financial value of business transactions, helping to establish financial controls and reduce the risk of fraud.
- b. assist in managing the financial affairs of an entity effectively; and
- c. supply essential financial information to support decision-making by stakeholders.

Accounting information is provided for:

- a. **management:** to equip managers with the necessary information for running the company efficiently. This is referred to as management accounting.
- b. **external Users:** various stakeholders outside the entity rely on accounting information. For example, a company prepares financial statements for its shareholders, tax authorities, investors, trade unions, and other interested parties. This is referred to as financial accounting.

1.3.2 Types of accounting

Since various users of accounting information have different needs, accounting can be classified into the following areas:

- a. **Financial Accounting** involves the process of recording, classifying, preparing, and interpreting financial statements. It helps both internal and external users make informed financial decisions.
- b. **Cost Accounting**
Cost Accounting focuses on accumulating cost data to provide **information for planning, control, and decision-making** by management.
- c. **Performance Management**
It is a continuous process where managers and employees work together in **planning, monitoring, and reviewing** workforce effectiveness to achieve the overall objectives of the entity.
- d. **Auditing**
It is an **independent examination** of an entity's financial statements conducted by a professional auditor.
The auditor gathers evidence and forms an opinion on the fairness of the financial statements, which is expressed in an audit report.
- e. **Government Accounting**
It is a branch of public sector accounting that records, monitors, and reports the revenue and expenditure of government ministries, departments, and agencies (MDAs).
It helps ensure compliance with financial regulations and supports government planning, control, and decision-making.

f. **Taxation**

The accounting profits reported in financial statements serve as a basis for determining an entity's taxable profits.

Since tax laws differ from accounting standards, a proper understanding of taxable and non-taxable income and expenses is crucial for effective tax management.

g. **Financial Management**

It is the process of efficiently and effectively procuring, utilising, and accounting for an organisation's resources. It aims to maximise the wealth of business owners by making sound financial decisions.

h. **Forensic Accounting**

It is the application of accounting skills to investigate fraud, deliberate misrepresentations, misappropriations, or embezzlements within an entity.

Often involves legal proceedings to recover misappropriated funds.

i. **Social and Environmental Accounting**

Social and environmental accounting focuses on accounting for and reporting the social and environmental impacts of an entity's activities. It provides information relevant to various stakeholders, including investors, management, employees, customers, suppliers, and the local community.

j. **Bookkeeping**

Bookkeeping is the process of recording financial transactions in an entity's accounting records (the "books"). It includes posting transactions and extracting a trial balance to ensure accurate financial reporting. This text focuses on financial accounting, which involves the recording, classification, summarisation, interpretation, and reporting of financial transactions to provide useful information for decision-making by internal and external users.

1.3.3 The purpose of financial accounting

Financial accounting refers to:

- a. maintaining a system of accounting records for business transactions and other financial activities; and
- b. reporting an entity's financial position and financial performance through a set of financial statements.

The term entity encompasses all types of organisations, including companies, business partnerships, and sole proprietorships.

1.3.4 Accounting Systems

Business entities maintain a **system for recording business transactions**, known as a **bookkeeping system**. All large businesses (and many small ones) have a bookkeeping system to **regularly record financial transactions**. The bookkeeping records of a business are often referred to as its **accounts**.

The content of financial statements may vary depending on whether the business is a sole proprietorship, partnership, or limited liability company. However, the fundamental process used to record transactions remains similar across all entity types. This process is known as double-entry bookkeeping, which will be explained in detail later.

Accounting is a key function in almost every business. In small firms, it may be handled by a bookkeeper or accountant, while larger companies typically have finance departments with multiple employees dedicated to managing financial records.

1.3.5 Differences Between Bookkeeping And Accounting

Bookkeeping and accounting are closely related but distinct processes in financial management. Here's how they differ:

Bookkeeping is the systematic recording of financial transactions of a business in an organised manner. It involves maintaining ledgers, journals, and financial records. Accounting is the process of summarising, analysing, interpreting, and reporting financial information based on the records kept through bookkeeping.

Bookkeeping focuses on recording daily financial transactions such as sales, purchases, receipts, and payments. Accounting includes bookkeeping, but extends to preparing financial statements, analysing financial performance, tax preparation, and decision-making.

Bookkeeping ensures accurate record-keeping of financial transactions. Accounting provides financial insights and helps in strategic planning and decision-making.

Bookkeeping involves recording transactions, classifying them into accounts, and maintaining the ledger. Accounting involves adjusting entries, preparing financial statements (such as the income statement, statement of financial position, and cash flow statement), interpreting financial data, and advising management.

Bookkeeping requires basic financial knowledge and attention to detail. Accounting requires a deeper understanding of financial principles, tax laws, and financial analysis.

Bookkeepers do not typically make financial decisions; they focus on accurate data entry. Accountants analyse financial data and provide reports that assist business owners and managers in decision-making.

Bookkeeping produces ledgers, trial balances, and transaction records. Accounting produces financial statements, budgets, and reports for stakeholders.

Bookkeepers may not require formal certification and can work with minimal training. Accountants often require professional qualifications, such as ACA (Chartered Accountants)

In conclusion, bookkeeping is the foundation of accounting, focusing on accurate financial record-keeping, while accounting interprets, analyses, and reports financial data to support business decisions. Both functions are essential for the financial health of any organisation.

1.4 Roles of accountants and those charged with governance

1.4.1 Role of accountants in business

Qualified accountants possess extensive knowledge and expertise in various aspects of business, with a particular focus on financial data that reflects the position and performance of an organisation.

An accountant may fulfil or contribute to several key roles and functions, including:

- a. financial reporting – accountants generate financial reports by gathering, analysing, and presenting financial information in accordance with the accounting rules and standards applicable in the jurisdiction where the business operates.
- b. Compliance – accountants ensure that a business complies with legal and regulatory requirements, such as preparing financial statements in the required format as mandated by company law.
- c. Strategy – accountants provide financial analysis and insights that contribute to the formulation of a business's strategic direction.
- d. Planning – accountants assist businesses in planning their future activities by providing relevant financial data and projections.
- e. Control – accountants help establish financial targets, monitor performance, and report on variances to ensure effective financial management.
- f. Decision making – accountants provide critical financial information to support informed business decision-making.
- g. Taxation – accountants prepare tax computations or provide financial information to tax specialists to facilitate accurate tax reporting and compliance.
- h. Systems - Accountants help to set up and operate efficient systems of accounting and internal control.
- i. Treasury management – Accountants often serve as treasury managers, overseeing the financial resources of an organisation to ensure effective cash flow management, investment decisions, and financial risk control

1.4.2 Role of accountants in the economy

Accountants play a key role in the success of businesses, and this success is vital for the broader economy. Successful businesses create jobs, generate profits, and contribute to economic growth. Through taxes on wages and salaries, as well as taxes on business profits, companies provide essential revenue to governments, which is then used to benefit society.

The role of accountants in financial reporting is particularly crucial. Businesses often require capital, which may involve seeking investments from external parties. These investors need to monitor their investments and will rely on accounting information to assess the financial health and performance of the business. Accountants provide high-quality financial data that investors use to make informed investment decisions.

There is a legal requirement for companies to have their financial statements audited. An audit is an independent review conducted by a professional accounting firm, which offers an opinion on the accuracy and fairness of those financial statements.

The existence of reliable financial reports—prepared by accountants and audited by independent firms—helps capital markets function effectively by providing investors with the information they need to make sound investment choices.

1.4.3 Roles and duties of those charged with governance

a. Introduction

Those charged with governance are individuals or groups responsible for overseeing the strategic direction of an entity and ensuring accountability. This includes overseeing the financial reporting process and approving the financial statements. Their primary role is to supervise the operations of the entity and ensure that its activities align with the interests of stakeholders.

This group typically includes the Board of directors, audit committee, and, in some cases, members of the executive management team. While management handles the day-to-day operations, directors are tasked with providing strategic oversight.

b. 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 daily operations of the company and the preparation of financial statements that reflect the entity's financial position and performance;
- ii. audit committee reviews and oversees the financial reporting process, ensuring the integrity of the financial statements. They may raise concerns or seek clarifications before the statements are finalised;
- iii. directors approve the financial statements, ensuring that they fairly present the financial situation of the company and comply with relevant legal and regulatory requirements;
- iv. external auditors perform independent audits of the financial statements to confirm their accuracy, completeness, and compliance with accounting standards. Their work enhances stakeholders' confidence in the financial information; and
- v. stakeholders include investors, creditors, regulators, and others who rely on the financial statements for decision-making. They depend on the reliability and accuracy of the information presented

c Duties of directors

Directors owe a duty of care to the organisation they govern. This duty is outlined in the Companies and Allied Matters Act (CAMA) 2020 (as amended). Directors are expected to act with care, diligence, and skill comparable to that which would be exercised by a reasonable director under similar circumstances.

Since companies are not natural persons, directors are accountable to those who provide capital, such as shareholders, investors, and creditors on behalf of the company. In addition to the general responsibilities under CAMA, directors often operate under formal agreements that outline specific duties, including those related to financial reporting.

According to CAMA, directors must:

- i. act in good faith and in the best interests of the company;
- ii. avoid conflicts of interest;
- iii. exercise independent judgment;
- iv. maintain confidentiality of company information;
- v. not accept benefits from third parties; and
- vi. declare any interest in proposed transactions or arrangements.

d. Responsibilities of directors in relation to financial statements

Directors have specific responsibilities to ensure accurate and transparent financial reporting. These include:

- i. ensuring that financial statements are prepared in accordance with the applicable accounting framework, relevant regulations, and legal requirements;
- ii. confirming that the financial statements present a true and fair view of the entity's financial position, and ensuring that the disclosures in the financial statements are consistent with other financial information to avoid misleading users;
- iii. establishing appropriate and adequate financial reporting systems;
- iv. approving the annual budget and monitoring compliance with it;
- v. liaising with external auditors and ensuring the quality and independence of the audit process, including the approval of audit fees and scope;

- vi. establishing and reviewing internal control and internal check systems to ensure that the information used in financial reporting is accurate, timely, and verifiable;
- vii. reviewing other information in the Annual Report to confirm consistency with financial and management information;
- viii. understanding and approving the assumptions and key judgments used in preparing the financial statements. This includes regular review of the going concern assumption and applying professional scepticism to management's estimates and assessments; and
- ix. ensuring that financial statements are submitted to regulatory authorities on a timely and regular basis.

e. Conclusion

Those charged with governance particularly directors, play a vital role in ensuring the accuracy, transparency, and integrity of financial reporting. They must work closely with auditors and management while considering the long-term implications of their decisions.

Directors must also take into account the interests of employees, customers, suppliers, the local and global community, and the environment. Upholding high standards of conduct, maintaining a strong reputation, and acting fairly toward all members of the company are essential components of good governance.

By embracing these responsibilities, directors contribute to sound corporate governance, maintain stakeholder trust, and support the long-term sustainability and success of the organisation.

1.5 Financial statements

1.5.1 Introduction

Double-entry bookkeeping is used to record transactions in systems that allow business management to monitor progress and produce periodic financial statements and performance reports. The information recorded in the bookkeeping system (ledger records) is analysed and summarised periodically, typically at the end of each year. This summarised information is then presented in financial statements, which typically include:

- a. A statement of financial position
- b. A statement of profit or loss and other comprehensive income

The objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. This information explains the financial position of an entity at the end of a period (usually a year) and its financial performance over that period.

Financial statements relate to a specific period of time, known as the 'financial year,' 'accounting period,' or 'reporting period'. These statements are prepared from information contained in the financial accounting records (the books, ledgers, or accounts), though some adjustments and additions are needed to complete the financial statements, especially for companies. Financial statements are often referred to as the set of accounts of the business.

1.5.2 The business entity concept

Financial reports are prepared on the basis that the business is a separate entity from its owners. This principle is known as the business entity concept.

Under this concept, the affairs of the business are distinguished from the personal affairs of the owner(s), and only the financial activities of the business are recorded in its accounting records.

For companies, this separation has legal backing, as a company is recognised by law as a separate legal person distinct from its shareholders. However, the business entity concept also applies to sole traders and partnerships, even though they are not separate legal entities.

Illustration:

Imran Khan sets up a sole proprietorship as a builder and names the business *IK Builders*.

Legally, *IK Builders* does not have a separate legal personality—any debts incurred by *IK Builders* are, in fact, the personal debts of Imran Khan.

However, for the purpose of financial reporting, the business is treated as a separate entity from Imran Khan.

1.5.3 Responsibility for preparing financial statements

Type of entity	Responsibility
Sole trader	There may be no formal obligation to prepare financial statements (other than for tax purposes), but where required, the owner is responsible. The owner may employ one or more individuals to maintain the accounting records and prepare the financial statements.
Partnership	Similarly, there may be no formal obligation to prepare financial statements (other than for tax purposes), but where required, the partners are collectively responsible. They may also employ individuals to maintain the accounting records and prepare the financial statements.
Company	Companies are required to prepare financial statements for shareholders and for submission to the relevant regulatory bodies. It is the responsibility of the directors to ensure that this is done, although the actual work is usually delegated to employees or external professionals.

a. Financial reporting by sole traders and partnerships

The financial statements of a sole trader are private and do not need to be disclosed publicly, except to the tax authorities and, where applicable, to a lending bank. These statements should be prepared in accordance with accepted accounting principles and practices, but they are not required to fully comply with all accounting standards. Similarly, the financial statements of a business partnership are also private and not subject to public disclosure.

b. Financial reporting by companies

The financial statements of a company are prepared for its shareholders and are usually subject to audit. An audit is the independent examination of the financial statements by a qualified expert, who expresses an opinion on whether the statements give a true and fair view of the company's financial position and performance. Company law requires that financial statements be filed with a designated government

agency, where they become accessible to the general public.

Companies whose shares are traded on major stock exchanges also make their financial statements publicly available, often through their official websites.

In general, the financial statements of companies are subject to more regulation than those of sole traders or partnerships.

1.6 Regulation of financial reporting

1.6.1 Generally accepted accounting principles

Financial reporting is subject to regulation and control to ensure that the information presented in financial statements possesses the required qualities and content.

The concepts, principles, conventions, laws, rules, and regulations used in the preparation and presentation of financial statements are collectively known as *Generally Accepted Accounting Principles* (GAAP).

The main sources of GAAP in a given jurisdiction typically include:

- a. company law; and
- b. accounting standards.

GAAP differs from one country to another, as each country has its own legal and regulatory framework. For instance, there is Nigerian GAAP, US GAAP, and so on.

1.6.2 Accounting standards

The accountancy profession has developed a wide range of regulations and codes of practice that professional accountants are required to follow when preparing financial statements. These regulations are known as *accounting standards*.

Accounting standards are primarily applied by companies rather than sole traders or partnerships, although they are generally written to apply to all types of entities.

Nigeria, like many other countries, has adopted the *International Financial Reporting Standards* (IFRS), which are issued by the *International Accounting Standards Board* (IASB).

Accounting standards provide guidance in four key areas:

- a. **Recognition** – When an item should be included in the accounting records.
- b. **Measurement** – The value at which an item is recorded. This includes rules for both initial recognition (when the item first enters the records) and subsequent measurement (how it is valued later).
- c. **Presentation** – The structure and format of the financial statements and how items are displayed within them.
- d. **Disclosure** – Additional information that must be provided to help users of the financial statements better understand the financial position and performance of the entity.

1.6.3 Other Regulations Governing Financial Reporting in Nigeria

In addition to generally accepted accounting principles and international accounting standards, financial reporting in Nigeria is also governed by several national regulations, including:

a) Finance Acts 2019 and 2020

These Acts are part of the Federal Government of Nigeria's tax policy reforms aimed at improving financial management and enhancing public revenue. They also address some of the economic challenges brought about by the COVID-19 pandemic by creating mechanisms to mitigate its impact.

The Acts introduced amendments to 14 tax and fiscal laws, including:

- i. Capital Gains Tax Act (CGTA)
- ii. Companies Income Tax Act (CITA)
- iii. Industrial Development (Income Tax Relief) Act (IDITRA)
- iv. Personal Income Tax Act (PITA)
- v. Tertiary Education Trust Fund (Establishment, etc.) Act
- vi. Customs and Excise Tariff, etc. (Consolidation) Act (CETA)
- vii. Value Added Tax Act (VATA)
- viii. Stamp Duties Act (SDA)
- ix. Federal Inland Revenue Service (Establishment) Act (FIRSEA)
- x. Nigeria Export Processing Zones Act (NEPZA)
- xi. Oil and Gas Export Free Zone Act (OGEFZA)
- xii. Companies and Allied Matters Act (CAMA)
- xiii. Fiscal Responsibility Act (FRA)
- xiv. Public Procurement Act (PPA)
- xv. Other regulations that guide the preparation and presentation of financial reporting in Nigeria include:

b) Companies and Allied Matters Act (CAMA) 2020

The revised CAMA aligns company regulation in Nigeria with global best practices. It makes comprehensive provisions for the rights and responsibilities of shareholders, directors, auditors, employees, and other stakeholders. Key highlights include:

- i. mandatory annual audits;
- ii. sanctions for defaulting directors;
- iii. oversight mechanisms for the audit function;
- iv. procedures for convening annual and extraordinary general meetings;
- v. guidelines for prudent management of shareholders' assets;
- vi. rules on ownership transfers and shareholder rights enforcement;
- vii. secure systems for share registration, voting, and proxies; and
- viii. enhanced protection of minority shareholders.

c) The Financial Reporting Council of Nigeria (Amendment) Act, 2023

The Financial Reporting Council of Nigeria (FRCN) plays a key role in setting and regulating financial reporting standards. Under the FRCN Act, the Council is responsible for:

- i. Developing and publishing accounting and financial reporting standards for public interest entities.
- ii. Reviewing, promoting, and enforcing compliance with these standards.
- iii. Receiving notifications of non-compliance from preparers, users, auditors, or third parties.
- iv. Receiving copies of annual reports and financial statements of public interest entities within 60 days of Board approval.

1.7 Bases of Accounting

1.7.1 Introduction

There are three main bases of accounting that determine how transactions are recognised and measured in financial statements:

- a. Accruals basis
- b. Cash basis
- c. Break-up basis

In practice, the **accruals basis** is by far the most widely used and important of the three.

1.7.2 Accruals basis of accounting (matching concept)

The **accruals basis of accounting** (also referred to as accruals accounting or the accruals concept) recognises transactions and other events in the periods in which they occur, regardless of when the related cash flows happen. This method provides a more accurate picture of a business's financial performance and position.

Key features of the accrual basis include:

- a. Revenue from sales and other income should be recognised in the period in which it is earned, even if the cash is received in a different period.
- b. The **cost of sales** must be matched with the related revenue in the same accounting period. This ensures that income and the corresponding expenses are reported together, giving a true picture of profitability for that period.
- c. Other expenses should be recognised in the period to which they relate, not necessarily when they are paid.

Illustration: Statement of comprehensive income

	₦
Revenue (from sales made in the period)	X
Cost of sales (costs matched with sales made in the period)	<u>(X)</u>
Gross profit	X
Other costs (charged in the period in which the benefit paid for is used)	<u>(X)</u>
Net profit	<u>X</u>

Example: Accruals basis

A company prepares its financial statements to 31 December each year.

On 6 December Year 2, it sells goods worth ₦50,000 to a customer but does not receive payment until 15 January Year 3.

Accruals Basis:

Under the accruals basis of accounting, the sale is recognised as income in the financial year ending 31 December Year 2, even though the cash is received after the year-end. This is because the income was earned in Year 2.

Example: Accruals basis

A company starts business on 1 September Year 1. It pays one year's office rent in advance, covering the period to 31 August Year 2.

The total annual rent is ₦120,000. The company prepares its financial statements for the year ending 31 December.

Accruals Basis:

Under the accruals basis of accounting, only the portion of the rent applicable to the current financial period should be recognised as an expense.

For the period to 31 December Year 1, this amounts to four months' rent:

$$₦120,000 \times 4/12 = ₦40,000.$$

The remaining ₦80,000 represents a **prepayment** for the next financial period (Year 2), and should be reported as a current asset in the statement of financial position as at 31 December Year 1.

Accruals and prepayments**Definitions****Accrued Expense (Accrual):**

An *accrual* or *accrued expense* is a liability representing the amount an entity owes for goods or services received during a financial period but for which no invoice has yet been received. It is an estimate of the cost of the benefit consumed during that period.

Prepayment:

A *prepayment* is an amount paid in advance for goods or services that will be received in a future accounting period.

A prepayment made in Year 1 for expenses that relate to Year 2 should **not** be recognised as an expense in Year 1. Instead, it should be carried forward as a current asset and charged as an expense in Year 2, when the related benefit is actually received.

Example: Accrual

A company rents office space at a cost of ~~₦~~6,000,000 per year, payable **12 months in arrears** (i.e., payment is made at the end of the year).

The first payment is due on **30 June Year 2**.

The company prepares its financial statements to **31 December each year**.

Accruals Basis:

Although the company will not receive an invoice by 31 December Year 1, it has occupied the office space for **six months** (from 1 July to 31 December Year 1).

Under the accrual basis of accounting, the company must recognise:

- A **rental expense** of ~~₦~~3,000,000 (~~₦~~6,000,000 × 6/12) in the profit or loss for Year 1, and
- A corresponding **accrued liability** of ~~₦~~3,000,000 in the statement of financial position.

This is referred to as **accruing an expense** or **making an accrual**.

Accounting for accruals and prepayments is described in detail in a later chapter.

1.7.3 Cash basis of accounting

Cash basis accounting recognises transactions in the periods in which the related cash receipts and payments occur.

Revenue from sales and other income is reported in the period when the cash is received, which may be later than the period in which the income was earned.

Expenses are recorded in the period in which they are paid, not in the period in which they are incurred.

Example: Cash basis

A company prepares its financial statements to 31 December each year. It sold goods for ~~₦~~50,000 to a customer on 6 December Year 2, but did not receive a cash payment from the customer until 15 January Year 3.

- **Accruals basis:** The sale is recognised as income in the year to 31 December Year 2, even though the cash is not received until after the end of this financial year.
- **Cash basis:** The sale is recognised as income in Year 3, even though the sale was made in Year 2.

~~₦~~50,000 is recognised as revenue under both bases, but in different periods.

Example: Cash basis

A company prepares its financial statements to 31 December each year.

It sells goods for ~~₦~~50,000 to a customer on 6 December Year 2 but does not receive the cash payment until 15 January Year 3.

Cash basis:

The sale is recognised as income in Year 3, even though the sale was made in Year 2, because the cash was received in Year 3.

Example: Cash basis

A company starts in business on 1 September Year 1. It acquires an office and pays one year's rent in advance, covering the period to 31 August Year 2.

The annual rent is ₦120,000. The company prepares its financial statements for the year ending 31 December.

Cash basis:

The entire rent of ₦120,000 is recognised as an expense in the year to 31 December Year 1, because the payment was made in that year, even though part of the benefit relates to the following year.

Over time, both accruals-based accounting and cash-based accounting will result in recognising the same amounts. However, the timing of when transactions are recognised may differ between the two systems.

1.7.4 Break-up basis of accounting

Both the accruals basis and the cash basis assume that a business is a going concern, meaning that the business is expected to continue into the future. However, this may not always be the case.

A business might be brought to an end (wound up) due to financial difficulty or, less commonly, because the owners decide that the business has run its course.

The break-up basis of accounting is used when the business is no longer a going concern. Under this basis, all assets and liabilities are measured at the amount of cash that they can be sold for (assets) or settled for (liabilities).

Example: Break-up basis

A company prepares its financial statements to 31 December each year. The company is in severe financial difficulty and is not expected to survive. It has a building in its accounts carried at ₦1,500,000. Real estate professionals have advised that this building could only be sold for ₦1,200,000 in current market conditions.

Break-up basis

The building should be re-measured to ₦1,200,000 in the financial statements.

1.7.5 Modified cash basis

The cash and accrual bases may be merged together to form a modified cash basis. Under the modified cash basis, revenue and expenses are recognised as cash is received and disbursed, with the exception of large cash outflows for long-lived assets, which are recorded as assets and depreciated over time.

The need for financial statement**1.7.6 The objective of financial reporting**

The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity.

Most users cannot insist that businesses supply them with specific information. Instead, they have to rely on the financial statements produced by a business for much of the

financial information they need.

In other words, financial statements are drafted to provide information that should be useful to most users, but will not necessarily satisfy all of their needs. Users must also look elsewhere for additional information.

Parties with an interest in a business are described as its stakeholders. Stakeholders have an interest in the contents of a business's financial statements.

1.7.7 Informational needs of those who use financial statements

a) **Investors**

Investors in a business entity are the providers of risk capital. Unless they are managers as well as owners, they invest to obtain a financial return on their investment. They need information that will help them make informed investment decisions.

For shareholders in a company, these decisions often involve whether to buy, hold, or sell shares in the company. Their decision might be based on an analysis of the company's past financial performance and financial position, and by attempting to predict future outcomes based on historical data. Financial statements also provide some indication of the company's ability to pay dividends to its shareholders out of profits.

b) **Lenders**

Lenders, such as banks, are interested in financial information about businesses that borrow from them. Financial statements help lenders assess the borrower's ongoing ability to pay interest, and its ability to repay the loan principal when it comes due.

c) **Suppliers and other trade creditors**

Financial information about an entity is also useful for suppliers who provide goods on credit to a business, and for other trade creditors who are owed money by the entity as a result of debts incurred in its business operations (such as money owed for rent, electricity, or telephone charges). They can use the financial statements to assess how much credit they might safely extend to the entity.

d) **Government**

The government and government agencies are interested in the financial statements of business entities. They might use this information for business regulation purposes or to determine taxation policies.

e) **The public**

In some cases, members of the general public might have an interest in the financial statements of a company. The IASB Framework comments: *"For example, entities may make a substantial contribution to the local economy in many ways, including the number of people they employ and their patronage of local suppliers."*

f) **Employees**

Employees need information about the financial stability and profitability of their employer. An assessment of profitability helps employees form an opinion about the employer's ability to pay higher wages or offer better job opportunities in the future.

g) **Customers**

Customers might be interested in the financial strength of an entity, especially if they rely on that entity for the long-term supply of key goods or services.

h) **Managers**

Managers are not typically included in this list of users by the IASB Framework, because they should have access to all the financial information they need, often in much more detail than financial statements provide. However, management is responsible for producing the financial statements and may still be interested in the information contained within them.

1.8 The Components of Financial statements

1.8.1 Financial statements

A full set of financial statements typically includes the following:

- a. a statement of financial position
- b. a statement of profit or loss and other comprehensive income
- c. a statement of changes in equity
- d. a statement of cash flows
- e. notes to the financial statements

These components are described in more detail in later chapters. The remainder of this section will explain the contents and basic structure of the statement of financial position and the statement of comprehensive income.

1.8.2 The statement of financial position

The statement of financial position is a summary of an entity's assets, liabilities, and equity as at a specific date. It provides a snapshot of the financial health of the entity at that moment. Each of these components is explained in more detail in subsequent sections.

A statement of financial position (formerly known as a balance sheet) reports the financial position of an entity at a particular date, usually at the end of the financial year. It reflects the entity's assets, liabilities, and equity (owner's capital).

a) **Assets**

An asset is a resource that an entity owns, controls, or is owed. (While this is not the technical definition, it serves as a basic explanation for now. A more detailed definition of an asset is provided in the next chapter.)

Assets are classified in the statement of financial position under two main categories:

- i. **Current assets:** Assets that are expected to provide economic benefits within the short term, usually within a year.

- ii. **Non-current assets:** Assets that have a long useful life and are expected to provide economic benefits over several years.

Example: Current assets

Inventory, cash, trade receivables (money owed by customers who have purchased goods or services on credit).

Example: Non-current assets Property, machinery, patent rights

b) **Liabilities**

A liability is an amount that the entity owes to another party. (This is a simplified definition; a more detailed technical definition will be provided later).

Liabilities are presented in the statement of financial position under two main categories:

Current liabilities: Amounts payable by the company within 12 months

Non-current liabilities: Amounts not payable within the next 12 months

Example: Liabilities

Trade payables (amounts owed to suppliers for goods purchased) Bank loans

c) **Equity**

Equity is the residual interest in the business that belongs to its owner(s) after the liabilities have been deducted from the assets. It is sometimes referred to as the 'net assets' of the business, which means assets minus liabilities.

Equity represents the amount the entity 'owes' to its owners, while liabilities represent amounts it owes to others. The total assets owned by the business are equal to the total amount of equity plus liabilities it owes.

This relationship can be expressed through the accounting equation:

Formula: Accounting equation

$$\text{Assets} - \text{Liabilities} = \text{Equity} \text{ or } \text{Assets} = \text{Liabilities} + \text{Equity}$$

The statement of financial position provides a detailed representation of this equation.

d. **Format of a statement of financial position**

A simple statement of financial position is divided into two sections:

- The **upper section** shows the assets of the business, beginning with non-current assets, followed by current assets.
- The **lower section** shows equity, followed by liabilities—first non-current (long-term) liabilities, then current liabilities.

The total of the assets in the upper section must always equal to the of equity and liabilities in the lower section

The total of the assets in the upper section must always equal the total of equity and liabilities in the lower section.

Illustration: Statement of financial position

Lagos Shipping Limited: Statement of financial position as at [date]

Assets	₦(000s)	₦(000s)
Non-current assets:		
Land and buildings		400,000
Plant and equipment		100,000
Motor vehicles		<u>80,000</u>
		580,000
Current assets:		
Inventory	20,000	
Receivables	30,000	
Cash	<u>5,000</u>	
		<u>55,000</u>
Total assets		<u>635,000</u>
Equity and liabilities		
Equity:		
Owner's capital		440,000
Non-current liabilities:		
Bank loan		170,000
Current liabilities:		
Bank overdraft	10,000	
Trade payables	<u>15,000</u>	
		<u>25,000</u>
Total equity and liabilities		<u>635,000</u>

- e) **The statement of financial position is not a statement of value.**
The value of a business is determined by the profits that the business is expected to generate using the assets that it owns. There is no way of telling what a business is worth by looking at the financial statements. (Further analysis would be required to arrive at a valuation).

1.8.3 The statement of profit or loss and other comprehensive income

This statement provides information about the financial performance of an entity over a specific period. It comprises two parts:

- a. **The statement of profit or loss** – which lists income and expenses, resulting in a profit or loss for the period; and
b. **The statement of other comprehensive income** – This includes other gains and losses that have arisen during the period.

Transactions reported in the statement of other comprehensive income are **not** included in your syllabus. For this reason, all examples and exercises in this syllabus focus only on items that are reported in the **statement of profit or loss**.

A detailed technical definition of *income* and *expense* is provided later. For now, simple examples are given below.

a) **Income**

Income includes:

- I. Revenue from the sale of goods or services
- II. Other income, such as interest received from investments
- III. Gains from disposing of non-current assets for more than their carrying amount in the records.

Example: If a machine is sold for ₦15,000 and its carrying amount is ₦10,000, the gain on disposal is ₦5,000.

In financial reporting, the term '**revenue**' refers specifically to income earned in the normal course of business operations. In a statement of profit or loss, **revenue** and **other income** are presented as separate items.

b) **Expenses**

Expenses consist of:

- I. expenses arising in the ordinary course of activities, including the cost of sales, wages and salaries, the cost of the depletion of non-current assets, interest payable on loans and so on
- II. losses arising from disasters such as fire and flood, and also losses from disposing of non-current assets for less than their carrying value in the statement of financial position.

c) **Format of a simple statement of profit or loss**

The order of presentation is usually as follows:

- i. Revenue (sales)
- ii. Cost of sales
- iii. Gross profit (Revenue minus cost of sales)
- iv. Other income, such as interest income and gains on the disposal of non-current assets
- v. Other expenses, which may be itemised in some detail

(There is no strict rule about the order in which expenses are listed, but it is common to begin with administrative expenses, followed by selling and distribution expenses, and finally financial expenses such as interest charges, bad debts, and audit fees.)

- vi. Net profit (Gross profit plus other income, minus other expenses)
- vii. Tax charge, in the case of a company – representing the tax payable on its profits

Illustration: Statement of profit or loss

Lagos Shipping Limited: Statement of profit or loss for the year ended [date]

	₦ (000s).	₦ (000s)
Revenue		800,000
Cost of sales		<u>500,000</u>
Gross profit		300,000
Other income:		
Gain on disposal of non-current asset		<u>10,000</u>
		310,000
Expenses		
Employees' salaries	120,000	
Depreciation	10,000	
Rental costs	30,000	
Telephone charges	15,000	
Advertising costs	30,000	
Selling costs	40,000	
General expenses	20,000	
Interest charges	3,000	
Bad debts	<u>2,000</u>	
		<u>270,000</u>
Net profit		<u>40,000</u>

Gross profit and net profit

It is usual to show both the gross profit and the net profit in a statement of comprehensive income.

- a. Gross profit is the sales revenue minus the cost of sales in the period, and
- b. Net profit (or loss) is the profit after taking into account all other income and all other expenses for the period.

Cost of sales is the cost of making the products sold in a period. The expenses included in 'cost of sales' differ according to the activities or type of industry in which the entity operates. For example:

- a. in a retailing business, the cost of sales might be just the purchase cost of the goods that have been sold;
- b. in a manufacturing business, the cost of sales might be the cost of producing the goods sold during the period, including raw materials, components, labour and other expenses incurred in production.

1.8.4 Relationship between the statement of profit and loss and other comprehensive income and the statement of financial position

The statement of financial position shows the equity of a business at a point in time. In practice, the balances for the previous year are also included. These are known as comparatives.

The following example is based on a simplified version of the statement of financial position shown earlier at section 5.2.

Illustration: Statement of financial position (with comparatives)

Lagos Shipping Limited: Statement of financial position as at December 31, 2019

	2019 ₦(000s)	2018 ₦(000s)
Assets		
Non-current assets	580,000	575,000
Current assets	55,000	25,000
Total assets	<u>635,000</u>	<u>600,000</u>
Equity and liabilities		
Capital	440,000	400,000
Non-current liabilities	170,000	180,000
Current liabilities	<u>25,000</u>	<u>20,000</u>
Total equity and liabilities	<u>635,000</u>	<u>600,000</u>

Comparatives are required for the other financial statements also. You will not be asked to produce financial statements with comparatives in the exam. They are shown here to help you understand how the different financial statements relate to each other.

Notice in the above that equity (capital) has increased by ~~₦~~40,000 (000) and net assets have increased by the same amount.

Illustration: Change in equity and net assets

	2019 ₦(000s)	2018 ₦(000s)
Total assets	635,000	600,000
Non-current liabilities	170,000	180,000
Current liabilities	25,000	20,000
Capital	(195,000)	200,000
Net assets (=equity)	<u>440,000</u>	<u>400,000</u>

The statement of profit or loss ends with a figure showing net profit for the period. Profit belongs to the owner (or owners) of the business. It is therefore, an addition to equity.

The statement of profit or loss links last year's statement of financial position to that

constructed at the end of this year.

In the above example, the capital of the Lagos Shipping Company has increased by ₦40,000 (000). This is the profit for the year shown in the illustration of the statement of profit or loss shown in section 5.3.

1.8.5 Statement of changes in equity

The relationship between the opening equity and closing equity is shown in a statement of changes in equity.

Illustration: Statement of changes in equity

Lagos Shipping Limited: Statement of changes in equity for the year - ended December 31, 2019

	₦(000s)
Equity at the start of the year	400,000
Profit for the year	40,000
Equity at the end of the year	440,000

In practice, equity would be made up of a number of different balances each with a separate column in the statement of change in equity

1.9 Business Transactions

1.9.1 Introduction

A business transaction is an interaction between a business and customer, supplier or any other party with whom they do business. It is an economic event that must be recorded in the business's accounting system.

There are many different types of business transaction including:

- Cash sales of goods or services,
- Credit sales of goods or services.
- Receipt of cash from a customer to whom a sale on credit has been made.
- Cash purchase of raw materials or goods.
- Credit purchase of raw materials or goods.
- Payment of cash to a supplier from whom a credit purchase has been made.
- Receipt of loan proceeds.
- Repayment of a loan.
- Payments made to employees.
- Payments made to the government (for example taxes).
- Purchase of non-current assets.

There are many more examples.

1.9.2 **Classification of business transactions**

Business transactions can be classified in a number of ways including:

- a. Simple transactions and complex transactions
- b. One-off transactions and ongoing transactions
- c. Capital transactions and revenue transactions

a. **Simple or complex**

Many transactions involve simple exchanges. For example, the sale of a Samsung Galaxy phone by a retailer to a customer for cash is a simple transaction. If the same sale is made on credit (where the customer does not pay immediately) the transaction is more complex. In this case it might involve a series of payments and some of the amount received might constitute interest.

b. **One-off transactions and ongoing transactions**

Many transactions might occur on a single occasion. However, there are some relationships which lead to a series of transactions of an ongoing nature. For example, a person buying a Samsung Galaxy would need a contract with a mobile phone network. This contract would involve a series of commitments by each party and result in a series of payments by the owner of the phone to the network provider in return for the provision of service of a specified level.

One of the most important ongoing relationships is that between a person or a business and their banks. These may last for many years and involve the provision of a series of different services through a whole series of transactions.

c. **Capital and revenue transaction**

A business entity typically operates over many years but prepares financial statements annually at the end of each financial year.

- i. It incurs expenditure for both long-term purposes—such as investing in machinery, equipment, and other non-current assets—and short-term needs, such as paying for supplies, services, and employee wages or salaries.
- ii. It generates income from its operating activities and may also receive funds from other sources, such as bank loans or capital contributions from the owner.

A clear distinction is made between capital and revenue items:

- i. Capital items are of a long-term nature. These include property, plant, and equipment that are used in the ongoing operations of the business.
- ii. Revenue items are short-term in nature and relate to the normal cycle of business operations, such as daily expenses and income from regular trading activities.

As a general (though not strictly accurate) guide:

- i. Capital items are reported in the statement of financial position, as they provide long-term economic benefit.
- ii. Revenue items are reported as income or expenses in the statement of profit or loss and other comprehensive income, reflecting their impact within the financial year.

d. **Capital and revenue expenditure**

i) **Capital expenditure** refers to expenditure incurred to acquire or improve long-term assets that are used in the operations of a business. These expenditures provide benefits that extend beyond the current financial year. Examples of capital expenditure include:

- Purchase of property, plant and equipment, office furniture, and motor vehicles
- Installation costs associated with new equipment
- Improvements or additions to existing non-current assets (e.g., building extensions, installation of air-conditioning systems)
- Fees paid to raise long-term finance

A 'capital asset' is also referred to as a 'non-current asset'.

According to the IASB, capitalisation means recognising a cost as an asset, or as part of the cost of an asset. When a cost is *capitalised*, it is treated as an asset rather than as an expense.

a. **Revenue expenditure** refers to spending on the day-to-day running costs of a business. These expenditures are incurred in the normal course of operations and are generally consumed within the financial year.

Examples of revenue expenditure include:

- i. Purchase of goods for resale
- ii. Purchase of raw materials and components for manufacturing goods
- iii. Operating expenses such as rent, electricity, and wages
- iv. Repairs and maintenance of non-current assets
- v. Distribution costs, such as delivery of goods to customers
- vi. Administrative costs such as accounting services, licence fees, and office supplies

Revenue expenditure is recorded as an expense in the statement of profit or loss and other comprehensive income.

Note: In practice, it is not always easy to distinguish clearly between capital and revenue expenditure. Judgment is sometimes required to determine the appropriate classification.

e. **Revenue income and capital receipts**

Revenue income is income generated from the normal operations of a business and from its investments.

Examples include:

Revenue from the sale of goods.

- i. Commissions and fees received and receivable for the provision of services.
- ii. Interest received and receivable from savings.
- iii. Rent received and receivable from letting out property.

Revenue is reported in the statement of profit or loss within the statement of comprehensive income.

Capital receipts refer to receipts of 'long-term' income, such as money from bank loan or new money invested by the business owners (referred to as 'capital').

Capital receipts affect the financial position of an entity, but not its financial performance. Therefore, capital receipts are excluded from the statement of comprehensive income.

Illustration:

A business entity borrows ₦100,000 from a bank for five years and pays interest of ₦8,000 on the loan for the first year.

- The loan is classified as a non-current liability (and part of the long-term 'capital' of the business – a capital receipt).
- The interest paid is an expense (and qualifies as revenue expenditure).

A business has two identical vehicles, both with engine problems.

- The engine of one vehicle is repaired – the costs associated with the repair are revenue expenditure.
- The engine of the second vehicle is replaced – the costs associated with the replacement are capital expenditure.

1.10 Ethical Considerations for Preparers of Financial Statements

1.10.1 The need for professional ethics in financial reporting

Professional accountants face various ethical pressures and influences from employers, clients, executives, and politicians. Their responsibility extends beyond satisfying clients or employers to acting in the public interest.

1.10.2 Importance of ethical behaviour

Financial reports are essential for decision-making by shareholders, creditors, employees, suppliers, governments, and the public. Accountants must produce reports based on fundamental qualities, including:

- a. Honesty
- b. Integrity
- c. Transparency
- d. Accountability

1.10.3 Ethics and code of professional conduct

Ethics refer to general principles such as honesty, integrity, and morals. The code of professional conduct is a specific set of rules set by governing boards of professional accountancy bodies. While rules may vary, some principles are universal.

1.10.4 Fundamental principle of professional ethics

The Institute of Chartered Accountants of Nigeria (ICAN) code of ethics outlines the following fundamental principles:

- i. **Integrity**
 - Professional accountants must be honest and straightforward in their dealings.
 - Integrity implies honesty, fair dealings, and truthfulness.
- ii. **Objectivity**
 - Members must not allow bias, conflicts of interest, or undue influence to override their professional judgments.
 - Professional competence and due care
 - Members must maintain their professional knowledge and skills to provide competent services.
 - They must act diligently and in accordance with technical and professional standards.
- iii. **Professional behaviour**
 - Members must comply with laws and regulations, behave with courtesy, and avoid actions that can harm the profession.
- iv. **Confidentiality**
 - Members must not disclose clients' or employers' information without consent, unless required by law or professional duty.

- Confidential information must not be used for personal advantage or third-party benefit.

1.10.5 Types of manipulation in financial statements

a. **Misrepresentation of liabilities**

- i. Omitting liabilities from the statement of financial position
- ii. Misclassifying liabilities as equity
- iii. Treating preference shares as equity instead of debt instruments

This can increase net assets, reduce gearing and avoid breaching debt covenants.

b. **Revenue manipulation**

- i. Understating revenue to reduce tax liability
- ii. Recognising fictitious revenue to attract investors
- iii. Raising invoices before the end of the accounting year to inflate sales figures
- iv. Recording loan proceeds as revenue

c. **Depreciation manipulation**

- i. Setting arbitrary depreciation rates or methods
- ii. Increasing the salvage value of depreciable assets
- iii. Extending the useful life of assets

d. **Asset manipulation**

- i. Arbitrarily revaluing non-current assets to reduce debt/equity ratio
- ii. Selling off under-depreciated assets to earn one-off gains

e. **Expense manipulation**

- i. Capitalising operating costs to reduce expenses
- ii. Failing to recognise impairment losses or writing down inventory to its net realisable value

f. **Disclosure manipulation**

- i. Inadequate disclosure to hide information that may affect the credibility of financial statements
- ii. Failure to write off doubtful receivables to avoid reporting losses

These compromises can have significant consequences, including misleading stakeholders, undermining trust in financial reporting, and potentially leading to legal and regulatory issues.

1.10.6 Motivations for unethical financial reporting

Companies may engage in unethical financial reporting for various reasons, including:

a. **Personal gain**

- i. Management bonuses tied to performance levels, leading to manipulation of financial statements to meet earnings targets.

- ii. Increasing personal wealth and benefits through inflated financial performance.
- b. **Market pressure**
 - i. Increasing market indicators to boost market capitalisation and attract investors.
 - ii. Responding to pressure from competitors to maintain a competitive edge.
- c. **Tax benefits**
 - i. Reducing tax liabilities through aggressive tax planning or manipulation of financial statements.
- d. **Concealment of misdeeds**
 - i. Covering up assets misappropriated by employees or management.
 - ii. Concealing material losses or financial difficulties through self review threats.
- e. **Lack of internal controls**
 - i. Inadequate or inefficient internal control systems, allowing unethical financial reporting to occur undetected.
 - ii. Weak governance structures and lack of oversight, enabling management to engage in unethical behaviour.

1.10.7 Threats to compliance with ethical behaviour

The International Federation of Accountants (IFAC) identifies five threats that may affect professional accountants' compliance with ethical behaviour:

- a. **Self-interest threats**
Self-interest threats occur when a professional accountant's financial or personal interests, or those of a close family member, inappropriately influence their decisions or actions. This can lead to conflicts of interest, compromising the accountant's objectivity and independence.
- b. **Self-review threats**
Self-review threats arise when a professional accountant reviews his/her own work or that of another individual within the same firm. This can lead to a lack of objectivity, as the accountant may be less critical of his/her own work or that of a colleague. Examples include:
 - i. preparing financial statements for a client and then conducting the audit
 - ii. reviewing one's own tax returns or financial planning advice
- c. **Advocacy threats**
Advocacy threats occur when an accountant promotes a client's point of view, potentially impairing his/her objectivity. Examples include:
 - i. acting as a professional witness in a legal dispute
 - ii. promoting a client's interests in a negotiation or business transaction

- d. **Familiarity threats**
Familiarity threats arise from long or close relationships with clients, which can lead to an accountant becoming too sympathetic to the client's point of view. This can compromise the accountant's objectivity and independence.
- e. **Intimidation threats**
Intimidation threats occur when a professional accountant's objectivity and independence are compromised by real or perceived pressures. These pressures can come from clients, colleagues, or superiors, and can lead to an accountant compromising his/her ethical principles.

1.10.7 Resolving Ethical Conflicts

Professional accountants responsible for preparing financial reports must adhere to accounting standards to produce reliable and accurate reports. To resolve ethical conflicts with clients or employers, accountants should follow these steps:

- a. **state the facts:** Examine the ethical issues involved and gather relevant information.
- b. **apply fundamental principle:** Explain the principles relating to the matter, such as integrity, objectivity, and transparency.
- c. **explain Generally Accepted Accounting Principles (GAAP) and standards:** Identify the relevant Generally Accepted Accounting Principles (GAAP) and standards and explain the consequences of adopting unethical approaches.
- d. **establish internal procedures:** Develop procedures to resolve issues internally.
- e. **explore alternative actions:** If internal procedures fail, explore alternative courses of action consistent with fundamental principles.
- f. **consult with governing boards or audit committees:** Seek guidance from governing boards or audit committees.
- g. **document the issue:** Record the substance of the issue, discussions, and decisions.
- h. **seek external advice:** If necessary, obtain advice from professional bodies or legal experts without breaching confidentiality.
- i. **disengage or resign:** If all else fails, consider disengaging from the assignment or resigning.

1.10.8 Consequences of unethical financial reporting

Unethical financial reporting can have severe consequences, including:

- a. **Loss of investor confidence:** Low participation in the stock market and substantial falls in stock prices.
- b. **Lawsuits and creditor claims:** Companies may face lawsuits from lenders and creditors.
- c. **Doubts about integrity of financial statements:** Unethical reporting can undermine trust in financial statements.
- d. **Going concern threats:** Unethical practices can lead to liquidation, causing stakeholders to suffer losses, including:
 - i. shareholders: loss of investment
 - ii. government: loss of revenue
 - iii. employees: loss of jobs
 - iv. suppliers: loss of business

- e. **Depressed economic climate:** Widespread unethical practices can negatively impact the economy.
- f. **Higher capital costs:** Unethical reporting can increase the cost of obtaining capital.

1.10.9 Measures in place to ensure quality financial reporting

- a. **Conceptual Framework:** The IASB Conceptual Framework provides guidance on measurement, recognition, and disclosures.
- b. **Principle-based accounting standards:** International Financial Reporting Standards (IFRS) are principle-based, promoting more disclosures and transparency.
- c. **Professional accountants' codes of ethics:** Codes of ethics, such as those issued by the Institute of Chartered Accountants of Nigeria (ICAN), promote ethical behaviour.
- d. **Companies' codes of ethics:** Many companies have codes of ethics that commit to integrity, healthy business environments, and employee welfare.

1.11 Chapter Review

Chapter review

Before moving on to the next chapter, check that you can now:

- a. clearly define and explain the key characteristics of a business.
- b. identify and compare the features of sole proprietorships, partnerships, and limited liability companies.
- c. differentiate between the accrual, cash, and break-up bases of accounting, and determine the appropriate circumstances for using each.
- d. evaluate the importance of financial information for various users of financial statements.
- e. analyse the purpose and structure of the statement of financial position and the statement of comprehensive income.
- f. list and describe the essential components of financial statements and explain their relevance.
- g. apply the correct presentation formats for the statement of financial position and the statement of profit or loss and other comprehensive income.
- h. Accurately classify and record transactions that meet the definition of business transactions.
- i. identify the accounting bases and when they should be applied

1.12 End of chapter questions and suggested solutions

Question 1:

There are three main bases of accounting that determine how transactions are recognised and measured in financial statements.

Required:

- a. Differentiate between the accrual, cash, and break-up bases of accounting.
- b. Explain the advantages and limitations of each basis and identify situations in which each would be most appropriate.

1. Accrual Basis of Accounting

- a. Definition: Under the accrual basis, revenues are recognised when they are earned (not when cash is received), and expenses are recognised when they are incurred (not when paid).
- b. Example: If a business delivers goods in December but receives payment in January, the revenue is recorded in December.
Advantages:
- c. Provides a more accurate and complete picture of a company's financial performance and position.
- d. Matches revenues with the related expenses in the same accounting period, improving comparability and decision-making.
- e. Limitations:
- f. More complex and requires estimates (e.g., depreciation, bad debts).
- g. May not reflect actual cash flows, which can be critical for liquidity analysis.
- h. Appropriate Situations:
- i. Mandatory for companies and large businesses under IFRS/IAS.
- j. Most suitable when financial information is needed for investment, lending, and regulatory decisions.

2. Cash Basis of Accounting

- a. Definition: Revenue and expenses are recognised only when cash is received or paid.
- b. Example: If payment is received in January for goods delivered in December, the revenue is recorded in January.
Advantages:
- c. Simple and easy to apply.
- d. Reflects actual cash flow, useful for small businesses or personal finances.
Limitations:
- c. Does not give a true reflection of profitability, especially in credit transactions.
- c. Can distort performance comparisons between periods.
Appropriate Situations:
- d. Small businesses or sole proprietors with minimal credit transactions.
- e. Not acceptable under IFRS/IAS for general-purpose financial reporting.

3. Break-up (Liquidation) Basis of Accounting

- a. Definition: Used when an entity is no longer a going concern. Assets are value at their net realizable value, and liabilities are recorded at amounts expected to be paid on settlement.
- b. Example: If a company is winding up, its inventory might be valued at liquidation price instead of cost.
Advantages:
- c. Provides realistic values when a business is about to cease operations.
- d. Helps creditors and stakeholders understand potential recoveries.
Limitations:
- e. Not appropriate for a continuing business.
- f. May lead to significant write-downs and user confusion if wrongly applied.
Appropriate Situations:
- g. When liquidation or discontinuation is certain or imminent.
- h. Required by IAS 1 when going concern is no longer appropriate.

Conclusion

Each accounting basis serves a different purpose:

- a. Accrual is ideal for general-purpose reporting and long-term decision-making. Cash is suitable for simplicity and short-term cash flow monitoring.
 - b. Break-up is necessary when an entity is facing liquidation or closure.
- The choice of basis depends on the nature, size, and financial status of the business and the users' needs.

Question 2:

Lighthouse Ltd. presents the following in its financial report:

Non-current assets: ~~₦~~50 million

- a) Current assets: ~~₦~~20 million
- b) Current liabilities: ~~₦~~10 million
- c) Non-current liabilities: ~~₦~~25 million
- d) Equity: ~~₦~~35 million

Using this information:

- i. prepare a simple statement of financial position.
- ii. briefly explain the relationship between total assets, liabilities, and equity in financial reporting.

Answer

- a) Simple Statement of Financial Position for Lighthouse Ltd.
Lighthouse Ltd.
Statement of Financial Position
As at [date]

	₦ in Millions
Assets	
Non-current assets	50
Current assets	<u>20</u>
Total assets	<u>70</u>
Equity and liabilities	
Equity	35
Non-current liabilities	25
Current liabilities	<u>10</u>
Total equity and liabilities	<u>70</u>

- b) Relationship Between Total Assets, Liabilities, and Equity
In financial reporting, the statement of financial position is based on the accounting equation:
$$\text{Assets} = \text{Liabilities} + \text{Equity}$$
 - i. Assets represent what the business owns or controls (~~₦~~70 million).
Liabilities are what the business owes to outsiders (~~₦~~35 million: ~~₦~~25 million non-current + ~~₦~~10 million current).
 - ii. Equity represents the residual interest of the owners after liabilities have been deducted from assets (~~₦~~35 million).In this case, Lighthouse Ltd.'s total assets (~~₦~~70 million) are equal to the total of liabilities (~~₦~~35 million) and equity (~~₦~~35 million), demonstrating the fundamental balance in financial reporting. This relationship ensures that the business's financial position is presented fairly and transparently.

Question 3:

The following transactions occurred in Glory Enterprises during the month of March:

- a. Goods worth ~~₦~~400,000 were sold on credit.
- b. Cash sales amounted to ~~₦~~200,000.

- c. Wages of ~~N~~150,000 were incurred but only ~~N~~100,000 was paid.
- d. Rent of ~~N~~50,000 was paid in advance for the next month.

Required:

- i. Calculate the profit for the month using the **cash basis**.
- ii. Calculate the profit for the month using the **accrual basis**.

Answer

a. Profit using the *Cash Basis* of Accounting

Under the cash basis, only cash receipts and payments are recognised. Revenues and expenses are recorded only when cash is received or paid.

Cash Receipts:

- i. Cash sales = ~~N~~200,000
- ii. Credit sales are not included under cash basis.

Cash Payments:

- i. Wages paid = ~~N~~100,000
- ii. Rent paid (even though for next month) = ~~N~~50,000

$$\begin{aligned}
 \text{Profit} &= \text{Cash Receipts} - \text{Cash Payments} \\
 &= \text{N}200,000 - (\text{N}100,000 + \text{N}50,000) \\
 &= \text{N}200,000 - \text{N}150,000 \\
 &= \text{N}50,000 \\
 \text{Cash Basis Profit} &= \text{N}50,000
 \end{aligned}$$

b. Profit using the *Accrual Basis* of Accounting

Under the accrual basis, revenue and expenses are recorded when earned or incurred, regardless of when cash is received or paid.

Revenues:

- i. Credit sales = ~~N~~400,000
 - ii. Cash sales = ~~N~~200,000
- Total Revenue = ~~N~~600,000

Expenses:

- i. Total wages incurred = ~~N~~150,000 (not just what is paid)
- ii. Rent for the next month (~~N~~50,000) is a prepayment, so it is not an expense this month.

$$\begin{aligned}
 \text{Total Expenses} &= \text{N}150,000 \\
 \text{Profit} &= \text{Total Revenue} - \text{Total Expenses} \\
 &= \text{N}600,000 - \text{N}150,000 \\
 &= \text{N}450,000 \\
 \text{Accrual Basis Profit} &= \text{N}450,000
 \end{aligned}$$

THE IASB'S CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Contents

- 2.0 learning objectives
- 2.1 Learning outcomes
- 2.2 A conceptual framework for financial reporting
- 2.3 The IASB conceptual framework
- 2.4 Qualitative characteristics of useful financial information
- 2.5 Recognition in financial statements: IASB conceptual framework
- 2.6 Other accounting concepts
- 2.7 Fair presentation
- 2.8 Chapter review
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2. The IASB's Conceptual Framework for Financial Reporting

2.0 Learning objective

This chapter explains the foundational principles that guide the preparation and presentation of financial statements, including the role of GAAP and the IASB Conceptual Framework for Financial Reporting, the needs of users, the objective of financial reporting, the qualitative characteristics of financial information, and the recognition and presentation of the elements of financial statements.

2.1 Learning outcomes

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

- a. explain the meaning of Generally Accepted Accounting Principles (GAAP)
- b. describe the purpose of the IASB's Conceptual Framework
- c. identify the users of financial statements and their informational needs
- d. state the objective of financial statements
- e. describe the qualitative characteristics of useful financial information
- f. list and define the elements of financial statements
- g. state the recognition criteria for the elements of financial statements
- h. explain the concepts of materiality, offsetting, and consistency
- i. explain the meaning and importance of fair presentation

2.2 A Conceptual Framework for Financial Reporting

2.2.1 The meaning of GAAP

The preparation and presentation of financial statements is based on a large number of concepts, principles and detailed rules. Some of these are contained in law and others are in financial reporting standards. Many of the most fundamental concepts are not contained in any law or regulation or standard but are simply accepted accounting principles and conventions.

All the concepts, principles, conventions, laws, rules and regulations that are used to prepare and present financial statements are known as Generally Accepted Accounting Principles or GAAP.

Generally accepted accounting principles' vary from country to country, because each country has its own legal and regulatory system. For example, there is US GAAP, EU GAAP, UK GAAP, Nigerian GAAP and so on.

Nigeria' in common with many other countries has adopted International Financial Reporting Standards or IFRSs, sometimes called International Accounting Standards (IASs). It is now fairly common to use the term IFRS (or IAS) to refer to the totality of the rules set out in the International Accounting Standards Board's (IASB's) conceptual framework, all international accounting standards (IFRSs and IASs), and all the associated interpretations and guidelines.

2.2.2 The meaning of a conceptual framework

A conceptual framework is a system of concepts and principles that underpin the preparation of financial statements. These concepts and principles should be consistent with one another.

The International Accounting Standards Committee (the predecessor of the IASB) issued a conceptual framework document in 1989. This was called the *Framework for the Preparation and Presentation of Financial Statements* and was adopted by the IASB.

The IASB has been working closely with FASB (the US standard setter) on a wide range of projects with the aim of converging IFRS and US GAAP. One of the projects has had the aim of producing a conceptual framework common to each GAAP.

The new conceptual framework was developed on a chapter by chapter basis. The complete new conceptual framework was published in March 2018 and is called "*The conceptual framework for financial reporting*".

Note that the changes are not fundamental in terms of their impact on IFRS.

The new document is made up of the following sections:

- a. **Chapter 1** – The objective of general purpose financial reporting.
- b. **Chapter 2** – Qualitative characteristics of useful financial information.
- c. **Chapter 3** – Financial statements and the reporting entity.
- d. **Chapter 4** – The elements of financial statements.
- e. **Chapter 5** – Recognition and derecognition
- f. **Chapter 6** – Measurement
- g. **Chapter 7** – Presentation and disclosure
- h. **Chapter 8** – Concepts of capital and capital maintenance.

2.2.3 The purpose of a conceptual framework

Most preparers and users of financial statements recognise that there is a need for a formal conceptual framework and that this can be useful in a number of ways.

Where there is a formal conceptual framework for accounting, accounting practice and accounting standards are based on this framework.

Lack of a formal framework often means that standards are developed randomly or only to deal with particular problems. The result is that standards are inconsistent with each other or with legislation.

Lack of a conceptual framework may also mean that accounting standards fail to address important issues. For example, until the IASB developed its Framework, there was no proper definition of terms such as 'asset', 'liability', 'income' and 'expenses'.

The business environment is becoming increasingly complex. It is unlikely that accounting standards can cover all possible transactions. Where an entity enters into an unusual transaction and there is no relevant accounting standard, it can refer to the framework and apply the principles in it.

It can also be argued that a conceptual framework strengthens the credibility of financial reporting and the accounting profession in general.

2.2.4 The alternative to a conceptual framework

The alternative to a system based on a conceptual framework is a system based on detailed rules.

Accounting standards based on detailed rules are open to abuse. 'Creative accounting' is the name given to techniques which enable management to give a biased impression (usually favourable) of the company's performance while still complying with accounting standards and other regulations. During the 1980s there were a number of scandals in which investors were misled by the financial statements of apparently healthy companies which then collapsed. This was one of the original reasons why the IASB and other standard setters developed their conceptual frameworks. Principles are normally much harder to evade than rules.

Another disadvantage of a rule-based system is that standard setters are more likely to be influenced by 'vested interests' such as large companies or a particular business sector. The existence of a conceptual framework is an important safeguard against this kind of political pressure.

Despite these problems, some preparers and regulators still appear to favour rule based standards. Standards based on principles may require management to use its judgement (and to risk making a mistake), while rules simply need to be followed. This can be important where management can face legal action if an investor makes a poor decision based on the financial statements.

The use of a conceptual framework can lead to standards that are theoretical and complex. They may give the 'right answer' but be very difficult for the ordinary preparer to understand and apply. However, a system of extremely detailed rules can also be very difficult to apply.

2.3 The IASB Conceptual Framework

2.3.1 Introduction

Financial reports are based on estimates, judgements and models rather than exact depictions. The Conceptual Framework establishes the concepts that underlie those estimates, judgements and models.

The Conceptual Framework deals with:

- a. the objective of financial reporting;
- b. the qualitative characteristics of useful financial information;
- c. the definition, recognition and measurement of the elements from which financial statements are constructed; and
- d. concepts of capital and capital maintenance.

The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. Its purpose is to:

- a. assist the IASB to develop IFRS Standards (Standards) that are based on

consistent concepts;

- b. assist preparers to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when IFRS allows a choice of accounting policy; and
- c. assist all parties to understand and interpret IFRS.

This Conceptual Framework is not an IFRS and nothing in the Conceptual Framework overrides any specific IFRS.

On very rare occasions there may be a conflict between the Conceptual Framework and an IFRS. In those cases, the requirements of the IFRS prevail over those of the Conceptual Framework.

2.3.2 Users and their information needs

Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. These are the primary users to whom general purpose financial reports are directed.

- a. General purpose financial reports cannot provide all the information needed and users also need to consider pertinent information from other sources.
- b. General purpose financial reports do not show the value of a reporting entity; but they provide information to help users estimate a value.
- c. Individual primary users have different information needs. The aim of IFRSs is to provide information that will meet the needs of the maximum number of primary users.

Other users

Regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful but these reports are not primarily directed to these groups.

A company's management is often interested in financial information but the management do not need to rely on general purpose financial reports.

2.3.3 Objective of general purpose financial statements

The objective of general purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework flow logically from the objective.

a. The objective

The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

- i. In order to make these decisions the users need information to help them assess the prospects for future net cash inflows to an entity.
- ii. In order to assess an entity's prospects for future net cash inflows,

users need information about:

- the resources of the entity;
- claims against the entity; and
- how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources. (This information is also useful for decisions by those who have the right to vote on or otherwise influence management performance).

b. Information provided

General purpose financial statements provide information about:

- i. the financial position of the entity – information about economic resources and the claims against them; and
- ii. changes in its financial position which could be due to:
 - financial performance; and/or
 - other events or transactions (e.g. share issues).

c. Economic resources and claims

Information about the nature and amounts of economic resources and claims can help users to:

- i. identify the financial strengths and weaknesses of a reporting entity;
- i. to assess a reporting entity's liquidity and solvency and its needs for additional financing;

Information about priorities and payment requirements of existing claims helps users to predict how future cash flows will be distributed among those with a claim against the reporting entity.

d. Changes in economic resources and claims – financial performance

Accrual accounting reflects the effects of transactions and other events on a reporting entity's economic resources and claims in the periods in which they occur, even if the related cash flows arise in a different period. This approach offers a more accurate basis for evaluating an entity's past and future performance than focusing solely on cash receipts and payments during the period.

e. Importance of Information about financial performance:

- i. it helps users assess the returns generated from the entity's economic resources, indicating how effectively and efficiently management has used those resources.
- ii. it provides insight into the entity's ability to generate net cash inflows from its operations, rather than through additional capital from investors or creditors.
- iii. it shows how external factors, such as changes in market prices or interest rates, may affect the entity's capacity to generate future net cash

- inflows.
- iv. information on the variability and components of returns is essential for understanding the uncertainty surrounding future cash flows.
- v. historical performance data supports users in forecasting future returns on the entity's economic resources.

e. Cash Flow Management as Part of Performance:

Another aspect of performance is how well management handles cash flows. Information on cash flows during a reporting period helps users evaluate the entity's ability to generate future net cash inflows. It shows how the entity acquires and uses cash, including:

- i. borrowings and debt repayments;
- ii. cash dividends or distributions to investors; and
- iii. Factors affecting liquidity and solvency.

Such insights enable users to understand the entity's operational capabilities, evaluate its financing and investing activities, and assess its financial flexibility.

f. Changes in economic resources and claims – other events and transactions

Information about changes in economic resources and claims resulting from events and transactions beyond day-to-day operations is also necessary. It helps users fully understand the reasons behind changes in financial position and their implications for future performance.

g. Objectives of financial statements: summary

The objectives of financial statements are achieved through:

The main financial statements:

- a. statement of financial position;
- b. statement of profit or loss and other comprehensive income;
- c. statement of changes in equity;
- d. statement of cash flows; and
- e. Supporting notes to the financial statements, which provide additional explanations and details.

These statements collectively provide a comprehensive picture of the reporting entity's financial performance, position, and changes over time.

2.3.4 Financial statements and there porting entity

a. Objective and scope of financial statements

The objective of financial statements is to provide financial information about the reporting entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the reporting entity and in assessing management's stewardship of the entity's economic resources.

That information is provided:

- i. in the statement of financial position, by recognising assets, liabilities and equity;

- ii. in the statement(s) of financial performance, by recognising income and expenses; and
- iii. in other statements and notes, by presenting and disclosing information about:
 - recognised and unrecognised assets and liabilities, equity, income and expenses;
 - cashflows;
 - contributions from holders of equity claims and distributions to them; and
 - the methods, assumptions and judgements used in estimating the amounts presented or disclosed, and changes in those methods, assumptions and judgements.

b. Reporting period

Financial statements are prepared for a specified period of time (reporting period) and provide information about:

- a. assets and liabilities (including unrecognised assets and liabilities) and equity that existed at the end of the reporting period, or during the reporting period; and
- b. income and expenses for the reporting period.

c. Going concern assumption

Financial statements are generally prepared on the assumption that the reporting entity is a going concern, meaning it will continue in operation for the foreseeable future.

If the entity intends, or is required, to cease operations or liquidate, financial statements may need to be prepared on a different basis. In such cases, the alternative basis used must be clearly disclosed.

2.4 Qualitative Characteristics Of Useful Financial Information

2.4.1 Introduction

This topic is covered in Chapter 2 of the IASB Conceptual Framework.

For financial information to be useful in decision-making, it must possess certain characteristics. The IASB Conceptual Framework identifies two categories of qualitative characteristics:

- a. fundamental qualitative characteristics; and
 - b. enhancing qualitative characteristics
- Fundamental qualitative characteristics are:
- c. relevance; and
 - d. faithful representation

Enhancing qualitative characteristics, which improve the usefulness of relevant and faithfully represented information, are:

- a. comparability;
- b. verifiability
- c. timeliness; and
- d. understandability

“For financial information to be useful, it must be relevant and faithfully represent what it claims to represent. Its usefulness is further enhanced when it is comparable, verifiable, timely, and understandable.”

Emphasis

For information to be useful, it must be both *relevant* and a *faithful representation*. Enhancing qualitative characteristics cannot compensate for a lack of relevance or faithful representation.

2.4.2 Relevance

Information is relevant when it meets the decision-making needs of users. It is considered relevant if it has *predictive value*, *confirmatory value*, or both.

- a. It has **predictive value** if it helps users forecast future outcomes.
- b. It has **confirmatory value** if it helps users confirm or revise past evaluations.
- c. Materiality affects the relevance of information.
- i. Information is **material** if its omission or misstatement could influence decisions made by users based on the financial information of a specific reporting entity.
 - Materiality is **entity-specific** and depends on the nature, magnitude, or both, of the information in the context of the entity’s financial report.
 - Consequently, the IASB does **not** prescribe a uniform quantitative threshold or define in advance what may be considered material in a given situation.

2.4.3 Faithful representation

Financial reports represent economic phenomena—such as economic resources, claims against the reporting entity, and the effects of transactions, events, and conditions that change those resources and claims—by depicting them in words and numbers.

To be useful, financial information must not only be relevant but must also **faithfully represent** the phenomena it purports to depict.

A perfectly faithful representation possesses three key characteristics:

- a. complete – the depiction includes all information necessary for users to understand the phenomenon, including all relevant descriptions and explanations.
- b. neutral – the information is presented without bias in both its selection and presentation.
- c. free from error – the information contains no errors or omissions in the description of the phenomenon, and the process used to generate the information has been applied without error.

2.4.4 Enhancing qualitative characteristics

a. Comparability

Comparability enables users to identify and understand similarities and differences among items.

Information about a reporting entity is more useful when it can be compared with similar information from other entities, or with the same entity's information for another period or date.

While consistency is related to comparability, the two are not identical. Consistency refers to the use of the same methods for the same items, either from period to period within a single entity or across entities in a given period. Consistency supports the achievement of comparability.

b. Verifiability

Verifiability assures users that the information faithfully represents the economic phenomena it purports to depict.

- i. It means that different knowledgeable and independent observers could reach a consensus that a particular representation is a faithful depiction.
- ii. Verifiability does not require a single point estimate; a range of possible amounts, along with their associated probabilities, can also be verified.

Materiality affects the relevance of information.

Information is **material** if its omission or misstatement could influence decisions made by users based on the financial information of a specific reporting entity.

- i. Materiality is **entity-specific** and depends on the nature, magnitude, or both, of the information in the context of the entity's financial report.
- ii. Consequently, the IASB does **not** prescribe a uniform quantitative threshold or define in advance what may be considered material in a given situation.

2.5 Recognition in Financial Statements: IASB Conceptual Framework

2.5.1 Recognition

(As covered in Chapter 5 of the IASB Conceptual Framework)

Recognition is the process of including in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements.

Recognition involves both:

- a. describing the item in words, and
- b. assigning a monetary amount to it.

The amount at which an asset, liability, or equity item is recognised in the statement of financial position is referred to as its carrying amount.

Recognition is interrelated among elements. The recognition (or change in carrying amount) of one item often necessitates the recognition or derecognition of another. For

example, revenue is recognised at the same time as the corresponding receivable.

2.5.2 Recognition criteria

Items are recognised in financial statements only if they meet the following criteria:

- a. they meet the definition of an asset, liability, or equity to be recognised in the statement of financial position, or
- b. they meet the definition of income or expenses to be recognised in the statement(s) of financial performance.

However, meeting a definition alone is not sufficient. An item is recognised only if the recognition provides financial statement users with useful information, specifically:

- a. relevant information about the asset or liability, and any resulting income, expenses, or changes in equity; and
- b. a faithful representation of the asset or liability, and of any resulting income, expenses, or changes in equity.

Recognition may not be appropriate if:

- a. there is significant uncertainty about the existence of the asset or liability, or
- b. there is only a low probability of future economic inflows or outflows associated with the item.

The ability to provide a faithful representation may also be limited by:

- a. the degree of measurement uncertainty, or
- b. other relevant factors.

2.5.3 Derecognition

Derecognition occurs when an item is removed from the financial statements as an asset, liability, or equity. This should take place when the item no longer meets any of the recognition criteria. Derecognition often involves the transfer of risks and rewards associated with the item.

Key Principles of Derecognition

a. Derecognition of an Asset:

An asset is derecognised when the entity loses control over it. This happens when the entity no longer has the ability to direct the use of the asset or obtain the associated economic benefits.

b. Derecognition of a Liability:

A liability is derecognised when the obligation is discharged, cancelled, or expires.

These principles are essential in determining when an item should be removed from the financial statements to ensure that the financial position of the entity is accurately presented.

Example

Recognition:

Entity A purchases a piece of equipment for ₦10,000,000. The equipment:

- a. Meets the definition of an asset: It is a resource controlled by the entity from which future economic benefits are expected.
- b. Is measurable: The cost of ₦10,000,000 can be reliably measured.

- c. Provides faithful representation: It accurately reflects the underlying economic reality.

Therefore, the equipment is recognised in the financial statements.

Derecognition:

If Entity A subsequently sells the equipment, it must derecognise it as an asset. This is because the equipment no longer meets the recognition criteria—it is no longer controlled by the entity and will no longer provide economic benefits.

This explanation aligns with the IASB Conceptual Framework, ensuring that only items that continue to meet the definition and recognition criteria remain in the financial statements.

2.5.4 **Commentary on the new recognition criteria**

Under the previous Conceptual Framework, an asset or liability was recognised when:

- a. it met the definition of an element; and
- b. it satisfied the following two additional criteria:
- c. it was probable that future economic benefits associated with the item would flow into or out of the entity; and
- d. the item had a cost or value that could be measured reliably.

However, based on its deliberations in this and other projects, the IASB concluded that the probability of inflows or outflows should not be treated as a separate recognition criterion, but rather as a consideration in measurement and relevance.

While this shift in focus is unlikely to have significant practical effects, it is considered to provide a stronger conceptual foundation for the recognition process. It aligns recognition more closely with the objectives of providing relevant and faithfully represented information.

2.5.5 **Measurements of elements of financial statements**

Measurement refers to the basis on which the elements of financial statements are recognised and reported. The choice of a measurement basis should consider the fundamental qualitative characteristics of useful financial information, relevance and faithful representation, as well as measurement uncertainty and the cost constraint

The IASB Conceptual Framework states that several measurement bases can be used for the elements in financial statements. These include:

- a. historical cost. Assets are measured at the amount of cash paid, or the fair value of the consideration given to acquire them. Liabilities are measured at:
- b. the amount of proceeds received in exchange for the obligation (e.g., bank loan or a bank overdraft), or
- c. the amount of cash that will be paid to settle the liability.
- c. current cost (or current value). This basis is used in current value or current cost accounting. Assets are measured at the amount that would be paid to purchase the same or a similar asset at the current time. Liabilities are measured at the

- d. amount that would be required to settle the obligation at the current time.
- d. **realisable value (or settlement value).** This measurement basis is relevant when an entity is not a going concern, such as in liquidation and a forced sale scenario. Assets are measured at the amount that could be obtained from selling them. Liabilities are measured at the amount that would be required to settle them at the currently.
- e. **present value.** Assets may be measured at the present value of the future net cash inflows they are expected to generate. Similarly, liabilities may be measured at the discounted present value of the expected future cash outflows required to settle them.

Individual accounting standards specify which measurement basis should be applied in particular circumstances. Historical cost remains the most commonly used measurement basis. However, it is often modified by other bases. For example, inventories are typically measured at the lower of cost and net realisable value.

2.5.6 Commentary on the new recognition criteria

Under the previous framework, an asset or liability would be recognised when:

- a. it meets the definition of an element: and
- b. satisfies the following two criteria:
- c. it must be **probable** that the future economic benefit associated with the item will flow either into or out of the entity; and
- d. The item should have a cost or value that can be measured reliably.

The IASB's deliberations on this and other projects have led them to the conclusion that the probability of an inflow or outflow is not a recognition attribute but a measurement attribute.

The practical impact of the change in focus of the criteria will be negligible but is believed to provide a stronger conceptual foundation to the recognition process.

2.5.6 Measurements of elements of financial statements

Measurement refers to the basis on which the elements of financial statements are recognised and reported. The choice of a measurement basis should consider the fundamental qualitative characteristics of useful financial information, relevance and faithful representation, as well as measurement uncertainty and the cost constraint

The IASB Conceptual Framework states that several measurement bases are used for the elements in financial statements. These include:

- a. **Historical cost.** Assets are measured at the amount of cash paid, or at the fair value of the consideration given to acquire them. Liabilities are measured at:
- b. the amount of proceeds received in exchange for the obligation (for example, bank loan or a bank overdraft), or
- c. the amount of cash that will be paid to satisfy the liability.
- d. **Current cost or current value.** This is the basis used in current value

accounting/current cost accounting. Assets are measured at the amount that would be paid to purchase the same or a similar asset at the current time. Liabilities are measured at the amount that would be required to settle the obligation at the current time.

- e. Realisable value (or settlement value). This method of measurement is relevant when an entity is not a going concern, and is faced with liquidation and a forced sale of its assets. Assets are measured at the amount that could be obtained by selling them. Liabilities are measured at the amount that would be required to settle them at the current time.
- f. Present value. Assets might be measured at the value of the future net cash inflows that the item is expected to generate, discounted to a present value. Similarly, a liability might be measured at the discounted present value of the expected cash outflows that will be made to settle the liability.

Individual standards specify which of these should be used. Historical cost is the most commonly-used measurement basis. However, the other bases of measurement are often used to modify historical cost. For example, inventories are measured at the lower of cost and net realisable value.

2.6 Other Accounting Concepts

Other accounting concepts are used in financial reporting. In addition to guidance in the IASB Conceptual Framework.

Some of these are described in IAS 1 *Presentation of Financial Statements*.

2.6.1 Materiality and aggregation

IAS 1 also states that each material class of similar items should be presented separately in the financial statements.

The relevance of information is affected by its materiality.

Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity.

An error which is too trivial to affect a user's understanding of financial statement is referred to as immaterial.

There is no absolute measure of materiality that can be applied to all businesses. In other words there is no rule that says any item greater than 5% of profit must be material. Whether an item is material or not depends on its magnitude or its nature or both in the context of the specific circumstances of the business.

Magnitude

Whether an item of a given size is deemed to be material depends on the context of the number in relation to other numbers in the financial statements.

Two similar businesses prepare financial statements. Business A reports non-current assets of ₦10,000,000, while Business B reports a profit for the year of ₦100,000. Each business subsequently discovers a ₦20,000 error.

	Error	Comment
1	The error relates to how Business A arrived at the total for non-current assets, which are now overstated by ₦20,000	This is immaterial. ₦20,000 is a small amount in the context of the ₦10,000,000 asset figure, and its omission would not mislead users of the financial statements
2	The error relates to how Business B calculated its profit for the year, which is now overstated by ₦20,000.	This is material. The error represents 20% of the reported profit, and omitting it would significantly misstate the financial performance.

Example: Materiality

A business owes Mr. A ₦1,000,000 and is owed ₦950,000 by Mr B.

Instead of showing an asset of ₦950,000 and a liability of ₦1,000,000, the business shows a single liability of ₦50,000.

This is a material misstatement. Although the amount is correct it hides the fact that the amount is made of two much larger amounts. A user would be unable to judge the risk associated with Mr B's ability of pay unless the two amounts are shown separately.

Nature

Businesses are sometimes placed under a legal obligation to disclose certain information in their financial statements (for example, companies must disclose directors' remuneration). Omission of such amounts is always a material misstatement regardless of the size of the amount in relation to the other numbers in the financial statements.

This is only mentioned for illustrative purposes. Examples of this kind are beyond the scope of this syllabus.

2.6.2 Offsetting

IAS 1 states that:

Assets and liabilities should not be offset against each other.

Similarly income and expenses should not be offset against each other.

Instead they should be reported separately.

The exceptions to this rule are when:

- a) offsetting is required or permitted by an accounting standard or the Interpretation of a standard
- b) offsetting reflects the economic substance of a transaction. An example specified in IAS 1 is reporting of a gain or loss on disposal of a non-current asset at sale value minus the carrying value of the asset and the related selling expenses.

Net

This refers to the result of combining a positive and a negative amount. The outcome may be a net asset, net liability, net income, or net expense. For example, a *net asset* arises when an asset is offset against a related liability.

2.6.3 Consistency of presentation

Consistency of presentation is needed if financial information is to be comparable. IAS 1 states that there should be consistency in the presentation and classification of items in the financial statements from one year to the next. There are just two exceptions to the requirement for consistency:

Consistency is not required when it is apparent, following a significant change in the entity's operations or a review of its financial statements, that a different presentation or classification would be more appropriate.

Consistency is not appropriate if a new accounting standard (or the issue of an interpretation of a standard by IFRSIC) requires a change in the presentation of information.

Example: Consistency

A manager of a business has been promised a bonus if he can improve gross profit to more than 10% above what it was last year.

In the event the results of the business have been exactly the same but the manager has prepared the financial statements on a slightly different basis.

	2012	2013
	₦000	₦000
Sales	25,000	25,000
Cost of sales:		
Production costs	10,000	10,000
Warehousing costs	10,000	
	(20,000)	(10,000)
Gross profit	5,000	15,000
Less: Other expenses	(4,000)	(14,000)
Net profit	1,000	1,000

This year's presentation is inconsistent with last year's. The manager has presented the information in a different way by classifying warehouse costs as other expenses instead of as cost of sales as was previously the case.

This might mislead the user of the financial statements (in this case the person who will decide if the manager will receive a bonus).

It might be that the manager's presentation is correct but in this case the previous year's results should be represented on to a consistent basis in order to prevent a misleading impression.

2.6.4 Prudence

Prudence is a concept which was described in the previous version of the framework but no longer appears. However, approaches based on prudence are found in several standards so it is important to understand what it means.

Financial statements must sometimes recognise the uncertainty in business transactions. For example, if a business is owed ₦1,000,000 by a number of its customers, there will be some uncertainty as to whether all the money will actually be collected. Prudence involves allowing for some caution in preparing financial statements, by making reasonable and sensible allowances in order to avoid overstating assets or income and to avoid understating expenses or liabilities.

As a general indication of prudence, rules exist to prevent a business recognising an asset in its financial statements at an amount greater than the cash it will generate. When such a circumstance arises the asset is reduced in value down to the cash expected to result from the ownership of the asset.

Example: Prudence

A company has receivables of ₦10,000,000.

The company knows from experience that about 2% of its receivables will not be collected because of customers being in financial difficulty.

It is prudent to make an allowance for doubtful debts to 2% of receivables (but it would be inappropriate to make an excessive allowance, say 10% of receivables).

The company would recognise an allowance of ₦200,000 to set against the receivable in the statement of financial position showing a net amount of ₦9,800,000 (10,000,000 less 200,000).

The ₦200,000 would also be recognised as an expense in the statement of comprehensive income.

Accounting for bad and doubtful debts is described in detail in a later chapter.

Other accounting concepts include:

- a. **Going concern:** Unless otherwise stated, it is always assumed that a business entity will continue in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or curtailing significantly the scale of its operation.

- b. **Accruals:** This can be called either accrual or matching concept. The accrual concept states that income should be recognised when they are earned and not when they are received in cash. Expenses should also be recorded when they are incurred and not when paid.

The application of this concept gives rise to prepayments and accrued expenses (accrual). An accrued expense occurs when it has been incurred but has not been paid. Prepaid expenses occur when payment has been made for services but benefits have not been derived from them. They give rise to liabilities and assets, respectively. Prepaid expenses and outstanding receivables are assets, while income received in advance and outstanding payables are liabilities of the business.

- c. **Substance over form:** Although business transactions are usually governed by legal principles; nevertheless they are accounted for and presented in accordance with their financial substance and reality and not merely by their legal form. In order to be useful, information contained in financial statements must be relevant and reliable. This can only be achieved if the substance of transactions is recorded. If this did not happen, the financial statements would not represent faithfully the transactions and other events that had occurred. Examples are found in sales and re-purchase agreements, lease contracts and consignment of goods.
- d. **Business entity:** The essence of the entity concept is to distinguish the income and costs of the business from the private income and costs of the proprietor or his drawings from the business. For instance, if the owner of a business draws cash from the business bank account to travel for business course, it would be regarded as business expenses. But if he pays his wife's school fees with the business cash, the amount will be treated as drawings of the owner rather than expenses. The entity concept is key to the proper understanding of the double entry principle.

2.7 Fair presentation

2.7.1 What is meant by fair presentation (or a true and fair view)?

Financial statements are often described as showing a "true and fair view" or "presenting fairly" the financial position, financial performance, and changes in the financial position of an entity. In some countries (for example, the UK), this is the central requirement of financial reporting.

Under International Financial Reporting Standards (IFRS), specifically IAS 1 – Presentation of Financial Statements, financial statements are required to present fairly the financial position, performance, and cash flows of the entity.

Although the IASB Conceptual Framework does not directly define the term "true and fair view," it explains that if an entity complies with IFRSs and its financial information possesses the qualitative characteristics (such as relevance and faithful representation), then the financial statements should convey what is generally understood as a true and fair view.

IAS 1 states that:

"Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the IASB Framework."

Faithful representation goes beyond simply ensuring that amounts in the financial statements are materially correct. It means that financial information should clearly and accurately depict the transactions and events it is intended to represent. This includes:

- a. reflecting the substance and economic reality of transactions (not just their legal form);
- b. ensuring that important information is not obscured through poor classification or inadequate disclosure;
- c. presenting financial information in a way that avoids misleading users.

In essence, where there is a conflict between the legal form and the economic substance of a transaction, the financial statements must reflect the economic substance.

2.7.2 Fair presentation and compliance with IFRSs

The application of IFRSs, with additional disclosure when necessary, is presumed to result in financial statements that achieve a fair presentation.' IAS 1 states that:

- a. When the financial statements of an entity comply fully with International Financial Reporting Standards, this fact should be disclosed.
- b. An entity should not claim to comply with IFRSs unless it complies with **all**
- c. the requirements of **every** applicable Standard.

IAS 1 appears to equate fair presentation with compliance with accounting standards.

In some situations fair presentation may require more than this. It is important to apply the spirit (or general intention) behind an accounting standard as well as the strict letter (what the standard actually says).

2.8 Chapter review

Chapter review

Before moving to the next chapter, check that you can now:

- a. explain the meaning of GAAP
- b. describe the purpose of the IASB's Conceptual Framework
- c. identify the users of financial statements and describe their information needs
- d. state the objective of financial statements
- e. describe the qualitative characteristics of financial information
- f. list and define the elements of financial statements
- g. state the recognition criteria for elements of financial statements
- h. explain the concepts of materiality, offsetting and consistency
- i. explain the meaning of fair presentation

2.9 End of chapter questions and suggested solutions

Question 1

One of the accounting principles is the matching concept

- a. Explain what is meant by the concept
- b. The following information is available regarding Mao Ltd, which reporting date is March 31:
 On March 14, 2025 the company received inventory of ₦15 million
 On April 13, 2025, the vendor was paid
 On May 11, 2025, the company sold the inventory for ₦20 million

Required:

- a. Explain when Mao Ltd should recognise revenue
- b. Explain when the inventory should become an expense

Answer

Mao Ltd

- a. **Matching Concept Explanation** The matching concept is an accounting principle that requires expenses to be matched with the revenues they help to generate. In other words, costs are recognised as expenses in the same period as the revenue they contribute to. This principle aims to accurately reflect the financial performance of a business by ensuring that the costs and revenues are properly aligned.
- b.
 - i. **Mao Ltd Solution i. Revenue Recognition** According to the revenue recognition principle, revenue should be recognised when it is earned, regardless of when the payment is received.
 - ii. **Revenue Recognition**
 According to the revenue recognition principle, revenue should be recognised when it is earned, regardless of when the payment is received. In this case, Mao Ltd should recognise revenue of ₦20 million on May 11, 2025, when the inventory is sold.
 - iii. **Inventory Expense Recognition**
 The matching concept requires that the cost of inventory be matched with the revenue generated from its sale. Therefore, the inventory cost of ₦15 million should become an expense (Cost of sales) on May 11, 2025, when the inventory is sold. This ensures that the expense is matched with the revenue generated from the sale.

Question2

What is meant by “fair presentation” in financial reporting? Explain how the application of IFRSs ensures fair presentation and describe circumstances where compliance with IFRSs may not be sufficient to achieve fair presentation.

Answer

“Fair presentation” refers to the accurate, complete, and unbiased representation of a reporting entity’s financial position, financial performance, and cash flows. It implies that the financial statements reflect the economic substance of transactions and other events—not just their legal form. This concept is closely related to the idea of presenting a “true and fair view” of the entity’s affairs.

Fair presentation requires:

- a. Faithful representation of transactions and events,

- b. Proper classification and disclosure,
- c. No omission or misstatement that could mislead users,
- d. Application of accounting policies that result in information that is relevant and reliable.

How does the application of IFRSs ensure fair presentation?

IAS 1 *Presentation of Financial Statements* states that the application of International Financial Reporting Standards (IFRSs), along with appropriate additional disclosures, when necessary, is presumed to result in financial statements that achieve fair presentation.

- a. IFRSs are developed based on the Conceptual Framework and aim to enhance the qualitative characteristics of financial information, such as relevance, faithful representation, comparability, and understandability.
- b. IFRSs provide uniform principles for recognition, measurement, presentation, and disclosure, thus promoting consistency and transparency.
- c. An entity is required to state compliance with IFRSs only if it has complied with all applicable standards.

Circumstances where compliance with IFRSs may not be sufficient to achieve fair presentation:

While following IFRSs is generally sufficient to ensure fair presentation, there are rare cases where it may not be adequate, and additional actions are required:

Substance over form issues: A transaction may comply with the legal form as per IFRSs but not represent its economic reality. In such cases, fair presentation requires going beyond the legal form to reflect the true economic impact.

- 1. Unusual or complex transactions: Certain unique transactions may not be adequately covered by existing IFRSs. In such instances, judgment is needed to present information fairly, even if it means providing additional disclosures or adjusting the accounting treatment.
- 2. Misuse of accounting policy options: IFRSs sometimes allow choices in accounting policies (e.g., cost vs. revaluation for PPE). Using an option that is technically allowed but misleading in the specific context of the entity could undermine fair presentation.
- 3. Over-aggregation or omission: Even if the figures follow IFRS rules, over-aggregating line items or omitting important disclosures could obscure relevant information.

Conclusion:

Fair presentation is a fundamental objective of financial reporting and is largely achieved through compliance with IFRSs. However, achieving true fair presentation may also require judgment, transparency, and the spirit of the standards, not just their literal application. In exceptional cases, additional disclosures or deviations from IFRSs might be necessary to avoid misleading users and to faithfully represent the financial reality of the reporting entity.

Question 3

A company has the following balances at year-end:

- a. Receivables: ₦8,000,000
- b. From past experience, 3% of receivables are expected to be irrecoverable.

Required:

- (a) Calculate the allowance for doubtful debts.
- (b) Show how this will be presented in the statement of financial position and the statement of profit or loss.
- (c) Explain how the concept of prudence justifies this accounting treatment.

Answer

- (a) Calculate the allowance for doubtful debts

The allowance for doubtful debts is calculated as a percentage of receivables based on past experience:

$$\text{Allowance} = 3\% \times \text{N}8,000,000 = \text{N}240,000$$

- (b) Presentation in the financial statements
Statement of Financial Position (extract):

Assets

Trade receivables	N 8,000,000
Less: Allowance for doubtful debts	(240,000)
Net receivables	7,760,000

Statement of Profit or Loss (extract):

Expenses	N
Allowance for doubtful debts (expense)	240,000

This amount will be charged as an expense in the period to reflect the expected loss from irrecoverable debts.

- (c) Explanation using the concept of prudence
The prudence concept (also referred to as conservatism) requires that:
Assets and income should not be overstated, and

a. Liabilities and expenses should not be understated.

- i. In this case, although N8,000,000 is due from customers, experience suggests that not all of it will be collected. Recognising an allowance for doubtful debts of N240,000 reflects this uncertainty in recoverability, ensuring that the net receivables figure presents a more realistic and cautious estimate of the expected cash inflow.
- ii. By doing so, the financial statements provide a faithful and fair presentation, avoiding overstatement of assets and giving users a more reliable basis for economic decisions.
- iii. This treatment aligns with IAS 1's requirement for faithful representation and helps achieve fair presentation in accordance with IFRSs.

ACCOUNTING EQUATION AND THE DOUBLE ENTRY SYSTEM

Contents

- 3.0 Learning Objectives
- 3.1 Learning Outcomes
- 3.2 The accounting equation
- 3.3 Introduction to accounting systems
- 3.4 Basic rules of double entry bookkeeping
- 3.5 Account balances and the trial balance
- 3.6 The journal and transaction recording
- 3.7 The chart of accounts and the general ledger
- 3.8 Chapter review
- 3.9 End of chapter questions and suggested solutions

3. Accounting equation and the double entry system

3.0 Learning objective

This chapter explains the accounting equation and the basic principles of double-entry bookkeeping, including the structure and function of the general ledger, the relationship between ledger balances and the trial balance, the interconnection between financial statements, and the preparation of simple financial statements from transactional data.

3.1 Learning outcomes

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

- a. Apply the accounting equation (Assets = Liabilities + Equity) in simple, practical, and common scenarios;
- b. Describe the main features of the general ledger;
- c. Post entries to the general ledger;
- d. Explain the interaction between general ledger balances and the trial balance;
- e. Explain the links between financial statements; and
- f. Prepare simple financial statements.

3.2. The Accounting equation

3.2.1. Introduction

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

3.2.2 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, government agencies, and not-for-profit organisations.

The entity concept has significant implications for accounting, particularly in the separation of business transactions from personal transactions. For instance, when an owner invests cash in their business, it is treated as capital. If an owner borrows money for business use, the amount is recorded as a liability of the business.

This chapter explores the accounting equation and the double-entry principles that underpin it.

3.2.3 The accounting equation

The accounting equation is expressed as:

$$\text{Assets} = \text{Capital} + \text{Liabilities}$$

These three elements form the basis of the statement of financial position, discussed in Chapter 1. In this equation:

- a. Assets represent resources owned by the entity.
- b. Capital and liabilities represent claims to those resources.

a. Classification of assets

i. **Non-current assets** are held for use in the operations of the business, not for resale.

Examples: property, machinery, and patent rights.

ii. **Current assets** are expected to be converted into cash or consumed within one year.

Examples:

- i. Inventories – goods manufactured or purchased for resale
- ii. Trade receivables – amounts owed by customers for credit sales
- iii. Cash

b. **Classification of liabilities**

i. **Non-current liabilities** are obligations due after more than 12 months.

Examples: long-term loans, bonds payable

ii. **Current liabilities** are payable within 12 months of the reporting date.

Examples: trade payables, tax liabilities, bank overdrafts

c. **Equity (Capital)**

Equity is the residual interest in the entity's assets after deducting its liabilities. It includes the owner's capital and retained profits. Under the entity concept, capital is considered a liability owed to the owner.

3.2.4 The accounting equation in practice

Assets = Capital + Liabilities

In accounting, every transaction affects the financial statements in two ways. This is known as the dual effect. As a result, the accounting equation must always remain balanced.

Mastering these fundamental concepts is essential for preparing accurate financial reports.

As one progresses, he/she will appreciate better the application of the entity concept in more complex accounting situations, involving companies and other corporate entities.

a. **Illustrations**

Transaction 1: Adeyemi sets up a business to sell shirts from a stall in the marketplace. He begins by depositing ₦600,000 into the business bank account.

Assets		Solution		Equity (Capital)		Liabilities	
	₦'000	=			₦'000		₦'000
Cash	600		Initial	600	+		0

Explanation: Cash increased by ₦600,000 and capital increased by the same amount.

Transaction 2: Adeyemi borrowed ₦800,000 from his brother for business use.

Solution

Assets	=	Capital	+	Liabilities
	₦'000			₦'000
Cash	600	Original	600	0
Cash	<u>800</u>		<u> </u>	Loan
	<u>1,400</u>		600	<u>800</u>

Explanation: The business receives ₦800,000 in cash and records a loan liability of the same amount.

Transaction 3: Adeyemi purchases a motor van using the money borrowed from his brother.

Solution

Assets	=	Capital	+	Liabilities
	₦'000			₦'000
Cash	600	Original	600	0
Cash	800			Loan
Motor van	800			
Cash	<u>(800)</u>		<u> </u>	
	<u>1400</u>		<u>600</u>	<u>800</u>

Explanation: The purchase of the motor van increased non-current assets by ₦800,000 and reduced another asset (cash) by the same amount. There is no change in the total value of assets—just a reclassification.

b. Additional Transactions for the 6 Months Ended 30 June 2025

Below are further business transactions undertaken by Adeyemi and their effects on the accounting equation;

Transaction 4: Adeyemi buys a market stall and pays ₦100,000 in cash.

Transaction 5: Adeyemi purchases shirts (inventory) worth ₦360,000 on credit.

Transaction 6: Adeyemi pays ₦200,000 to his suppliers.

Transaction 7: Adeyemi sells 50% of the shirts (cost = ₦180,000) for ₦240,000 in cash.

Transaction 8: Adeyemi sells more shirts (cost = ₦100,000) for ₦180,000 on credit.

Transaction 9: Adeyemi repays ₦200,000 of the loan.

Transaction 10: Adeyemi pays ₦120,000 to trade suppliers.

Transaction 11: Adeyemi receives ₦160,000 from a customer (trade receivable).

Transaction 12: Adeyemi purchases additional shirts worth ₦50,000 on credit.

Transaction 13: Adeyemi withdraws ₦80,000 in cash and inventory worth ₦40,000 for personal use.

c. Drawings

The owner or owners of a business can withdraw profits made by the business for personal use. In principle, they may draw out all the profits, but in practice, most owners choose to withdraw only a portion and leave the remainder in the business to support its growth and operations.

- i. Profits retained in the business are referred to as retained earnings.
- ii. Profits withdrawn by the owner are known as drawings in the case of sole proprietorship and partnerships.
- iii. For companies, profits distributed to shareholders are called dividends.

While drawings are commonly made in cash, they can also take the form of inventory or even non-current assets, such as a motor vehicle. Whenever the owner takes goods or other assets for personal use, it is treated as a drawing and reduces the owner's equity in the business.

d. Explanations:

Now let us consider the effects of these transactions on the accounting equation:

Transaction 4: Adeyemi buys a market stall and pays ₦100,000 in cash.

- i. One asset (cash) decreases, and another asset (stall) increases.
- ii. No change in total assets; just a reallocation.

Transaction 5: Adeyemi purchases shirts (inventory) worth ₦360,000 on credit.

- i. Inventory (asset) increases by ₦360,000.
- ii. Trade payables (liability) also increase by ₦360,000.
- iii. Total assets and liabilities both increase by the same amount.

Transaction 6: Adeyemi pays ₦200,000 to his suppliers.

- i. Cash (asset) decreases by ₦200,000.
- ii. Trade payables (liability) decrease by the same amount.
- iii. Both assets and liabilities reduce.

Transaction 7: Adeyemi sells 50% of the shirts (cost = ₦180,000) for ₦240,000 in cash.

- i. Cash increases by ₦240,000.
- ii. Inventory decreases by ₦180,000.
- iii. The profit of ₦60,000 (₦240,000 - ₦180,000) is added to capital (equity).
- iv. Assets increase by the profit margin.

Transaction 8: Adeyemi sells more shirts (cost = ₦100,000) for ₦180,000 on credit.

- i. Trade receivables (asset) increase by ₦180,000.
- ii. Inventory decreases by ₦100,000.
- iii. Equity increases by ₦80,000 as a result of the profit earned on the sale.
- iv. Total assets also increase by the amount of the profit earned.

Transaction 9: Adeyemi repays ₦200,000 of the loan.

- i. Cash decreases by ~~N~~200,000.
- ii. Loan liability decreases by ~~N~~200,000.
- iii. Both assets and liabilities reduce equally.

Transaction 10: Adeyemi pays ~~N~~120,000 to trade suppliers.

- Cash decreases by ~~N~~120,000.
- Trade payables decrease by ~~N~~120,000.
- Both assets and liabilities decrease equally.

Transaction 11: Adeyemi receives ~~N~~160,000 from a customer (trade receivable).

- i. Cash increases by ~~N~~160,000.
- ii. Trade receivables decrease by ~~N~~160,000.
- iii. One asset is exchanged for another; no net change in total assets.

Transaction 12: Adeyemi purchases additional shirts worth ~~N~~50,000 on credit.

- i. Inventory increases by ~~N~~50,000.
- ii. Trade payables increase by ~~N~~50,000.
- iii. Both assets and liabilities increase equally.

Transaction 13: Adeyemi withdraws ~~N~~80,000 in cash and inventory worth ~~N~~40,000 for personal use.

- i. Cash and inventory (assets) decrease by ~~N~~80,000 and ~~N~~40,000, respectively.
- ii. Drawings reduce capital (equity) by ~~N~~120,000.
- iii. Total assets and capital reduce accordingly.

Notes:

- i. Transaction 7: Profit = ~~N~~240,000 - ~~N~~180,000 = ~~N~~60,000 added to equity.
- ii. Transaction 8: Profit = ~~N~~180,000 - ~~N~~100,000 = ~~N~~80,000 added to equity.
- iii. Transaction 13: Drawings = ~~N~~80,000 cash + ~~N~~40,000 inventory = ~~N~~120,000 deducted from equity.

Further Note:

Each of transactions 7 and 8 involves two accounting entries—one for the cost of inventory sold and one for the revenue and profit earned. These are summarised below:

Transaction 7

- i. Increase cash by ~~N~~240,000 — representing the proceeds from inventory sold
- ii. Decrease inventory by ~~N~~180,000 — reflecting the cost of inventory sold
- iii. Increase cash by ~~N~~60,000 — representing the profit earned from the sale
- iv. Increase capital by ~~N~~60,000 — to recognise the profit earned from the transaction

In Summary:

- i. Cash increases by ~~N~~240,000 (~~N~~180,000 from sale + ~~N~~60,000 profit)
- ii. Inventory decreases by ~~N~~180,000
- iii. Capital increases by ~~N~~60,000

Transaction 8

Adeyemi sells more shirts (cost = ₦100,000) for ₦180,000 on credit.

- i. Increase trade receivables by ₦180,000 — representing inventory sold on credit
- ii. Decrease inventory by ₦100,000 — reflecting the cost of inventory sold
- iii. Increase cash by ₦80,000 — representing the profit earned from the sale
- iv. Increase capital by ₦80,000 — to recognise the profit earned from the transaction

In Summary:

- i. Trade receivables increase by ₦180,000 (₦180,000 from sale + ₦60,000 profit)
- ii. Inventory decreases by ₦100,000
- iii. Capital increases by ₦80,000

a. Presentation in tabular accounting equation format

S/n	Assets		=	Capital		+	Liabilities	
	Description	Amount		Description	Amount		Description	Amount
		₦'000			₦'000			₦'000
1	Cash	600		Initial	600			
2	Cash	800					Loan	800
3	Motor van	800						
	Cash	(800)						
4	Stall	100						
	Cash	(100)						
5	Inventory	360					Payables	360
6	Cash	(200)					Payables	(200)
7	Cash	240						
	Inventory	(180)	Profit		60			
8	Receivable	180						
	Inventory	(100)	Profit		80			
9	Cash	(200)					Loan	(200)
10	Cash	(120)					Payable	(120)
11	Cash	160						
	Receivable	(160)						
12	Inventory	50					Payable	50
13	Cash	(80)	Drawings		(120)			
	Inventory	(40)						
Total		<u>1,310</u>			<u>620</u>			<u>690</u>

Assets		=	Capital		+	Liabilities		
Description	amount		Description	Amount		Description	amount	N'000
	N'000			N'000			N'000	N'000
Cash	300		Initial	600		Loan	600	420
Motor Vehicle	800		Profit	140		Payables	90	
Stall	100		Drawings	(120)				
Inventory	90						410	
Receivables	20						410	
Total	1310			620			690	
			Less closing inventory (Transactions 5, 6, 7 & 12)				(130)	
			Cost of sales					(280)
			Gross profit					140

When additional capital is introduced, the accounting equation becomes:

Practice Question

On 1 July 2024, the net assets of the business totalled ~~N~~670,000.

Due to a shortage of cash, he introduced additional capital of ~~N~~40,000 in early June 2025.

	₦
Opening equity (net assets)	670,000
Profit	250,000
Capital introduced	40,000
Drawings	(220,000)
Closing equity (net assets)	<u>740,000</u>

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financial position

	₦'000	₦'000
Assets		
Non-current assets:		
Stall	100	
Motor van	<u>800</u>	900
Current assets:		
Inventory	90	
Receivables	20	
Cash	<u>300</u>	
		<u>410</u>
Total assets		<u>1,310</u>
Capital and liabilities:		
Capital – Initial	600	
Profit for the 6-month period	140	
Drawings	<u>(120)</u>	
Closing capital		620
Non-current liabilities:		

Loan	600
Current liabilities:	
Payables	<u>90</u>
Total equity and liabilities	<u>1,310</u>

The statement of financial position presents the financial position of a business at a specific point in time. It is based on the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

The statement of profit or loss, on the other hand, reports the revenues earned and expenses incurred over a period of time, ultimately showing the profit or loss for that period.

Although these two statements serve different purposes, they are closely linked in the financial reporting system. **Adeyemi statement of financial position as at 30 June 2025**

Key links:

- i. Profit from the statement of profit or Loss directly affects the equity section of the statement of financial position. Specifically, net profit earned during a period increases the owner's equity (e.g., retained earnings or capital account).
- ii. Drawings or withdrawals made by the owner from the business, often out of the profit earned, reduce the owner's capital. These reductions are also reflected in the equity section of the Statement of Financial Position.
- iii. Drawings out of profits also affect the statement of financial position, by reducing the owner's capital.

The net effect of profit and drawings during a period helps to determine the updated capital or equity position shown in the Statement of Financial Position.

3.3 Introduction to accounting systems

3.3.1 The dual nature of transactions

In the previous section, we introduced the accounting equation, which represents the foundational principle of accounting:

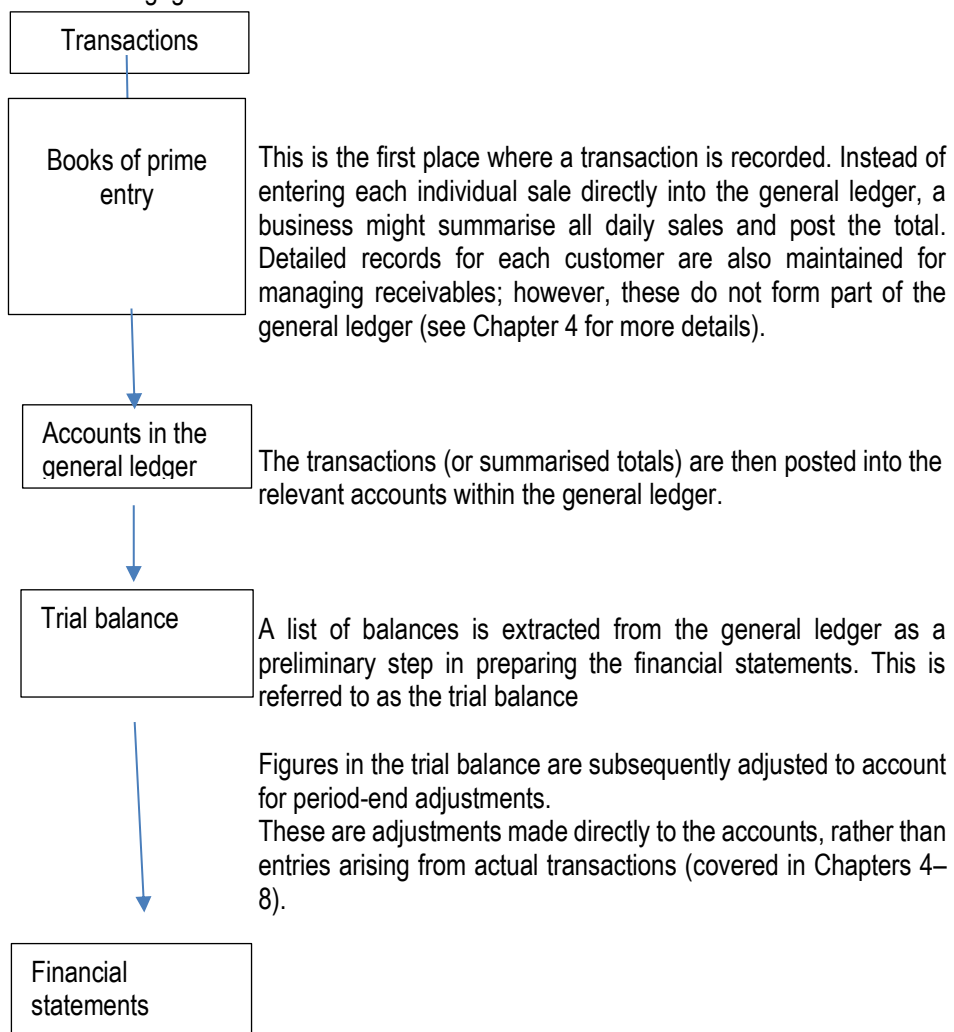
$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

This equation illustrates the dual nature of all business transactions. Every transaction affects the equation in at least two places to maintain its balance. There are no exceptions to this rule. Every financial event involving assets, liabilities, capital, income, or expenses must have a corresponding and opposite effect to ensure that the equation remains in balance.

This principle forms the basis of the double-entry bookkeeping system, where each transaction is recorded in two accounts—once as a debit and once as a credit.

While the accounting equation is a helpful conceptual tool for understanding the impact of transactions, it is not practical for recording large volumes of business activity. A typical business may conduct thousands of transactions in a single period, making it inefficient to update the equation manually after each transaction.

A business engages in thousands of transactions over time.



A trial balance can be extracted at any time; however, for the purposes of this book, we will assume it is prepared at the end of the accounting year. Any adjustments made after the trial balance is extracted must also be recorded in the general ledger accounts. In other words, if an entry is added or modified after the trial balance is drawn up, the same change must be reflected in the general ledger.

At the end of the accounting year, a major exercise is undertaken to tidy up the general ledger in preparation for the new financial period. This involves closing all income and expense accounts by transferring their balances to the statement of profit or loss. The resulting profit or loss is then transferred to equity. This process resets the income and expense accounts, ensuring the general ledger is ready for the next accounting period.

3.4 Basic Rules Of Double Entry Bookkeeping

3.4.1 Debit and credit entries, and T-accounts

Financial transactions are recorded in the accounts in accordance with a set of rules or conventions. The following rules apply to the accounts in the main ledger (nominal ledger or general ledger).

- Every transaction is recorded twice, as a debit entry in one account and as a credit entry in another account.
- Total debit entries and total credit entries must always be equal. This maintains the accounting equation.

It therefore helps to show accounts in the shape of a T, with a left-hand and a right-hand side. (Not surprisingly this presentation is known as a **T account**). By convention:

- debit entries are made on the left-hand side and
- credit entries are on the right-hand side.

Illustration:			
		Account	
	Amount		Amount
Debit side (Dr)	₹	Credit side (Cr)	₹
Debit transactions entered on this side		Credit transactions entered on this side	
Enter reference to the account where the matching credit entry is made	X	Enter reference to the account where the matching debit entry is made	X

By convention, the terms 'debit' and 'credit' are shortened to 'Dr' and 'Cr' respectively.

Alternative presentation

Accounts might also be presented in columnar forms. If this presentation is used care must be taken over the meaning of debit and credit in the context of the account. For example, a debit in a credit account would be shown as a deduction. In other words, it is easier to make mistakes with this format.

However, it can be useful when you want to show a single account or use a single account as a working. You will see examples of this presentation in later chapters but for now we will only use **T accounts**.

3.4.2 The Rules Of Debits And Credits

In the main ledger, there are accounts for assets, liabilities, equity, income and expenses. The rules about debits and credits are as follows:

Illustration:	
Account	
Debit side(Dr)	Credit side(Cr)
Record as a debit entry: An increase in an asset	Record as a credit entry: A reduction in an asset
A reduction in liability	An increase in a liability
A reduction in income	An increase in income
A reduction in capital	An increase in capital

You need to learn these basic rules and become familiar with them. Remember that in the main ledger, transactions entered in the debit side of one account must be matched by an offsetting credit entry in another account, in order to maintain the accounting equation and record the dual nature of each transaction.

Example

A purchase invoice is received for electricity charges for ₦46,000

The double entry is:

Debit: Electricity charges (= increase in expense)

Credit: Total trade payables (= increase in liability)

Electricity expense			
	₦		₦
Trade payables	46,000		
Expenses payables			
	₦		₦
		Electricity expense	46,000

This can be written as:

Dr	Electricity expense	46,000	
	Cr	Expenses payables	46,000

This is known as a journal entry (or journal for short). Journal entries are covered in more detail later in this chapter.

3.4.3 Double entry book keeping and the cash account

An entity would usually keep separate accounts to record cash. One is for cash in hand and the other for cash at bank.

It might help to learn the rules of double entry by remembering that transactions involving the receipt or payment of cash into the cash at bank account (or cash in hand account) are recorded as follows:

- The cash at bank account is an asset account (money in the bank is an asset).
- Receipts of cash: These are recorded as a debit entry in the cash at bank account, because receipts add to cash (an asset).
- Payments of cash. Payments reduce cash, so these are recorded as a credit entry in the cash at bank account.

Illustration

Cash at bank

Debit side(Dr)	Credit side(Cr)
Record as a debit entry: Transactions that provide an INCREASE in cash The matching credit entry might be to (1) A sales account for cash sales (2) the total trade receivables account for payments received from credit customers (3) the capital account for new capital introduced by the owner in the form of cash	Record as a credit entry: Transactions that result in a REDUCTION in cash The matching debit entry might be to (1) an expense account, for payments of cash expenses (2) the total trade payables account, for payments to suppliers for purchases on credit/amounts owing (3) a payment in cash for a new asset, (4) a drawings account, for withdrawals of profit by the business owner

Section 1 of this chapter explained the accounting equation and illustrated it with an example where Adeyemi set up a business. This session continues by showing how the same transactions would be recorded in ledger accounts.

The transactions are repeated on the next page for convenience.

Example: Adeyemi revisited

The following transactions relate to Adeyemi's business:

1. Adeyemi introduces ₦600,000 cash as capital.
2. Adeyemi borrows ₦800,000 to purchase a van.
3. Adeyemi buys a market stall for ₦100,000 cash.
4. Adeyemi purchases inventory worth ₦360,000 on credit.
5. Adeyemi pays ₦200,000 to his supplier.
6. Adeyemi sells inventory for ₦240,000 cash.
7. Adeyemi sells inventory for ₦180,000 on credit.
8. Adeyemi repays ₦200,000 of the loan.
9. Adeyemi pays ₦120,000 to his trade suppliers.
10. Adeyemi receives ₦160,000 from customers (trade receivables).
11. Adeyemi purchases additional inventory worth ₦50,000 on credit.
12. Adeyemi withdraws ₦80,000 cash from the business and also takes inventory costing ₦50,000 for personal use.

Post all transactions to ledger accounts.

Example: Adeyemi – Transaction 1

Adeyemi sets up a business by depositing ₦600,000 into a bank account. This increases the cash of the business, and also increases the owner's capital.

The double entry is:

Dr Bank (or cash)	₦600,000		
Cr Capital	600,000		
		Bank	
		₦	₦
(1) Capital	600,000		
		Bank	
		₦	₦
		(1) Bank	600,000

Note: The entry in each account shows the account where the matching debit or credit entry appears.

Example: Adeyemi – Transaction 2

Adeyemi borrows ₦800,000 to purchase a van.

There are two separate transactions:

1. Receipt of the loan (cash inflow), and
2. Purchase of the van (asset acquisition).

The double entries are:

2a Dr Bank ₦800,000		2b Dr Van ₦800,000	
Cr Loan ₦800,000		Cr Bank ₦800,000	
		Bank account	
		₦	₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000		
		Loan Account	
		₦	₦
		(2a) Bank	800,000
		Van Account	
		₦	₦
(2b) Bank	800,000		

Example: Adeyemi – Transaction 3

Adeyemi buys a market stall for ₦100,000. The double entry is:

Dr Stall	100,000		
Cr Bank	100,000		
		Bank Account	
		₦	₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
		Van Account	
		₦	₦
(3) Bank	100,000		

The next transaction is a purchase of inventory. This is recorded in an account

Example: Adeyemi – Transaction 4

Adeyemi purchases inventory for ₦360,000 on credit. The double entry is:

Dr Purchases	360,000		
Cr Bank	360,000		
Purchases			
(4) Trade payables	₦ 360,000		₦
Trade payables			
	₦	(4) Purchases	₦ 360,000

Note on purchases of inventory

In this type of bookkeeping system, there is no separate account for inventory at the time of purchase. Instead, purchases of materials and goods for resale are recorded in a Purchases account, which is treated as an expense account.

Inventory is not recorded as an asset until the business is ready to ascertain profit—typically at the end of an accounting period. At that point, the closing inventory is counted and valued. This value is then used to calculate the cost of sales.

(This will be illustrated later in this chapter, and the complete double entry for inventory will be explained in Chapter 8.)

Example: Adeyemi – Transaction 5

Adeyemi pays ₦200,000 to the supplier. The double entry is:

Dr Trade Payables ₦200,000

Cr Bank ₦200,000

Trade payables			
(5) Bank	₦ 200,000	(4) Purchases	₦ 360,000
Bank			
(1) Capital	₦ 600,000	(2b) Van	₦ 800,000
(2a) Loan	800,000	(3) Stall	100,000
		(5) Trade payables	200,000

Example: Adeyemi – Transaction 6

Adeyemi sells inventory for ₦240,000 cash. The double entry is:

Dr Bank ₦240,000

Cr Sales ₦240,000

Bank			
	₦		₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
Sales			
	₦		₦
		(6) Sales	240,000

Example: Adeyemi – Transaction 7

Adeyemi sells inventory for ₦180,000 on credit. The double entry is:

Dr Trade Receivables ₦180,000

Cr Sales ₦180,000

Trade receivables			
	₦		₦
7) Sales	180,000		
Sales			
	₦		₦
		(6) Sales	240,000
		(7) Trade receivables	180,000

Example: Adeyemi – Transaction 8

Adeyemi repays ₦200,000 of the loan. The double entry is:

Dr Loan ₦200,000

Cr Bank ₦200,000

Loan			
	₦		₦
(8) Bank	200,000	(2a) Bank	800,000

Bank			
	₦		₦
(2) Capital	600,000	(2b) Van	800,000
(2a) Bank	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
		(8) Loan	200,000

Example: Adeyemi – Transaction 9

Adeyemi pays ₦120,000 to the supplier.

The double entry is:

Dr Trade payables 120,000

Cr Bank 120,000

Trade Payable			
	₦		₦
(5) Bank	200,000	(4) Purchases	360,000
(9) Bank	120,000		

Bank			
	₦		₦
(2) Capital	600,000	(2b) Van	800,000
(2a) Bank	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
		(8) Loan	200,000
		(9) Trade payable	120,000

Example: Adeyemi – Transaction 10

Adeyemi receives ₦160,000 from a customer. The double entry is:

Dr Bank	160,000
Cr Trade receivables	160,000

Bank			
	₦		₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
(10) Trade receivables	160,000	(8) Loan	200,000
		(9) Trade payables	120,000
Trade receivables			
	₦		₦
(7) Sales	180,000	(10) Bank	160,000

Example: Adeyemi – Transaction 11

₦

Adeyemi purchases inventory for ₦50,000 on credit. The double entry is:

Dr Purchases	50,000
Cr Bank	50,000

Purchases			
		₦	
(4) Purchases		360,000	
(11) Purchases		50,000	
Trade payables			
		₦	₦
(5) Bank	200,000	(4) Purchases	360,000
(9) Bank	120,000	(11) Purchases	50,000

Example: Adeyemi – Transaction 12

Adeyemi draws ₦80,000 cash and took inventory which cost ₦40,000 for his own use.

If an owner takes inventory for his own use it means that some of the purchases have not been for the business. This is reflected in the double entry by reducing purchases.

There are two transactions but they can be combined into the following double entry:

Dr Drawings	120,000
Cr Bank	80,000
Cr Purchases	40,000

Bank

₦		₦	
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
(10) Trade receivables	160,000	(8) Loan	200,000
		(9) Trade payables	120,000
		(12a) Drawings	80,000

Purchases

₦		₦	
(4) Trade payables	360,000	(12b) Drawings	40,000
(11) Trade payables	50,000		

Drawings

₦		₦	
(12a) Bank	80,000		
(12b) Bank	40,000		

There is a practice question on page 107 of this chapter.

You may attempt part a of the exercise now or you could attempt the whole exercise after you have finished section 3 of this chapter.

3.5 Account balances and the trial balance

3.5.1 Closing off an account (and bring down the balance)

The balance on an account can be established at any time as the difference between the total value of debit entries and the total value of credit entries.

- a. Total both sides of the T-account.
- b. If the total debit entries exceed the credit entries, record the balance carried down on the credit side.
- c. If the total credit entries exceed the debit entries, record the balance carried down on the debit side.
- d. These balances are referred to as balance c/d (carried down) or balance c/f (carried forward).

When the balance on an account is established at the end of a period the process is described as closing off the account and bringing down the balance (though the same process is used whenever a balance is extracted). The figure identified in this way is called the closing balance.

- a. The closing balance is brought down on the opposite side and recorded as **balance b/d** (*brought down*) or **balance b/f** (*brought forward*).
- b. Balances on expense accounts and income accounts are transferred to the statement of profit or loss. (**Note:** There might be some accruals and prepayments on expense accounts. These are explained in a later chapter.)
- c. Balances on the asset, liability and capital accounts are carried forward as closing balances at the end of the period, and become opening balances at the beginning of the next period.

Example: Closing off and bringing down a balance (Using Adeyemi's cash account after transaction 12)

Step 1: Add up both sides of the account

Bank

	₦		₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
(10) Trade receivables	160,000	(8) Loan	200,000
		(9) Trade payables	120,000
		(12a) Drawings	80,000
	<u>1,800,000</u>		<u>1,500,000</u>

Example: Closing off and bringing down a balance (continued)

Step 2: Leave a line and write the biggest figure in totalling lines on each side of the account.

Bank			
	₦		₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
(10) Trade receivables	160,000	(8) Loan	200,000
		(9) Trade payables	120,000
		(12a) Drawings	80,000
	<u>1,800,000</u>		<u>1,500,000</u>
	<u>1,800,000</u>		<u>1,800,000</u>

Step3: One side of the account will not add up to the total. Insert a balancing figure describing this as **balance c/d** (carried down)

Bank			
	₦		₦
(1) Capital	600,000	(2b) Van	800,000
(2a) Loan	800,000	(3) Stall	100,000
(6) Sales	240,000	(5) Trade payables	200,000
(10) Trade receivables	160,000	(8) Loan	200,000
		(9) Trade payables	120,000
		(12a) Drawings	80,000
	<u>1,800,000</u>		<u>1,500,000</u>
	<u>1,800,000</u>	Balance c/d	<u>300,000</u>
			<u>1,800,000</u>

Example: Closing off and bringing down a balance (continued)

Step 4: Write the balancing figure below the totaling lines on the other side of the account describing it as *balance b/d* (brought down)

	₦	Bank		₦
(1) Capital	600,000		(2b) Van	800,000
(2a) Loan	800,000		(3) Stall	100,000
(6) Sales	240,000		(5) Trade payables	200,000
(10) Trade receivables	160,000		(8) Loan	200,000
			(9) Trade payables	120,000
			(12a) Drawings	80,000
				1,500,000
			Balance c/d	300,000
Balance b/d	<u>1,800,000</u>			<u>1,800,000</u>
	300,000			

Note that it is usual to skip step 2 and not write in the subtotals but go straight to step 3.

The full working in that case would look like this:

Example: Closing off and bringing down a balance (Using Adeyemi's cash account after transaction 12)

	₦	Bank		₦
(1) Capital	600,000		(2b) Van	800,000
(2a) Loan	800,000		(3) Stall	100,000
(6) Sales	240,000		(5) Trade payables	200,000
(10) Trade receivables	160,000		(8) Loan	200,000
			(9) Trade payables	120,000
			(12a) Drawings	80,000
			Balance c/d	<u>300,000</u>
	<u>1,800,000</u>			<u>1,800,000</u>
Balance b/d	300,000			

In this example, there is a debit balance on the bank account at the end of the period. The debit balance of ₦300,000 is brought forward as the opening balance on the account at the beginning of the next period.

This indicates that the business has an asset (a debit balance) of cash in the bank account totalling ₦300,000.

Note

In the above example we used c/d and b/d as a description of the balance on the closing off of the account.

You might also use c/f (which stands for carried forward) and b/f (which stands for brought forward).

Returning to Adeyemi.....

Example: Adeyemi – All accounts closed off with balances brought down

Capital			
	₦		₦
Balance c/d	<u>600,000</u>	(1) Bank	600,000
	<u>600,000</u>	Balance b/d	<u>600,000</u>
			600,000
Loan			
	₦		₦
(8) Bank	200,000	(2a) Bank	800,000
Balance c/d	<u>600,000</u>		
	<u>800,000</u>	Balance b/d	<u>800,000</u>
			600,000
Van			
	₦		₦
(2b) Bank	800,000	Balance c/d	800,000
	<u>800,000</u>		<u>800,000</u>
Balance b/d	<u>800,000</u>		
Stall			
	₦		₦
(3) Bank	100,000	Balance c/d	100,000
	<u>100,000</u>		<u>100,000</u>
Balance b/d	<u>100,000</u>		

Example: Adeyemi – All accounts closed off

Purchases

	₦		₦
(4) Trade payables	360,000	(12b) Drawings	40,000
(11) Trade payables	50,000		
		Balance c/d	370,000
	<u>410,000</u>		<u>410,000</u>
Balance b/d	370,000		

Trade payables

	₦		₦
(5) Bank	200,000	(4) Purchases	360,000
(9) Bank	120,000	(11) Purchases	50,000
Balance c/d	90,000		
	<u>410,000</u>		<u>410,000</u>
		Balance b/d	90,000

Trade receivables

	₦		₦
(7) Sales	180,000	(10) Bank	160,000
		Balance c/d	20,000
	<u>180,000</u>		<u>180,000</u>
Balance b/d	20,000		

Sales

	₦		₦
		(6) Bank	240,000
		(7) Trade receivables	180,000
Balance c/d	420,000		<u>420,000</u>
	<u>420,000</u>	Balance b/d	420,000

Drawings

	₦		₦
(12a) Bank	80,000		
(12b) Bank	40,000	Balance c/d	120,000
	<u>120,000</u>		<u>120,000</u>
Balance b/d	120,000		

3.5.2 Trial balance

The balance extracted for any single account is the net of all of the debit and credit entries in that account.

If double entries have been posted correctly then the total of all debit entries made to all of the accounts in the general ledger must equal the total of all credit entries. It follows that if balances are extracted for every account in the general ledger the sum of the debit balances must equal the sum of the credit balances.

A trial balance is a list of all the debit balances and all the credit balances from the accounts in the main ledger.-

The standard method of presentation is in two columns:

- a. one for debit balances, typically represent:
 - i. assets
 - ii. expenses
 - iii. drawings
- b. one for credit balances, typically represent:
 - i. liabilities
 - ii. income
 - iii. equity (including capital, share capital, and reserve accounts in the case of a company)

Example: Adeyemi – Trial Balance as at ...

(It is usual to specify a date when presenting a trial balance.)

	Dr	Cr
	₦	₦
Bank	300,000	
Capital		600,000
Loan		600,000
Van	800,000	
Stall	100,000	
Purchases	370,000	
Trade payables		90,000
Trade receivables	20,000	
Sales		420,000
Drawings	120,000	
	<u>1,710,000</u>	<u>1,710,000</u>

The Purpose of a Trial Balance

A trial balance serves two main purposes:

- a. It provides a starting point for preparing the statement of profit or loss and the statement of financial position at the end of an accounting period.
- b. It acts as a useful tool for identifying errors in the accounting system. An imbalance between the total debit and credit balances in the main ledger accounts indicates that errors have occurred.
- c. if the total of debit balances and total of credit balances on the main ledger accounts are not equal.

3.5.3 Preparing accounts from a trial balance

Year-end adjustments

The trial balance provides a foundation for preparing a statement of profit or loss and a statement of financial position at the end of an accounting period.

- a. A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts.
- b. These adjustments (covered later in chapters 6 to 9) include adjustments for:
 - i. Depreciation expense (to reflect the use of non-current assets);
 - ii. Accruals and prepayments;
 - iii. Bad and doubtful debts; and
 - iv. Inventory.

Further adjustments are made as necessary to deal with items missed or incorrectly dealt with during a period.

When the year-end adjustments have been made, a statement of profit or loss and then a statement of financial position can be prepared, using the adjusted balances.

This session will now use the trial balance of Adeyemi to illustrate the preparation of a set of accounts from a trial balance.

A useful first step is to identify the different types of balance (this will become automatic for you very quickly).

Extra Information:

Adeyemi's closing inventory is ₦90,000.

	Dr	Cr		Which element
Bank	300,000		Asset	
Capital		600,000		Equity
Accounts payable		600,000		Liability
Van	800,000		Asset	
Stall	100,000		Asset	
Purchases	370,000			Expense
Trade payables		90,000		Liability
Trade receivables	20,000		Asset	
Sales		420,000		Income
Drawings	120,000			Equity
Total	<u>1,710,000</u>	<u>1,710,000</u>		

The only year-end adjustment in Adeyemi's case relates to the closing inventory.

Illustration: Cost of sales

	₹	
Opening inventory	X	
Purchases	X	
		This is the total amount of goods X that were available to be sold.
Less: Closing inventory	<u>(X)</u>	This is the total amount of goods still held at the end of the period.
Cost of sales		Therefore, this is the total amount of X goods that were sold.

Inventory, at any point in time, represents goods made or purchased with the intention of selling them in the ordinary course of business, which remain unsold at that point in time.

Closing inventory is recognised as an asset and as a deduction against the cost of sales expense. (The double entry is Dr Inventory (asset) in the statement of financial position and Cr Cost of sales (reduction of an expense) in the statement of profit or loss. This is covered in detail in chapter 9).

Example: Adeyemi – Statement of Profit or Loss for the Period Ended 30 June 2025

	₦	₦
Sales		420,000
Opening inventory: None, as this is the first period.	0	
Purchases	<u>370,000</u>	
	370,000	
Closing inventory	<u>90,000</u>	
Cost of sales		<u>280,000</u>
Gross profit		140,000
Less: expenses (none in this instance)		<u>0</u>
Net profit		140,000

Adeyemi – Statement of Financial Position as at 30 June 2025

	₦	₦
Non-current assets		
Van		800,000
Stall		100,000
Total non-current assets		900,000
Current assets		
Inventory	90,000	
Trade receivables	20,000	
Bank	<u>300,000</u>	
Total current assets		<u>410,000</u>
Total assets		<u>1,310,000</u>
Capital introduced at the start of the business		600,000
Net profit for the period		<u>140,000</u>
		<u>740,000</u>
Drawings		<u>(120,000)</u>
Capital at period end		620,000
Non-current liabilities		
Loan		600,000
Current liabilities		
Trade payables		<u>90,000</u>
Total liabilities		<u>690,000</u>
Total capital and liabilities		<u>1,310,000</u>

Complete the practice question at the end of Section 5.

3.5.4 Uses and Limitations of a Trial Balance

Uses of a Trial Balance

A Trial Balance is a statement that lists all the ledger account balances (both debit and credit) at a particular point in time. It serves several important functions in financial accounting:

- a. **Check on arithmetical accuracy:** The trial balance helps to ensure that the total debits equal total credits. This is a basic check on the arithmetical accuracy of bookkeeping entries.
- b. **Basis for preparing financial statements:** It serves as the foundation for preparing the final accounts, including the Income Statement (Statement of Profit or Loss Account) and the Statement of Financial Position.
- c. **Error detection:** Although it does not detect all types of errors, it helps identify certain mistakes such as unequal debits and credits, omission of entries on one side, or wrong ledger postings.
- d. **Summarisation of ledger balances:** The trial balance provides a summary of all ledger balances, making it easier to analyse and prepare reports for internal and external users.
- e. **Facilitates adjustment entries:** Before the preparation of final accounts, adjustments such as depreciation, accrued income, and outstanding expenses are often identified and applied through the trial balance.
- f. **Audit trail:** It provides a reference point for auditors during verification and validation of financial records.
- g. **Time-saving tool:** It streamlines the accounting process by consolidating account balances in one document, thereby reducing the effort and time required in financial statements preparation.

Limitations of a Trial Balance

Despite its usefulness, the trial balance has certain limitations that restrict its ability to provide a complete assurance of accuracy:

- a. **Cannot detect all errors:** A trial balance cannot detect errors that do not affect the agreement of debit and credit totals. These include:
 - i. Errors of omission (when a transaction is completely omitted from the books).
 - ii. Errors of commission (correct amount posted to the wrong account).
 - iii. Errors of principle (e.g., capital expenditure treated as revenue).
 - iv. Compensating errors (errors of equal amounts that cancel each other).
- b. **Does not show fraud:** A trial balance may not detect deliberate fraud or manipulation of accounts since falsified entries may still be balanced.
- c. **No Assurance of account classification:** It does not confirm that account balances are recorded in the correct account type (For example, asset vs. expense, liability vs. income).
- d. **Limited to numerical accuracy:** It ensures arithmetical accuracy, but not accounting accuracy. It cannot validate the appropriateness or completeness of the financial transactions.

- e. **Not a financial statement:** A trial balance is not a final report to stakeholders. It must be adjusted and converted into formal financial statements to provide useful information for decision-making.

3.6 The Journal And Transaction Recording

3.6.1 Journal entries to record transactions

The general journal (journal for short) is a book of prime entry that is used to record transactions that are not recorded in any other book of original entry.

The journal might be used to provide a record and explanation of:

- a. postings from books of prime entry (explained in chapter 4);
- b. year-end adjustments (chapters 5 to 8);
- c. correction of errors (chapter 10) or
- d. any other adjustment.

The format of a journal entry is as follows:

Illustration

	Debit	Credit
Name of the account with the debit entry	X	
Name of the account with the credit entry		X

In practice, not all entries are recorded in a journal or journalised but of course it is possible to write a journal for any transaction. You might be required to record double entry transactions as 'journal entries'. This is simply a requirement to show the debit and credit entries for a transaction, without preparing T accounts.

3.6.1 Illustration using Adeyemi

Example: Adeyemi revisited

The following transactions relate to Adeyemi's business:

1. Adeyemi introduces ₦600,000 cash as capital.
2. Adeyemi borrows ₦800,000 to purchase a van.
3. Adeyemi buys a market stall for ₦100,000 cash.
4. Adeyemi purchases inventory worth ₦360,000 on credit.
5. Adeyemi pays ₦200,000 to his supplier.
6. Adeyemi sells inventory for ₦240,000 cash.
7. Adeyemi sells inventory for ₦180,000 on credit.
8. Adeyemi repays ₦200,000 of the loan.
9. Adeyemi pays ₦120,000 to his trade suppliers.
10. Adeyemi receives ₦160,000 from customers (trade receivables).
11. Adeyemi purchases additional inventory worth ₦50,000 on credit.

Adeyemi withdraws ₦80,000 cash from the business and also takes inventory costing ₦50,000 for personal use.

Prepare journals for each of the above transactions.

Example: Adeyemi—Journal is in (g) transactions

	Debit	Credit
	₦	₦
Transaction 1		
Cash	600,000	
Capital		600,000

Being the introduction of capital at the start of a new business

Transaction 2		
Cash	800,000	
Loan payable		800,000
Asset – Van	800,000	
Cash		800,000
Being the borrowing of cash and the purchase of a van.		

Transaction 3		
Asset – Market stall	100,000	
Cash		100,000

Being: The purchase of a market stall

Transaction 4	Debit	Credit
Purchases	360,000	
Payables		360,000
Being the purchase of inventory on credit		

Example: Adeyemi-Journalising transactions (continued)

Transaction 5	Debit	Credit
	₦	₦
Payables	200,000	
	0	
Cash		200,000

Being a payment to a supplier

Transaction 6		
Cash	240,000	
	0	
Sales		240,000

Being the cash sale of inventory

Transaction 7		
Receivables	180,000	
	0	
Sales		180,000

Being the sale of inventory on credit

Transaction 8		
Loan payable	200,000	
	0	
Cash		200,000

Being a part repayment on the loan

Transaction 9		
Payables	120,000	
Cash		120,000

Being payment to suppliers

Transaction 10		
Cash	160,000	
Receivables		160,000

Being cash received from credit customer

3.7 The chart of accounts and the general ledger

3.7.1 Introduction

The general ledger is a document which contains all of the individual accounts which are used to record the double entries of a business. It may have physical form as a book or it may be a software application.

All of the financial transactions of a business are entered into appropriate accounts in the general ledger. The balances on these individual accounts can be extracted as a trial balance as a step in preparing financial statements for the business.

Usually a business will organise its general ledger into the specific accounts which it uses. As part of this process, it might employ a coding system under which each individual ledger account is assigned a unique code.

The list of these codes is called a chart of accounts.

Chart of accounts

This is a list of accounts created by a business to be used to organise its financial transactions into identified categories of assets, liabilities, income and expenses.

Each general ledger account is identified by a unique code and heading. This allows a business to generate instructions and policies to be followed by those members of staff responsible for recording information.

The list is typically arranged in the order of the customary appearance of accounts in the financial statements, statement of financial position general ledger accounts followed by statement of profit or loss general ledger accounts. The structure and headings in the list aim to result in consistent posting of transactions.

A company might have complete freedom in designing its chart of accounts (within the boundaries set by the rules of accounting). In some countries, the government might issue a generic chart of accounts from which a business selects those codes that are appropriate to its needs.

The aim of the chart is to ensure that all transactions are recognised in accordance with the requirements of the business.

Illustration: Chart of accounts

Each major heading in the financial statements might be given arrange of codes from which codes can be selected for individual general ledger accounts:

	Code range		Code range
Non-current assets	100–199	Income	600–699
Current assets	200–299	Expenses	700–799
Non-current liabilities	300–399		
Current liabilities	400–499		
Equity	500–599		

Individual ledger accounts with in the above range for non-current assets:

Non-current assets	Code
Landdsd	110
Office buildings	120
Warehouses	130
Factories	140

Year-end exercise

An earlier section in this chapter explained that the trial balance is a foundation for preparing a statement of profit or loss and a statement of financial position at the end of an accounting period. The trial balance is extracted and various year-end adjustments are then made to the accounts after which a statement of profit or loss and then a statement of financial position can be prepared, using these adjusted balances.

Any of these adjustments must also be recorded in the general ledger accounts so that these agree with balances on the financial statements.

At the end of the period there is another exercise to perform in order to prepare the general ledger for use in the next accounting period.

You may have noticed that profit is calculated after the trial balance has been extracted. This means that there is no profit figure in the general ledger. Rather, it is represented by all of the balances on the income and expense accounts.

These must all be transferred to a general ledger profit or loss account. The balance on this account will then be the profit or loss for the period. This balance is transferred to the equity account.

Process:

- Step 1:** Perform double entry as necessary to capture the year-end adjustments in the general ledger accounts.
- Step 2:** Perform double entry to transfer all incomes statements amounts to a profit or loss general ledger account.
- Step 3:** Close off this account
- Step 4:** Transfer the balance on this account to capital.
- Step 5:** Transfer the balance on the drawings account to capital and close off the capital account.

Step1: Perform			
	Bank		
Balance b/d	300,000		
	Loan		
	Balance b/d	300,000	
	Van		
Balance b/d	800,000		
	Stall		
Balance b/d	100,000		
	Trade Payables		
	Balance b/d	90,000	
	Trade Receivables		
Balance b/d	20,000		
	Capital		
	Balance b/d	600,000	
	Drawing		
Balance b/d	120,000		
	Sales		
	Balance b/d	420,000	
	Purchaes		
Balance b/d	370,000		
	Invcntory (statement of Profit or loss)		
	Balance b/d	90.000	
	Inventory (Assets)		
Balance b/d	90,000		

Step 2: Perform double entry to transfer all income statement amounts to the profit or loss general ledger account.

Profit or loss (new account)			
Purchases	370,000	Sales	420,000
		Inventory	90,000
Sales			
Profit or loss		Balance b/d	420,000
<u>420,000</u>		<u>420,000</u>	
Purchases			
Balance b/d		Profit or loss	370,000
<u>370,000</u>		<u>370,000</u>	
Inventory (statement of profit or loss)			
Profit or loss		Balance b/d	90,000
<u>90,000</u>		<u>90,000</u>	

Step 3: Close off the Profit or Loss account.

Profit or loss (new account)			
Purchases	370,000	Sales	420,000
Capital	140,000	Inventory	90,000
<u>510,000</u>		<u>510,000</u>	

Step 4: Transfer the resulting profit or loss to the Capital account

Capital	
Balance b/d	600,000
Profit or loss	140,000

Step 5: Transfer the balance on the Drawings account to the Capital account and close off the Capital account.

Capital			
Drawings	120,000	Balance b/d	600,000
Balance c/d	<u>620,000</u>	Profit or loss	<u>140,000</u>
	<u>740,000</u>		<u>740,000</u>

Drawings		
Balance b/d	Capital	=
<u>120,000</u>	<u>120,000</u>	

Practice questions 1

Emmanuel sets up a trading business, buying and selling goods.

Record the following transactions which, occurred during his first month of trading (July 2019) in the relevant ledger accounts.

- 1 Emmanuel introduced ~~N~~500,000 into the business by paying money into a business bank account.
 - 2 The business bought a motor van for ~~N~~60,000. Payment was by cheque.
 - 3 The business bought some inventories for ~~N~~30,000, paying by cheque.
 - 4 The entire inventories purchased (transaction 3) were sold for ~~N~~50,000 in cash.
 - 5 More inventories were purchased for ~~N~~100,000 on credit.
 - 6 50% of the inventory purchased in transaction 5 were sold for ~~N~~80,000. All these sales were on credit.
 - 7 A payment of ~~N~~30,000 was made to a supplier for some of the purchases.
 - 8 A payment of ~~N~~40,000 was received from a customer for some of the sales on credit.
 - 9 Emmanuel withdrew ~~N~~10,000 from the bank account for his personal use.
 - 10 Emmanuel paid ~~N~~2,000 for diesel for the motor van using a business cheque
 - 11 The business paid ~~N~~15,000 by cheque for the premium on an insurance policy.
 - 12 The business received a bank loan of ~~N~~100,000, repayable in two years.
- a) Post all transactions to ledger accounts.
 - b) Close off each account and extract a trial balance.
 - c) Prepare a statement of profit or loss and a statement of financial position.(Assume that Emmanuel has closing inventory of ~~N~~50,000).

3.8 Chapter review

This chapter covers the basic principles of double entries in accounting with their illustrations.

3.9 End chapter questions and suggested solutions

Question 1

In the realm of financial accounting, understanding foundational principles and organisational tools is essential for accurate and efficient record-keeping. Two key components that underpin the accounting process are the principle of double-entry accounting and the chart of accounts. These elements not only ensure the integrity of financial data but also facilitate meaningful analysis and reporting.

- (a) Explain the principle of double-entry accounting and demonstrate, with examples, how business transactions are recorded, using this principle.
- (b) Define a chart of accounts and explain its purpose in a business accounting system.

Suggested solutions

- a. **Explain the principle of double-entry accounting and demonstrate, with examples, how business transactions are recorded using this principle.**

The principle of double-entry accounting states that every financial transaction has two equal and opposite effects in at least two different accounts. Each transaction is recorded by a debit in one account and a credit in another. The total amount of debits must always equal the total amount of credits, ensuring that the accounting equation remains balanced:

$\text{Assets} = \text{Liabilities} + \text{Equity}$

Double-entry accounting provides a complete record of financial transactions and helps to detect errors through the trial balance process.

Example 1:

A business owner introduces ₦500,000 cash into the business.

- i. Debit: Bank Account (Asset increases) – ₦500,000
- ii. Credit: Capital Account (Owner's Equity increases) – ₦500,000

Example 2:

The business buys inventory for ₦100,000 and pays by cheque.

- i. Debit: Inventory (Asset increases) – ₦100,000
- ii. Credit: Bank Account (Asset decreases) – ₦100,000

Each transaction has two entries of equal value — one debit and one credit — thus keeping the accounting system in balance.

- (b) **Define a chart of accounts and explain its purpose in a business accounting system.**

A chart of accounts is an organised list of all the accounts used by a business to record its financial transactions. Each account is usually assigned a unique code or number and classified into categories such as assets, liabilities, equity, income, and expenses.

Purpose of a chart of accounts:

- a. **Organisation:** It organises financial transactions into appropriate categories, making financial management and reporting more systematic and understandable.
- b. **Consistency:** It ensures consistency in recording transactions across different periods.
- c. **Reporting:** It facilitates the preparation of financial statements by grouping related accounts together.
- d. **Control:** It helps management to monitor and control business activities by tracking financial performance under different account headings.
- e. **Compliance:** It helps in meeting regulatory requirements by providing a clear structure for financial reporting.

For example, codes 1000–1999 may be assigned to asset accounts, 2000–2999 to liabilities, and so on.

Question 2

	N'000	N'000
Capital		50,224
12% Loan- Lobito		20,000
Inventory	18,826	
Receivables	26,016	
Prepayments	600	
Trade payables		26,000
Bank overdraft		14,634
Drawings	8,260	
Cash in hand	700	
Non-current assets	72,208	
Accruals		282
Profit or loss		18,400
Suspense	2,930	--
	<u>129,540</u>	<u>129,540</u>

Rigogo and Co, present the following trial balance as at September 30,2025

An investigation into the accounts revealed the following.

- i. The suspense account balance represents the difference on the trial balance
- ii. The purchases day book total of ~~N~~8,240,000 was posted to purchases account as ~~N~~8,420,000
- iii. Closing inventory was overstated by ~~N~~2,000,000
- iv. Cash in hand should be ~~N~~110,000
- v. Fixtures and fitting with a cost of ~~N~~10,000,000 and accumulated depreciation of ~~N~~5,400,000 had been omitted from the trial balance. Fixtures and fittings are being depreciated on 20% on cost.
- vi. Interest on loan for 6 months had not been provided for.
- vii. An invoice of ~~N~~500,000 for goods purchased was not posted to the personal

account of the supplier

- viii. A sales return of ₦200,000 had been debited to the customer's account.

Required:

- Prepare the journal entries, including narrations to correct the above errors
- Prepare the suspense account
- Prepare a revised statement of profit or loss
- Prepare the statement of financial position after correcting the errors.

Suggested solution

In the books of Rigogo & Co.

a. Journals

	₦'000	₦'000
Suspense	180	
Purchases		180
Being purchases previously overstated, now rectified		
Cost of sales	2,000	
Inventory		2,000
Being closing inventory previously overstated, now rectified		
Suspense	590	
Cash in hand		590
Correction of cash in hand overstated, now corrected		
Fixtures and fittings	4,600	
Suspense		4,600
Being omitted fixtures and fittings from trial balance, now recorded		
Depreciation expense	2,000	
Accumulated depreciation		2,000
Being depreciation charged on the fixture and fittings		
Interest expense	1,200	
Accrued interest		1,200
Being the interest on loan due now accrued and recorded.		
Suspense	500	
Payables		500
Recording purchases previously omitted in supplier's account.		
Suspense	400	
Receivables		400
Being sales return wrongly debited to customer's account, now rectified		

b. Suspense account

	₦'000		₦'000
Balance b/f	2,930	Fixtures and fittings	4,600
Purchases	180		
Cash	590		
Payables	500		
Receivables	400		

	4,600	4,600

	N'000	N'000
Profit as given		18,400
Adjustments:		
Add amount by which purchases was overstated		180
		18,580
Deduct:		
Depreciation expense	2,000	
Amount by which closing inventory was overstated	2,000	
Interest expense	1,200	(5,200)
Adjusted profit		13,380

Determination of the revised profit

Statement of financial position as at September 30, 2025

	N'000	N'000
Non-current assets N'000 (72,208 + 4,600 - 2,000)		74,808
Current assets:		
Inventory N'000 (18,826 - 2,000)	16,826	
Receivables N'000 (26,016 - 400)	25,616	
Prepayment	600	
Cash in hand N'000 (700 - 590)	110	
Total current assets		43,252
Total assets		117,960
Equity and liabilities:		
Capital	50,224	
Profit	13,380	
Drawings	(8,260)	
Total equity		55,334
Non-current liabilities:		
12% Loan notes		20,000
Current liabilities:		
Trade payables N'000 (26,000 + 500)	26,500	
Accrual N'000 (282 + 1,200)	1,482	
Bank overdraft	14,634	
Total current liabilities		42,616
Total equity and liabilities		117,960

Organis organisrecognis

Question 3

Enter the following transactions in the Petty Cash Book of Yaro Ventures, assuming the company operates on an imprest system with a float of N50,000.

Feb 1 Received cash to establish the petty cash fund

Feb 3 Paid for office supplies N10,000

Feb 5 Paid for postage N5,000

Feb 8 Reimbursed bus fare to staff N2,000

Feb 10 Purchased stationery N8,000

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

Suggested solution

Yaro 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				
<u>83,500</u>				<u>83,600</u>				
50,000	Mar 1	Balance b/f						

SOLUTIONS TO PRACTICE QUESTIONS

Solution		1a	
Bank			
₦		₦	
(1) Capital	500,000	(2) Motor van	60,000
(4) Sales	50,000	(3) Purchases	30,000
(8) Trade receivables	40,000	(7) Trade payables	30,000
(12) Bank loan	100,000	(9) Drawings	10,000
		(10) Motor expenses	2,000
		(11) Insurance	15,000
		Balance c/d	543,000
	690,000		690,000
Balance b/d	543,000		
Capital			
₦		₦	
Balance c/d	500,000	(1) Bank	500,000
	500,000		500,000
		Balance b/d	500,000
Purchases			
₦		₦	
(3) Bank	30,000		
(5) Trade payables	100,000		
	130,000	Balance c/d	130,000
Balance b/d	130,000		130,000
Van			
₦			
(2) Bank	60,000	Balance c/d	60,000
	60,000		60,000
Balance b/d	60,000		

Trade Payables			
	₦		₦
(7) Bank	30,000	(5) Purchases	100,000
Balance c/d	70,000		
	<u>100,000</u>		<u>100,000</u>
		Balance b/d	70,000

Trade receivables			
	₦		₦
(6) Sales	80,000	(8) Bank	40,000
		Balance c/d	40,000
	<u>80,000</u>		<u>80,000</u>
Balance b/d	40,000		

Drawings			
	₦		₦
(9) Bank	10,000		
		Balance c/d	10,000
	<u>10,000</u>		<u>10,000</u>
Balance b/d	10,000		

Motor expenses			
	₦		₦
(10) Bank	2,000		
		Balance c/d	2,000
	<u>2,000</u>		<u>2,000</u>
Balance b/d	2,000		

	Dr	Cr
Bank	543,000	
Capital		500,000
Van	60,000	
Purchases	130,000	
Trade payables		70,000
Trade receivables	40,000	
Sales		130,000
Drawings	10,000	
Motor expenses	2,000	
Insurance	15,000	
Bank loan		100,000
	<u>800,000</u>	<u>800,000</u>

SALES AND PURCHASES

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- 4.0 Learning objective
- 4.1 Learning outcomes
- 4.2 The books of prime entry
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- 4.6 Pettycash
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4 Sales and purchases

4.0 Learning Objective

This chapter explains the role of books of prime entry, identifies and describes the contents of the sales and purchases day books along with their respective ledgers, accurately record related transactions, and correctly account for discounts allowed and received.

4.1 Learning outcomes

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

- a) explain the role of the books of prime entry;
- b) describe the basic contents of the sales day book and the customer/debtors' ledger;
- c) record entries in the sales day book and the customer/debtors' ledger;
- d) account for discounts allowed;
- e) describe the basic contents of the purchases journal and the purchases (creditors) ledger; and
- f) record entries in the purchases journal and the purchases (creditors) ledger.
- g) account for discounts received

4.2 The books of prime entry

Book-keeping is the process of recording financial transactions in the accounting records (the 'books') of an entity. These transactions are recorded in accounts, with a separate account maintained for each type of transaction.

In practice, transactions are often not recorded directly in the ledger accounts as they occur. Instead, they are first entered into special records known as books of prime entry (also called books of original entry). Each book is designated for a specific type of transaction. Periodically, the totals from these books are transferred using the double entry system into the relevant ledger accounts in the general ledger

The books of prime entry include the following:

Book of prime entry	Function
Sales day book,	Records sales made on credit (receivables), based on sales invoices.
Sales returns day book	Records items returned by credit customers, supported by credit notes issued to them.
Purchases day book	Records purchases made on credit from suppliers (trade payables), based on purchase invoices.
Purchases returns day book	Records the return of goods purchased on credit, supported by relevant documents.

Cashbook	Records cash received into and cash paid out of the bank account. Cash receipts and payments form an integral part of the sales and purchases cycles.
Journal	Records non-regular or unusual transactions that are not captured in any of the other books of original entry.

Books of prime entry serve as a useful means of summarising large numbers of similar transactions such as credit sales, credit purchases, and cash and bank receipts and payments.

4.2.1 Posting transactions

You may find it useful to refer back to the diagram at paragraph 3.2 of chapter 3 before reading this section.

Books of prime entry help reduce the number of individual transactions that need to be recorded in the general ledger. For example, instead of recording 1,000 separate sales individually, a business can total them and make a single double entry posting. As a result, the general ledger will contain one account summarising all receivables, rather than a separate account for each customer. This summary account is called the receivables control account. (Note: In practice, it may be known by another name, but its function remains the same.)

Definition: Control account

A control account is a summary account in the general ledger that consolidates and reflects the total of a large number of individual transactions recorded in a subsidiary ledger.

(Examples include receivables control account, payables control account and payroll control account).

However, summarising receivables in a single control account creates a challenge. The business still needs information about individual customers and the amounts they owe. To address this, a separate record is maintained to track the balances of each customer. This is known as the receivables ledger (or sales ledger).

The receivables control account and the receivables ledger are updated simultaneously. The process of transferring transaction details from the books of prime entry to the ledger accounts is called posting.

The **receivables control account** and the **receivables ledger** are updated simultaneously. The process of transferring transaction details from the books of prime entry to the ledger accounts is called **posting**.

The balance in the receivables control account should always equal the total of all individual customer balances in the receivables ledger. If there is a discrepancy, an error has occurred and must be investigated. This topic is discussed in more detail in Chapter 9.

It is important to note that:

- a. The receivables control account is part of the double-entry accounting system.

Any entry made in this account must have a corresponding opposite entry elsewhere in the general ledger.

- b. The receivables ledger, however, is not part of the double entry system. It mirrors the entries in the receivables control account but does not record the corresponding double-entry. For this reason, it is often referred to as a memorandum account.

The same principles apply to purchases. Credit purchases are recorded in the purchases day book and posted to a payables control account in the general ledger. This is supported by a payables ledger, which contains individual accounts showing how much the business owes to each supplier.

Although this system may seem complex at first, the rest of this chapter will explain it in further detail.

4.3 Accounting For Sales

4.3.1 Documents in the sales cycle

A business aims to make a profit by selling goods or services to customers, thereby generating revenue or income. Sales can be made either for cash (e.g., coin, debit card, credit card, cheque, or banker's draft) or on credit.

The following documents might be used in a system designed to account for sales.

Document	Purpose	Accounting entry triggered
Sales order	Sent by the customer to place an order.	No
Goods despatched note	Notifies the customer that goods have been dispatched and are on their way.	No
Delivery note	Accompanies the goods. The customer uses it to check that the delivery matches the order.	No
Sales invoice	A formal request for payment from the customer for goods delivered. It includes the date, transaction details, and payment terms.	Yes
Statement	Summarises the amount the customer still owes at a point in time. It reflects invoices	No

	issued minus payments received.	
Credit note	Issued when goods are returned by the customer and the return is accepted. It acknowledges a reduction in the amount owed by the customer.	Yes

Illustration: Credit note

Entity A issues an invoice to a customer for ₦20,000.

Subsequently, A agrees to reduce the amount payable by ₦1,000 due to some of the goods being of poor quality.

A then issues a credit note to the customer for ₦1,000.

As, a result, the customer is now required to pay ₦19,000, which represents the original invoice amount of ₦20,000 less the ₦1,000 credit note.

4.3.3 Recording sales

a. Sales day book

The sales day book is one of the books of prime entry. It is used to make an initial record of sales made on credit. Credit sales transactions are listed chronologically in the sales day book.

Double entry and updating the receivables ledger

At regular intervals (daily, weekly, or monthly), the total of all credit sales transactions is posted to the general ledger as follows:

The total value of transactions recorded since the last posting is transferred using a double entry:

- i. Debit: Receivables Control Account
- ii. Credit: Sales Account

b. Each individual transaction is also posted to the receivables ledger by debiting the account of the specific customer with the value of the transaction.

This process ensures that the receivables control account in the general ledger agrees with the total of individual customer balances in the receivables ledger.

Illustration

A diagram showing an overview of this system along with the purchases and cash systems

Sales on credit	Debit	Credit

General ledger:		

Receivables control account	X	
Sales		X

Receivables ledger:	

Individual customer accounts	X

is provided at the end of this chapter.

Responsibilities

The main accountant is responsible for maintaining the general ledger and extracting financial information from it. The accountant also supervises accounting assistants (accounts clerks) who handle day-to-day postings and updates to subsidiary records

Example: Recording sales

A company made the following credit sales which are to be posted to the general ledger and the receivables ledger.

Sales day book:

Customer:	Sale
Danish	25,000
Fahad	10,000
Hasan	<u>40,000</u>
	<u>75,000</u>

General ledger

Receivable control account			
	<u>₹</u>		<u>₹</u>
Sales	75,000		
Sales account			
	<u>₹</u>		<u>₹</u>
		Receivables Control	75,000

Receivable ledger

Danish account			
	<u>₹</u>		<u>₹</u>
Sales	75,000		
Fahad account			
	<u>₹</u>		<u>₹</u>
Sales	10,000		
Fahad account			
	<u>₹</u>		<u>₹</u>
Sales	40,000		

The postings to the general ledger may be recorded using a journal entry as follows:

	Debit	Credit
	<u>₹</u>	<u>₹</u>
Receivable control account	Dr 75,000	
Sales account		75,000
Being posting of the sales from the sales day book		

There is a diagram showing an overview of this system together with the purchases and cash system at the end of this chapter.

4.3.4 Recording sales returns

Sales returns day book

The sales returns day book is a book of prime entry used to record goods returned by customers often due to damage or unsatisfactory quality.

When such returns occur, a credit note is issued to the customer.

Double entry and updating the receivables ledger

At regular intervals (daily, weekly, or monthly), the total value of all sales returns is posted to the general ledger. At the same time, the individual amounts are used to update each customer's balance in the receivables ledger.

Illustrations		
General ledger		
Sales on credit	Debit ₦	Credit ₦
Sales return	X	
Receivables		X
Receivable ledger		
Individual customer account		X

Sales day book	₦	
Customer: A	40,000	
Customer: B	50,000	
Customer: C	30,000	
Customer: D	20,000	
	140,000	(1)
Sales returns day book	₦	
Customer: A	5,000	(2)
Cash received Customer: B	₦	
	40,000	
Customer: C	20,000	
	60,000	(3)

Example: Receivable ledger:

	₦		₦
(1a) Sales	40,000	(2a) Sales returns	5,000
		Balance c/d	35,000
	<u>50,000</u>		<u>50,000</u>
Balance c/d	35,000		

Customer B

	₦		₦
(1b) Sales	50,000	(3a) Bank	40,000
		Balance c/d	10,000
	<u>50,000</u>		<u>50,000</u>
Balance c/d	10,000		

Customer C

	₦		₦
(1c) Sales	30,000	(3b) Bank	20,000
		Balance c/d	10,000
	<u>30,000</u>		<u>30,000</u>
Balance c/d	10,000		

Customer D

	₦		₦
(1d) Sales	20,000		

The balances on the accounts in the receivables ledger in total are:

	₦
Customer: A	35,000
Customer: B	10,000
Customer: C	10,000
Customer: D	20,000
	<u>75,000</u>

sold goods on credit. Each account shows the total value of credit sales made to the customer, any sales returns (recorded as credit notes), payments received, and the current amount the customer owes.

4.3.5 Discounts allowed

Introduction

Businesses sometimes give discounts to customers. There are two main types of discounts:

- a. trade discount; and
- b. settlement discount (or cash discount).

Trade discount

This is price reduction given to a customer. The invoice is issued at the reduced amount so there are no double entry problems caused by this type of discount. There is simply a sale at a lower price.

Example: Trade discounts

A building merchant sells bags of cement at ~~RM~~500 per bag. However, a trade discount reduces the price to ~~RM~~450 per bag for customers who buy 10 or more bags. The ~~RM~~50 reduction per bag is the trade discount.

Arif purchases 20 bags from the building merchant.

Without the discount, Arif would have paid ~~RM~~10,000 (~~RM~~500 × 20).

With the trade discount, he pays only ~~RM~~9,000 (~~RM~~450 × 20).

From the merchant's perspective, this is a sale of ~~RM~~9,000. No special accounting treatment is required for trade discounts, as the sale is recorded at the discounted price.

Settlement discounts

A settlement discount is offered to encourage credit customers to pay their outstanding balances earlier than the agreed credit period.

Discounts allowed

When a business grants a settlement discount to a customer, it is known as a discount allowed. This is treated as an expense in the business's accounts and is recorded separately from sales revenue.

Example: Settlement discounts

A building merchant offers credit terms to large customers. It allows a **3% settlement discount** to any credit customer who pays an invoice within 30 days. This means the customer is required to pay only **97%** of the invoice amount if payment is made within the specified period.

Benjamin Builders purchases goods worth ~~RM~~80,000.

- If Benjamin Builders pays **within 30 days**, it only needs to pay ~~RM~~77,600 (i.e., 97% of ~~RM~~80,000).
- If payment is **not made within 30 days**, the full amount of ~~RM~~80,000 becomes payable.

Discounts allowed are settlement discounts that a business offers to its credit customers. It is up to the customer to decide whether to pay the full amount or to pay the smaller amount earlier.

IFRS 15: Revenue from contracts with customers requires that revenue be recognised at the amount the entity expects to receive from the customer.

- Revenue is recognised at the net amount (i.e., after deducting any settlement discount) if it is probable that the customer will take advantage of the discount.
- Revenue is recognised at the gross amount (i.e., without deducting the discount) if the customer is not expected to take advantage of the settlement discount.

IFRS 15: Revenue from contracts with customers requires that revenue is recognised at the amount that the business making the sale expects to receive.

- Revenue is recognised as the net amount (discount deducted) when a customer is expected to take advantage of a settlement discount.
- Revenue is recognised as the gross amount (no deduction of the discount) when a customer is not expected to take advantage of a settlement discount.

Customer expected to take a discount

If a customer does not take a discount when expected to do so revenue is adjusted accordingly.

Example: Customer expected to take a discount (but does not qualify)

Facts as above but Benjamin pays in full as he was too late to qualify for the discount.

	Debit	Credit
At date of sale:		
Trade receivables	77,600	
Sales (97% of 80,000)		77,600
On day 30		
Trade receivables	2,400	
Sales (3% of 80,000)		2,400
At date that payment is received		
Bank	80,000	
Trade receivables		80,000

Example: Customer expected to take a discount (and settles on time) Adeola has sold goods to Benjamin for ₦80,000.

Adeola offers a 3% settlement discount if payment is made within 20 days.

At date of sale:

Trade receivables	77,600	
Sales (97% of 80,000)		77,600

At date that payment is received

Bank	80,000	
Trade receivables		80,000

Example: Customer not expected to take a discount Adeola has sold goods to Benjamin for ₦80,000.

Adeola offers a 3% settlement discount if payment is made within 20 days.

Based on previous experience, Adeola does not expect Benjamin to take advantage of the settlement discount and indeed, Benjamin pays after 20 days.

Adeola would record the transaction as follows:

	Debit ₦	Credit ₦
At date of sale:		
Trade receivables	80,000	
Sales		80,000
At date that payment is received (day 25)		
Bank	80,000	
Trade receivables		80,000

Revenue adjustments and the receivables ledgers

Adjustments to revenue must also be recorded in the individual customer accounts in the receivables ledger.

4.3.6 Receivables control account

A receivables ledger control account is the name given to the account in the general ledger for total receivables. A control account is an account that records total amounts – in this case, total amounts for receivables.

The receivables ledger control account records all transactions involving credit customers.

- Debit entries in the receivables control account are transactions that add to the total amount of receivables.
- Credit entries in the receivables ledger control account are transactions that reduce the total amount of receivables.

Debit side (Dr)		Credit side (Cr)	
Balance b/d	X		
Credit sales	X	Payments received from credit customers	X
Dishonoured cheques (see below)	X	Sales returns	X
Revenue adjustment (Customer fails to take a discount when expected to do so)	X	Revenue adjustment (Customer takes a discount when not expected to do so)	X
		Bad debts written off (explained later in chapter 7).	X
		Contra entries (explained later in this chapter)	X
		Balance c/d	X
	X		X
Balance b/d	X		

Dishonoured cheques

These are cheques received from customers where subsequently the bank refuses to make payment.

When a business receives a cheque from a customer it recognises that as an amount paid. If the business presents the cheque to the bank for payment and the bank refuse to accept it (perhaps because of insufficient funds in the customer's account) the business is still owed the money and must reverse the original entry (Dr Receivables, Cr Bank).

Entries not recorded in the receivables control account

Only transactions that relate to credit sales are recorded in the receivables ledger control account.

The following transactions are **not** recorded in the receivables ledger control account:

- a. Cash sales (for which the entry is Dr Bank, CrSales);
- b. Changes in the allowance for irrecoverable debts account (covered later in chapter 6).

The balance on the receivables control account might be described as trade receivables on the face of the statement of financial position.

4.3.6 Terminology

This chapter uses certain terminology to explain how sales might be accounted for. This is an area where you may see different terms used to describe what has been described above.

Used in this chapter	Common alternative
Sales day book	Sales journal
Receivables ledger	Debtors ledger,
	Sales ledger
Receivables control account	Receivables ledger control account Sales ledger control account Total sales control account Debtor control account Account receivable control account

Purchases day book

The purchases day book is a book of prime entry used to record credit purchases. Credit purchase transactions are listed in this book as they occur.

There may be several categories of item or service purchased each of which must be posted to an appropriate account.

4.4 Accounting for Purchases

4.4.1 Documents in the purchases cycle

Businesses make purchases from suppliers. Purchases are similar in many respects to sales, except that the business is buying from a supplier rather than selling to a customer.

The following documents might be used in a system designed to account for purchases.

Document	Purpose	Impacts double
Purchase order	Sent by the business to place an order with a supplier.	No
Goods received note	Produced when goods are received. It is prepared after checking the delivery against the purchase order and actual goods received. Sent to accounts staff to verify that the invoice matches the goods received.	No
Purchase invoice	A request for payment from the supplier for goods delivered.	Yes
Statement	A document from the supplier to show amount still owed at a specific point in time.	No

4.4.2 Recording purchases

Double entry and updating the payables ledger

Periodically (daily, weekly, monthly) a total for all transactions is posted to purchases and other expense accounts with the other side of the entry posted to the payables control account in the general ledger.

In addition the individual amounts are used to update the suppliers' individual balances in the payables ledger.

The payables (purchase) ledger is also used to record purchase invoices from suppliers of other items, as well as purchases of goods. (For example the payables ledger is used to record details of invoices for rental costs, telephone expenses, and electricity and gas supplies and so on).

Details of these expenses must be posted from the purchases ledger to the relevant accounts in the general ledger.

To facilitate this, a day book might have analysis columns which show the different types of expense.

Details of each individual invoice are also posted to the account of the individual supplier in the payables ledger.

Illustration

Purchases on credit	Debit	Credit
General ledger:		
Purchases	X	
Expense 1	X	
Expense 2 (etc.)		
Payables control account		X
Payables ledger:		
Individual customer accounts		X

There is a diagram showing an overview of this system together with the sales and cash system at the end of this chapter.

Purchase day book		Total	Purchases	Energy	Sundry
		₦(000)	₦(000)	₦(000)	₦(000)
3 May	BV Supplies	500	500		
3 May	South Electric	1,200			1,200
3 May	CD Power	3,000		3,000	
3 May	Sad Stationery	650			650
3 May	Woods Widgets	4,800	4,800		
3 May	Small Plastic	3,200	3,200		
3 May	Southern Gas	750			750
3 May	IT Solutions	500			500
		14,600	8,500	3,000	3,100

	Debit	Credit
	₦	₦
Purchases	8,500	
Payables control account		8,500
Energy expenses	3,000	
Payables control account		3,000
Sundry expenses	3,100	
Payables control account		3,100

4.4.3 Recording purchase returns

Purchases returns day book

The purchases returns day book is similar to the purchases day book, except that it records goods returned to suppliers.

When goods are returned, the business receives a credit note from the supplier. The purchases returns day book records the details of these credit note details.

The total purchases returns are posted to the general ledger, by:

- debiting the total trade payables account (reducing the amount owed to suppliers), and
- crediting the purchases returns account, or possibly the purchases account.

Returns to individual suppliers are also debited in the supplier's individual account in the payables ledger

Illustration:

Purchase returns	Debit	Credit

General ledger:

Payables	X	
Purchase returns		X

Payables ledger:

Individual customer accounts	X

Purchases day book

	₦	
Supplier: A	30,000	
Supplier: B	60,000	
Supplier: C	20,000	
Supplier: D	70,000	
	180,000	(1)

Purchase returns day book	Supplier:	₦	
B		20,000	(2)

Cash paid to:	Supplier: A	₦	
		29,000	
Supplier: D		25,000	
		54,000	(3)

Discount received	Supplier: A	₦	
		1,000	(4)

Payables control account

	₦		₦
Purchase returns (2)	20,000	Purchases (1)	180,000
Bank (3)	54,000		
Discount received (4)	1,000		
Balance c/d	105,000		
	180,000		180,000
		Balance c/d	105,000

Purchases

	₦		₦
Payables (1)	180,000		

Purchase returns		
₱		₱
	Payables (2)	20,000
Bank		
₱		₱
	Payables (3)	54,000
Discount received		
₱		₱
	Payables (4)	1,000

Example: General ledger

The posting to the general ledger might be recorded as journal entries

	Debit	Credit
	₱	₱
Purchases	180,000	
Payables control account		180,000
Being: Posting of purchases from the purchases daybook.		
Payables control account	20,000	
Purchase returns		20,000
Being: Posting of purchase returns from the purchase returns daybook.		
Payables control account	54,000	
Bank		54,000
Being: Cash paid to suppliers		
Payables control account	1,000	
Bank		1,000
Being: Discounts received		

Example: Payables ledger

Supplier A			
	₦		₦
(3a) Bank	29,000	(1a) Purchases	30,000
(4) Discount received	1,000		
	<u>30,000</u>		<u>30,000</u>
Supplier B			
	₦		₦
(2) Purchase returns	20,000	(1b) Purchases	60,000
Balance c/d	40,000		
	60,000		<u>60,000</u>
		Balance c/d	40,000
Supplier C			
	₦		₦
		(1c) Purchases	20,000
Supplier D			
	₦		₦
(3b) Bank	25,000	(1d) Purchases	70,000
Balance c/d	45,000		
	<u>70,000</u>		<u>70,000</u>
		Balance c/d	45,000
Supplier: A			
Supplier: B	40,000		
Supplier: C	20,000		
Supplier: D	45,000		
	<u>105,000</u>		

The **payables ledger** contains the accounts for each supplier from whom goods or services have been purchased on credit. Each trade payables account shows the total amount purchased on credit from the supplier, details of any purchase returns, payments made, and the outstanding balance currently owed to the supplier

4.4.4 Discounts received

Discounts received are settlement discounts offered by suppliers that a business takes advantage of by paying earlier and thereby paying a reduced amount.

Accounting for discounts received

The invoice is recorded in payables at the full amount when it is received. Discount received can only be recognised when payment is made within a given time frame so

that a business becomes entitled to a discount.

Discounts received from suppliers are recorded in a discounts received account. If a business decides to take up the offer of a settlement discount by paying the smaller amount sooner, the double entry for the payment is:

Illustration: Discount received double entry

	Debit	Credit
Trade payables	X	
Bank (cash paid to supplier)		X
Discount received (discount taken by us)		X

The entry in the discount received account is a credit entry because it is effectively a reduction in an expense. In the statement of profit or loss, it will be shown either as 'other income' or as a negative expense.

Discounts received do not affect the total figure for purchases in the period, or the total cost of sales. In this respect they differ from purchase returns, which do reduce total purchase costs.

- Discounts received are accounted for as an addition to profit in the period.
- They are not accounted for as a deduction from purchase costs.

Example: Discount received

Adeola has sold goods to Benjamin for ₦80,000.

Adeola offers a 3% settlement discount if payment is made within 20 days. Benjamin pays in 19 days.

Benjamin would record the transaction as follows:

	Debit	Credit
At date of purchase:		
Purchase	80,000	
Trade payables		80,000
At date of payment		
Trade payables	80,000	
Bank (cash paid = 97% of 80,000)		77,600
Discount received (discount taken by us = 3% of 80,000)		2,400

Discounts received and the payables ledgers

Discounts received are recorded in the individual supplier accounts in the payables ledger.

4.4.5 Payables control account

The payables ledger control account is the name given to the account in the general ledger for total trade payables.

Opening payables balance

The opening balance in the payables ledger control account is a credit balance, because amounts payable are liabilities.

The payables ledger control account records all transactions involving credit purchases. Since business entities make most of their purchases on credit, the control account records virtually all purchases.

- Credit entries in the payables control account are transactions that add to the total amount of payables.
- Debit entries in the payables ledger control account are transactions that reduce the total amount of payables.

The balance on the payables control account might be described as trade payables on the face of the statement of financial position.

Illustration: Double entries into payables control account

Payables control account

Debit side (Dr)		Credit side (Cr)	
Purchase returns	X	Balance b/d	X
Payments to suppliers	X	Purchases	X
Discounts received for early payment	X		
Contra entries (explained later in this chapter)	X		
Balance c/d	X		
	X		X
		Balance	X

4.4.6 Contra entries

A business might sell goods or services to another business, and also buy goods or services from that same business.

The other business is both a customer and a supplier, and might therefore be a receivable and a trade payable at the same time. When this happens, the two businesses might agree to offset the amounts that they owe each other, leaving a net amount payable by the business with the higher debt.

A contra entry is a double entry that offsets one amount against another.

Contra entries must be made in the general ledger and also the receivables and payables ledgers.

Illustration: Contra entry

Sales on credit	Debit	Credit
General ledger:		
Payables control account	X	
Receivables control account		X
Receivables ledger:		
Individual customer account		X
Payables ledger:		
Individual customer account	X	

	Debit	Credit
General ledger	₦	₦
Payables control account	50,000	
Receivables control account		50,000
(This reduces the balance on both accounts)		
Receivables ledger:		
Z's account (owed by Z)		50,000
Payables ledger:		
Z's account (owed to Z)	50,000	

4.4.7 Terminology

This chapter uses certain terminology to explain how purchases are accounted for. It is important to note that different terms may be used to describe the same concepts.-

Purchases daybook

Purchases journal

Used in this chapter

Common alternative

Payables ledger

Creditors
ledger,

Purchases
ledger

Payables control account

Payables ledger control account
Purchases ledger control
account Total purchases control
account Creditor control account
Account payable control account
Bought ledger adjustment
account

Imprest system

A commonly used petty cash system is the **imprest system**. Under this system, a fixed amount (for example, ₦100,000) is established as the **imprest**.

At any given time, the sum of the petty cash balance and the total of invoices and petty cash vouchers should equal the imprest amount. Periodically, the supporting documents (invoices and vouchers) are removed, and an equivalent amount of cash is replenished to restore the imprest balance in cash.

Example: Imprest system

A business operates a petty cash system using the imprest method, with the imprest amount set at ₦10,000.

At the beginning of the month, there is ₦10,000 in cash in the petty cash tin.

During the month, ₦600 was paid to Lydia as reimbursement for a payment she made on behalf of the business.

After this transaction, the petty cash tin will contain ₦9,400 in cash and a petty cash voucher or invoice from Lydia for ₦600.

The total of the cash on hand (₦9,400) and the voucher (₦600) equals the imprest amount of ₦10,000.

4.5 Accounting For Cash

4.5.1 The cashbook

The cash book is often a book of prime entry. It is used to record receipts and payments of cash into the business bank account.

The cash book has two sides, a side for receipts of money and a side for

payments. Both sides have a number of columns so that cash receipts and payments can be analysed to make it easier to construct journals for double entry.

A business can analyse the amounts received and paid in any way it chooses.

Cash receipts

Cash from cash sales is banked on a regular basis. It is entered as a cash receipt in the cash book when it has been banked.

Cash might be received from a credit customer in a number of ways. Usually payment is made by cheque or by bank transfer. Payments by cheques must be banked on a regular basis. When a cheque is received it is entered into the cash book as a cash receipt.

On a periodic basis the receipts side of the cash book is summed and totals posted to the general ledger. Amounts received from credit customers are also recognised in the customer's personal account in the receivables ledger must also be adjusted.

Some businesses may include ~~might choose to use~~ a column in the cash receipts side of the cash book to record revenue adjustments for settlement discount taken by customers, even when such discounts were not anticipated that it would be. Although these discounts do not represent actual cash receipts, they may be recorded in this section to help the business keep track of them. This type of entry is referred to as a memorandum (reminder) record.

A simplified example of the **cash receipts side** of the cash book is shown below.

Illustration: Cash receipts

	Total	Receivables	Other receipts	Revenue adjustment (memoonly)
	₦	₦	₦	₦
SmithCompany	28,500	28,500		1,500
KBrown	5,000	5,000		
Banking from Cashesale	1,000		1,000	
Dividend	5,000		5,000	
CCropper	57,000	57,000		3,000
VBIndustries	87,000	87,000	-	
	183,500	177,500	6,000	4,500

A journal can easily be constructed to affect the double entry

	Debit	Credit
	₦	₦
Bank	183,500	
Receivables control account		177,500
Sale		1,000
Dividend income		5,000

And

Discounts allowed	4,500	
Receivables control account		4,500

The cash received from individual customers and any the discounts allowed to individual customers must be credited to their respective individual accounts in the receivables ledger.

4.5.2 Cash payments

Cash payments are recorded in a similar way to cash receipts. Payments are recorded in both the general ledger and (if the payment is to a supplier) in the account of the supplier in the payables ledger.

A business might choose to record discounts received in a memorandum column in the cash book.

A simplified example of the cash payments side of the cash book is shown below.

Illustration: Cashpayments

	Total	Payables	Expenses	Discount received
	₤	₤	₤	₤
KPT Supplies	59,000	59,000		1,000
Duck Company	86,000	86,000		
Rent	74,500		74,500	
Fast Supplies	2,200	2,200	-	
	221,700	147,200	74,500	1,000

	Debit	Credit
	₤	₤
Payables control account	147,200	
Expenses	74,500	
Bank		221,700

And

Payables control account	1,000	
Discounts received		1,000

The cash paid to individual suppliers and the discounts received from individual suppliers will be debited to their individual accounts in the payables ledger.

There is a diagram showing an overview of this system together at the end of this chapter.

4.6 Petty Cash

4.6.1 Definition of petty cash

Petty cash is cash (notes and coins) held by a business to pay for small items of expense, in situations where it is more convenient to pay in notes and coin than to pay through the bank account. Petty cash might be used, for example, to pay for bus fares, taxi fares, tea and coffee for the office, and so on.

Recording petty cash transactions

When petty cash transactions take place, the entity needs to record both an expense, and a reduction in the asset "petty cash".

These entries are made in the main ledger accounts as follows:

Illustration x	Debi	Credit
Office expenses	X	
Petty cash		X

Although the amounts involved in petty cash are usually small, it is one of the easiest assets to be stolen or "lost".

Responsibility for managing petty cash is typically assigned to an accounts clerk. The accounts clerk will maintain a balance of petty cash in a lockable tin and will pay out cash presentation of either an invoice for an already amount spent or a signed a ~~note~~ (petty cash voucher) acknowledging of cash. The accounts clerk will also maintains a petty cash book, which serves as a book of prime entry. This book is periodically summarised and posted to the general ledger

4.7 Value Added Tax (VAT)

4.7.1 Nature and Concept of VAT

Value Added Tax (VAT) is a consumption tax levied on the value added to goods and services at each stage of production and distribution. It is ultimately borne by the final consumer, but collected and remitted by businesses acting as agents for the government.

Key Concepts of VAT

Businesses registered for VAT act as government agents for collecting and remitting VAT.

VAT is charged on both purchases and sales of VATable goods and services.

VAT on purchases is termed input VAT, while VAT on sales is output VAT. Sales and purchases are reported, excluding VAT in the financial statements.

If output VAT exceeds input VAT, the difference is payable to the tax authorities. Conversely, if input VAT exceeds output VAT, the business is entitled to a refund or can carry it forward to offset future VAT.

Most goods and services are VATable unless specifically exempted or zero-rated.

The current VAT rate in Nigeria is 7.5%.

4.7.2 Calculating VAT on Business Transactions

VAT may be shown separately on invoices. If not, calculations are required:

1. VAT Included in Price

If a price is inclusive of VAT (7.5%), use the formula:

$$\text{VAT} = (7.5 / 107.5) \times \text{Total Amount}$$

2. VAT Exclusive Price

If a price is exclusive of VAT, use:

$$\text{VAT} = 7.5\% \times \text{Net Amount}$$

Illustration 1: Purchases

Kuti Enterprises bought the following inventories on credit:

i) Inventory costing ₦946,000 inclusive of VAT

ii) Inventory costing ₦960,000 exclusive of VAT

VAT Rate = 7.5%

Solution

i) Input VAT = $(7.5 / 107.5) \times \text{₦}946,000 = \text{₦}66,000$

ii) Input VAT = $7.5\% \times \text{₦}960,000 = \text{₦}72,000$

Illustration 2: Sales

Kuti Enterprises sold the above inventories on credit (VAT-inclusive):

- i. Inventory 1: ₦1,176,000
- ii. Inventory 2: ₦1,247,000

Solution

- i. Output VAT = $(7.5 / 107.5) \times ₦1,176,000 = ₦82,000$
- ii. Output VAT = $(7.5 / 107.5) \times ₦1,247,000 = ₦87,000$

4.7.3 Accounting Entries for VAT

Since both purchases and sales are reported net of VAT, the entries are:

On Purchases

	Debit (₦)	Credit (₦)
Dr Purchases (net of VAT)	X	
Dr VAT (Input VAT)	X	
Cr Payables or Bank (Gross Amount)		X

Application to Kuti Enterprises

	Debit (₦)	Credit (₦)
Dr Purchases	1,906,000	
Dr VAT	138,000	
Cr Payables		2,044,000

On Sales

	Debit (₦)	Credit (₦)
Dr Receivables or Bank (Gross Amount)	X	
Cr Sales (Net of VAT)		X
Cr VAT (Output VAT)		X

Application to Kuti Enterprises

	Debit (₦)	Credit (₦)
Dr Receivables	2,592,000	
Cr Sales (Net of VAT)		2,423,000
Cr VAT (Output VAT)		169,000

4.7.4 Ledger Entries**Purchases Account**

Particulars	Debit (₦)	Credit (₦)
Payables – Inv. 1		946,000
Payables – Inv. 2		960,000

Payables Account

Particulars	Debit (₦)	Credit (₦)
Purchases – Inv. 1	946,000	
Purchases – Inv. 2	960,000	

Particulars	Debit (₦)	Credit (₦)
VAT – Inv. 1		66,000
VAT – Inv. 2		72,000

Sales Account

Particulars	Debit (₦)	Credit (₦)
Receivables – Inv. 1		1,176,000
Receivables – Inv. 2		1,247,000

Receivables Account

Particulars	Debit (₦)	Credit (₦)
Sales – Inv. 1	1,176,000	
Sales – Inv. 2	1,247,000	
VAT – Inv. 1	82,000	
VAT – Inv. 2	87,000	

VAT Account

Particulars	Debit (₦)	Credit (₦)
Payables – Inv. 1	66,000	
Payables – Inv. 2	72,000	
Receivables – Inv. 1		82,000
Receivables – Inv. 2		87,000
Balance c/d	31,000	
Total	169,000	169,000
Balance b/d		31,000

Amount Due to Tax Authorities = ₦31,000

4.7.5 Zero-Rated vs VAT-Exempt Goods

Zero-Rated Goods

Taxable, but at a rate of 0%.

Input VAT can be claimed as a credit.

Examples: exports, some medical supplies, educational materials

Illustration: Reign Ltd (Exports)

Export sales = ₦10,000,000 (0% VAT)

Purchases = ₦3,225,000 (includes ₦225,000 VAT)

Accounting Entries:

	Debit (₦)	Credit (₦)
Dr Purchases	3,000,000	
Dr VAT (Input VAT)	225,000	
Cr Payables		3,225,000
Dr Receivables	10,000,000	
Cr Sales		10,000,000
Cr VAT		0

Result: Reign Ltd can claim ₦225,000 as input VAT.

Not subject to VAT.
Input VAT **cannot be claimed**.
VAT on purchases becomes part of cost.
Examples: education, financial services, charities.

Illustration: Bright Hope (Education)

Revenue: ₦10,000,000 (VAT exempt)

Purchases: ₦2,150,000 (includes ₦150,000 VAT)

Accounting Entries:

	Debit (₦)	Credit (₦)
Dr Purchases	2,000,000	
Dr VAT (Input VAT)	150,000	
Cr Payables		2,150,000

Dr Receivables	10,000,000	
Cr Sales		10,000,000

Result: Bright Hope **cannot claim** the ₦150,000 input VAT; it is added to expense.

4.8 Banking Procedures And Documentation

4.8.1 Introduction

Banking systems and services have transformed how entities manage their finances by offering convenience, accessibility, and security.

a. Components of the Banking System

The banking system comprises three primary components:

- i. Commercial Banks – These institutions provide essential financial services such as savings accounts, loans, and credit facilities, catering to individuals and businesses.
- ii. Central Banks – They regulate the money supply and oversee monetary policy to ensure the stability of the financial system.
- iii. Non-Banking Financial Institutions – These specialise in services like investments and insurance, complementing those offered by commercial banks.

b. Benefits of Banking Services

Modern banking services have evolved to provide enhanced convenience, accessibility, and security. Key services include:

- i. Online Banking – enables customers to manage accounts, transfer funds, pay bills, and track transactions remotely.
- ii. Mobile Banking – allows users to perform banking transactions via mobile apps.
- iii. Digital Payment Systems – platforms like NEFT, RTGS, and UPI facilitate fast and secure fund transfers.

Customers can also apply for loans and credit cards, and access various investment and insurance products through digital or physical channels.

Additional benefits include:

- i. 24/7 account access
- ii. remote financial management
- iii. enhanced security through encryption and two-factor authentication
- iv. improved efficiency and productivity in financial operations

Technological advancements continue to reshape the banking industry. For instance:

- i. AI-powered financial assistants offer personalised financial insights.
- ii. Banking as a Service (BaaS) enables partnerships between banks and fintech firms.
- iii. Core Banking Systems support the management of accounts, transactions, and risk.

These developments are making financial services more efficient, secure, and customer-centric.

c. Types of Bank Accounts

- i. Current (demand deposit) account
- ii. Interest-bearing accounts

d. Current (demand deposit) account

A current account is designed for individuals or businesses that handle frequent and high-volume financial transactions.

4.8.2 Key features of a current account include:

- a. unlimited Transactions – No cap on daily deposits or withdrawals.
- b. overdraft facility – allows withdrawals beyond the account balance, offering liquidity and flexibility.
- c. no interest – balances typically do not earn interest.
- d. minimum balance – usually higher than for savings accounts, varies by bank.
- e. cheque and debit card facilities – for making payments and accessing funds.
- f. online and mobile banking – for efficient account management.
- g. direct debits and third-party payments – useful for business financial operations.

a. Bank statements

At regular intervals, usually monthly, the bank sends a statement of account to customers. This includes:

- i. cash deposits (lodgements)
- ii. cheque and electronic payments
- iii. bank charges
- iv. direct transfers and dividend warrants received on behalf of the customer

b. Opening a current account

To open a current account, a reporting entity must provide the following:

- i. a written application specifying the type and purpose of the account
- ii. two or more reference letters from current account holders
- iii. completed mandate cards
- iv. specimen signatures of authorised signatories (used for cheque verification)
- v. two or more passport-sized photographs
- vi. for companies: Copy of the Memorandum and Articles of Association; for partnerships: deed of partnership; for unincorporated bodies: constitution
- vii. extract of minutes of the meeting approving the opening of the account
- viii. an initial deposit as required by the bank
- ix. evidence of tax compliance (For example, recent tax returns)
- x. Bank Verification Number (BVN)
- xi. identity proof (For example, driver's license or national ID card) of authorized signatories
- xii. proof of address for the entity (For example, certificate of incorporation, lease agreement, or utility bill)

c. Cheques

A cheque is a written order directing a bank to pay a specified amount from the account holder's funds to a named individual or bearer.

i. Key features of a cheque

- Payee's name – indicates who should receive the payment
- Drawer's signature – authorises the payment
- Date of issue – establishes when the cheque becomes valid
- Amount to be paid – clearly written in both figures and words to ensure accuracy

ii. Types of cheques

- Bearer Cheque – payable to whoever presents the cheque
- Order Cheque – payable only to the person or organisation named on the cheque
- Crossed Cheque – must be deposited into the payee's bank account and cannot be encashed directly
- Open Cheque – can be encashed over the counter or deposited into a bank account

iii. Benefits of using cheques

- Record-keeping – creates a paper trail for accountability

- Security – can be cancelled or stopped if lost or stolen
- Control – enables the drawer to determine the exact amount and payee

iv. Common uses of cheques

- Business-to-business transactions
- Large payments such as rent or security deposits
- Formal or ceremonial payments, such as donations or grants

v Digital alternatives

Although cheques remain in use, digital payment systems are increasingly preferred for their speed, security, and convenience.

vi. Dishonoured cheques

A dishonoured cheque is one that a bank refuses to pay. This situation can create inconvenience and financial strain for the payee.

vii. Common Reasons for Dishonour

- Insufficient funds in the drawer's account
- Signature mismatch with the bank's records
- Stale cheque – Presented after its validity period (usually 3–6 months)
- Post-dated cheque – Presented before the date written on it
- Closed or frozen account
- Stop payment instruction issued by the drawer

viii. Consequences of Dishonoured Cheques

- Financial inconvenience for the payee
- Bank penalties or charges for the drawer
- Negative impact on the drawer's credit reputation
- Possible legal action by the payee in serious or repeated cases

ix. Preventive Measures

- Ensure sufficient funds in the account before issuing cheques
- Verify cheque details (date, amount, signature) before issuance
- Communicate proactively with the payee in case of issues
- Avoid issuing post-dated or stale cheques unless clearly agreed upon
- Responsible cheque handling protects both the drawer's financial standing and business reputation.

d. Pay-in slips

A pay-in slip is a form used to deposit cash or cheques into a bank account. It is usually issued by the bank and completed by the depositor.

a. Key features of a pay-in slip

- Date of deposit
- Bank and branch where the deposit is being made
- Account number of the recipient
- Depositor's details – Name, address, and signature
- Amount deposited – Stated in both figures and words
- Payment method – Indicates whether deposit is by cash or cheque
- Cheque details – If applicable: cheque number, date, and amount

Note: Cheque details are typically recorded on the reverse side of the slip. The bank teller signs and returns a duplicate copy to the depositor as proof of deposit. This serves as documentation and can be reconciled with the entity's cash book.

b. Digital alternatives

With increasing digitisation, pay-in slips are gradually being replaced by mobile banking, automated teller machines (ATMs), and online banking platforms, which allow customers to deposit funds without paperwork.

4.8.3 Interest-bearing accounts

Interest-bearing accounts are deposit accounts that earn interest on the funds held, allowing account holders to grow their savings over time. These accounts are typically low-risk, making them ideal for individuals seeking capital preservation while earning returns. Additionally, many interest-bearing accounts offer liquidity, enabling access to funds when needed. They can also be used to diversify investment portfolios by spreading risk and increasing potential returns.

a. Types of interest-bearing accounts

There are several types of interest-bearing accounts, each with distinct feature and benefits. These include:

b. Savings accounts

A savings account is a deposit account that provides modest interest rates and allows easy access to funds. It is ideal for individuals who want to save while retaining liquidity.

i. Key Features:

- Enables easy withdrawal of funds when needed.
- Typically, does not provide overdraft facilities.
- Withdrawals often require physical presence at the bank.
- References are generally not required, unless the account will receive cheques (e.g., salary accounts).
- Transactions are done using pay-in slips and withdrawal forms.
- Funds are not tied to a fixed term, providing flexibility.

c. Term Deposits

Term deposits involve placing a fixed sum of money with a bank for a predetermined period at a fixed interest rate.

These include:

- Fixed Deposits (FDs): Offer fixed interest rates over specified periods, generally higher than savings accounts.
- Certificates of Deposit (CDs): Similar to FDs, with fixed rates and maturity dates, commonly issued in negotiable form.

d. Common Features of Term Deposits:

- Funds are locked in for a fixed term.
- Higher interest rates compared to savings accounts.
- Low risk investment vehicle for capital preservation.
- Repayable on maturity, with an option to roll over on written request.
- Usually, no references required for opening.
- Bank statements are generally not issued; details are communicated at maturity or on request.
- Term deposits are ideal for individuals or businesses saving for specific goals or fixed-term needs, offering stability and guaranteed returns.

4.8.4 Effective cash handling, storage, and security

Proper handling, storage, and security of cash are essential for minimising risks such as theft, fraud, and errors. The following strategies help safeguard financial resources:

a. Cash Handling

- Establish and regularly update cash handling policies, including guidelines for receiving, counting, storing, and depositing money.
- Implement segregation of duties by assigning different individuals to various aspects of cash management to prevent fraud.

- Encourage electronic payments and limit the amount of cash retained in tills or offices.
- Use secure bags or containers for transporting cash, and always verify the identity of those handling cash.

b. Cash Storage

Effective storage protects against loss, damage, and theft.

- Use appropriate safes, considering fire resistance, size, and durability.
- Employ point-of-sale (POS) and back-office safes for excess cash.
- Conduct regular audits and reconciliations to detect discrepancies.
- Store cash in dry, secure areas, free from environmental hazards.

c. Cash Security

Strong security protocols are essential to prevent unauthorised access and fraud.

- Restrict access to cash storage areas to authorised personnel only.
- Regularly update safe combinations and PIN codes.
- Install CCTV cameras, alarms, and, where necessary, employ security personnel.
- Train employees on cash handling procedures, security practices, and how to detect suspicious behaviour.
- Use tools such as counterfeit detection devices and transaction monitoring systems.
- Perform frequent reconciliations between physical cash, receipts, and deposit records to ensure accountability.

4.8.5 Inter-bank transfers

Introduction

Inter-bank transfers refer to the movement of funds from one bank account to another when the sender and the recipient maintain accounts in different banks. These transfers are common in today's digital economy, where individuals and businesses frequently transfer funds across different financial institutions. Inter-bank transfers are facilitated through various channels, including ATMs, electronic fund transfers (EFT), debit cards, and credit cards. These methods provide convenient, efficient, and secure means to transfer funds across banks and geographical boundaries.

a. Channels for inter-bank transfers

Automated teller machines (ATMs)

An Automated Teller Machine (ATM) is a self-service terminal that enables bank customers to access their funds and perform basic banking functions without interacting with a bank cashier. With an ATM, customers can:

- Withdraw cash
- Check account balances
- Transfer funds between accounts
- Initiate inter-bank transfers

To conduct an inter-bank transfer using an ATM, customers typically:

- Insert their ATM cards
- Enter their Personal Identification Numbers (PINs)
- Select the 'Transfer' option
- Enter the recipients' bank details and the amount to be transferred

b. Electronic fund transfers (EFTs)

Electronic Fund Transfers (EFTs) enable the electronic movement of money from one bank account to another without using physical cash or cheques. EFTs can be initiated:

- Via online banking platforms
- Through mobile banking apps
- At bank branches

To complete an EFT, the sender must provide recipient's:

- full name
- Bank name
- Account number
- Bank verification details (such as routing or sort code)

Funds are typically credited to the recipient's account within a defined timeframe, depending on the system used (for example, NEFT, RTGS, or UPI).

4.8.6 Debit cards

A debit card allows customers to make payments or transfer funds directly from their bank accounts. Inter-bank transfers using debit cards may occur:

- During Point-of-Sale (POS) transactions
- Through mobile apps and online banking platforms
- At ATMs

The transaction is processed electronically, and the corresponding amount is immediately debited from the account holder's bank account. Debit cards are useful for real-time fund transfers and payments.

b. Credit cards

Credit cards enable users to borrow money from the issuing bank or financial institution to make payments or, in some cases, to transfer funds. When used for inter-bank transfers, credit cards:

- Provide instant credit
- Require repayment, often with interest and service fees
- May attract additional transaction charges and have limits

Due to the costs and restrictions, credit cards are less commonly used for direct inter-bank transfers, except in special circumstances.

c. Key differences between debit cards and credit cards

Feature	Debit Card	Credit Card
Source of Funds	Linked to the customer's bank account; funds are deducted instantly.	Borrowed from the card issuer; repayment is required.
Interest Charges	None, since the cardholder uses their own funds.	May incur interest, if the balance is not paid in full by the due date.
Debt Risk	No risk of debt beyond the available account balance.	High risk of accumulating debt if not managed responsibly.
Fraud Protection	Generally, less robust; may be liable for unauthorised use, if not reported quickly.	Typically, stronger protections; many issuers offer zero-liability policies.
Additional Benefits	Basic banking convenience.	May include rewards, cashback, and travel perks.

d. Conclusion

Inter-bank transfers play a vital role in modern financial systems, offering secure and efficient methods for moving funds across institutions. Understanding the various channels, ATMs, EFTs, debit cards, and credit cards, as well as their advantages and limitations, enables individuals and organisations to choose the most appropriate transfer method for their needs.

4.9 Chapter review

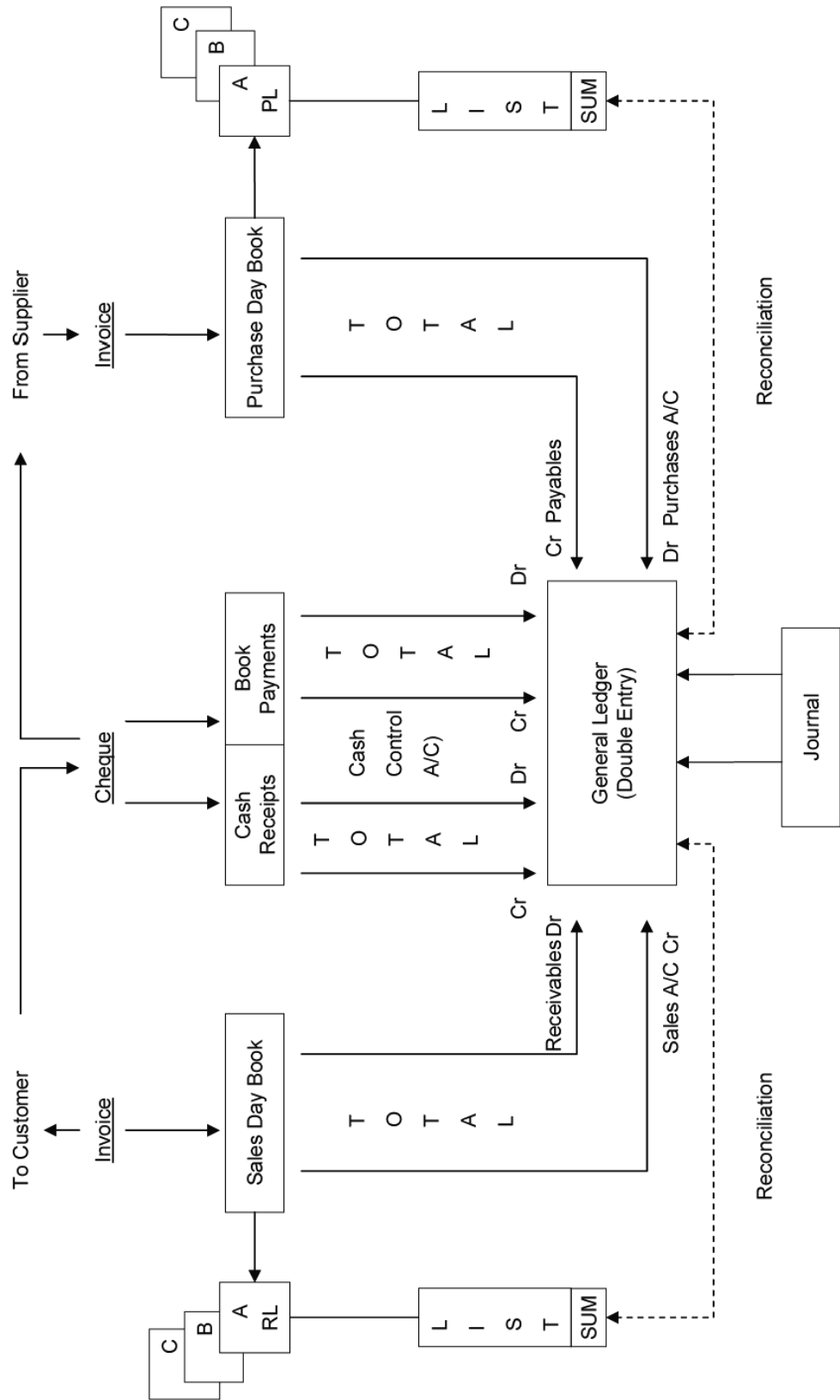
Chapter review

Before moving on to the next chapter, check that you are now able to:

- explain the role of books of prime entry;
- describe the basic contents of the sales day book and the customer/debtors ledger;
- record transactions in the sales day book and the customer/debtors ledger;
- account for discounts allowed;
- describe the basic contents of the purchase journal and the purchase ledger/creditors ledger;
- record transactions in the purchase journal and purchase ledger/creditors ledger;
- account for discounts received;
- account for value added tax (VAT);
- explain the methods of fund transfer, including handling, storing and security of monies; and
- Explain the uses of debit and credit cards.

Illustration: Overview

Books of Prime Entry – The System



4.10. End of chapter questions and suggested solutions

Question 1

Nwachukwu Ventures, a company engaged in food processing, is currently undertaking a reconciliation exercise to align the payables and receivables ledger control account balances of ₦218,320,000 and ₦172,120,000 respectively with the total of the balances on the individual accounts in the payables and receivables ledgers, which stand at ₦197,660,000 and ₦156,134,000 respectively for the month of March 2019. The following discrepancies were detected

- i. Cash received of ₦1,070,000 was debited to the customer's account.
- ii. Discount received of ₦17,150,000 was not entered in the control account but has been entered in the individual ledger accounts.
- iii. On listing-out a supplier's credit balance of ₦2,050,000 was treated as a debit.
- iv. A ₦2,555,000 cheque from a customer was 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 customer's account as ₦233,000.
- vii. Purchases day book was undercast by ₦20,000,000.
- viii. Total credit sales of ₦4,500,000 to an accountancy firm, Emma 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 of ₦120,000 were not entered in the control account.

Required:

- a. Prepare the trade payable ledger control account and reconcile it to the sum total of individual accounts.
- b. Prepare the trade receivable ledger control account and reconcile it to the sum total of individual accounts.

Solution to control account

a. Receivables account

i. Receivables ledger control account

	₦'000		₦'000
Balance b/f	172,120	Payables set off-(contra)	20,040
Credit sales	4,500	Discount allowed	120
		Balance c/f	156,460
	176,620		176,620
Balance b/f	156,460		

ii. Reconciling receivable ledger balances with the control account balance

	₦'000	₦'000
Balance as per accounts receivables ledger		156,134
Cheque dishonoured omitted from the customer's account		2,555
Understatement of the amount paid by a customer	322,000 - 233,000	(89)
Cash received from a customer incorrectly debited to his account	1, 070 x 2	(2,140)
Balance as per adjusted receivables control account		<u>156,460</u>

b. Payables account

i. Payables ledger control account

	₦'000		₦'000
Discount received	17,150	Balance b/f	218,320
Receivables control	20,040	Purchases	20,000
Balance c/f	<u>201,130</u>		<u>176,620</u>
	<u>238,130</u>		<u>238,130</u>
		Balance b/f	201,130

ii. Reconciling receivable ledger balances with the control account balance

	₦'000	₦'000
Balance as per accounts payable ledger		197,660
Credit balance incorrectly treated as debit	2 x 2,050	4,100
Petty cash payment to supplier not recorded		(630)
Balance as per adjusted receivables control account		<u>201,130</u>

Question 2

Adeola Enterprises made the following credit sales in the first week of May:

Date	Customer	Invoice No.	Amount (₦)
May 1	Olu Ltd	INV001	120,000
May 3	Tobi Ltd	INV002	85,000
May 6	Kemi Ltd	INV003	95,000

All transactions are subject to a 2% settlement discount if payment is received within 10 days.

Required:

- Enter these transactions into a sales day book.
- Post the relevant entries to the receivables (debtors) ledger and general ledger (showing

necessary double entries).

Suggested solution

2a Adeola Enterprises – Sales Day Book (Week 1 of May)

Date	Customer	Invoice No.	Amount (₦)	Discount Terms
May 1	Olu Ltd	INV001	120,000	2% if paid within 10 days
May 3	Tobi Ltd	INV002	85,000	2% if paid within 10 days
May 6	Kemi Ltd	INV003	95,000	2% if paid within 10 days
Total			300,000	

Note: Sales Day Book only records credit sales; discount is not recognised here until taken.

2b Receivables Ledger (Individual Customer Accounts)

Olu Ltd Account:

- May 1 – To Sales A/C – ~~₦~~120,000

Tobi Ltd Account:

- May 3 – To Sales A/C – ~~₦~~85,000

Kemi Ltd Account:

- May 6 – To Sales A/C – ~~₦~~95,000

General Ledger Entries

Double Entry for Credit Sales:

Date	Account	Debit (₦)	Credit (₦)
May 7	Receivables Control A/C	300,000	
	Sales A/C		300,000

Narration: Being posting of credit sales from sales day book for the first week of May.

Explanation:

- The Sales Day Book totals are posted to the Sales Account (Credit) and the Receivables Control Account (Debit).
- Each individual invoice is posted to the debit of the respective customer's receivables ledger account.

Question 3

Rehoboth Enterprises is registered for VAT and deals in a mix of taxable and VAT-exempt goods. It recently made the following transactions in a given month:

purchased raw materials for ~~₦~~5,375,000 inclusive of ~~₦~~375,000 VAT.

sold taxable goods for ~~₦~~7,526,000 inclusive of VAT.

sold educational materials (VAT-exempt) for ~~₦~~2,000,000.

purchased educational textbooks worth ~~₦~~1,505,000 inclusive of ~~₦~~105,000 VAT.

Required:

- Identify which input VAT can be claimed and which cannot.
- Calculate the VAT payable for the period.
- Explain the VAT treatment of the educational services and the implications for input VAT

on the textbook purchase.

Suggested solution

Given Transactions:

Transaction	Amount (₦)	VAT Treatment
Purchased raw materials	5,375,000	Inclusive of ~~₦~~ 375,000 VAT
Sold taxable goods	7,526,000	Inclusive of 7.5% VAT
Sold educational materials (VAT-exempt)	2,000,000	No VAT
Purchased educational textbooks	1,505,000	Inclusive of ~~₦~~ 105,000 VAT

- (a) Identify which input VAT can be claimed and which cannot
- Claimable Input VAT:
~~₦~~375,000 from the purchase of raw materials (used for taxable goods)
 - Non-claimable Input VAT:
~~₦~~105,000 on purchase of educational textbooks (related to VAT-exempt supplies)

Explanation: Input VAT is only claimable when incurred on purchases related to taxable (VATable) sales. For VAT-exempt activities, the input VAT is not claimable and is instead treated as part of the cost of the goods or services.

- (b) Calculate the VAT payable for the period
- Step 1: Extract output VAT from taxable sales
- Use the formula:

$$\text{VAT} = \frac{7.5}{107.5} \times \text{₦}7,526,000 = \text{₦}525,000$$

Step 2: VAT Payable

$$\text{VAT Payable} = \text{Output VAT} - \text{Claimable Input VAT} = \text{₦}525,000 - \text{₦}375,000 = \text{₦}150,000$$

- (c) Explain the VAT treatment of the educational services and the implications for input VAT on the textbook purchase
- Educational services and educational materials are VAT-exempt, meaning no VAT is charged on their sales.

Consequently, input VAT on related purchases (e.g., textbooks) is not recoverable.

The ~~₦~~105,000 input VAT on textbooks must be added to the cost of the educational materials and expensed or capitalized depending on use.

Implication: This reduces the profitability of exempt activities since the business cannot offset input VAT against output VAT.

Summary:

- Claimable Input VAT: ~~₦~~375,000
- Non-claimable Input VAT: ~~₦~~105,000
- Output VAT: ~~₦~~525,000
- VAT Payable: ~~₦~~150,000
- Educational services: VAT-exempt; input VAT on textbooks not recoverable

NON-CURRENT ASSETS AND DEPRECIATION

Contents

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5 Non-current assets and depreciation

5.0 Learning objectives

This chapter explains the accounting rules for property, plant and equipment and intangible assets. It covers the principles and procedures for recognising, measuring, depreciating, and disposing of property, plant and equipment, including the treatment of asset impairment.

5.1 Learning outcomes

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

- a. identify the cost components of an item of property, plant and equipment (PPE)
- b. calculate depreciation expense using both the straight line and reducing balance methods
- c. record and account for depreciation expense in the financial records
- d. post journal entries to recognise depreciation expense
- e. compute profit or loss on the disposal of an item of property, plant and equipment
- f. record the accounting entries for the of Account for profit (loss) disposal of an item of property, plant and equipment, including any resulting gain or loss.
- g. prepare Construct a simple basic property, plant and equipment note to the financial statements
- h. adjust financial statements for revaluation gains or losses on property, plant and equipment
- i. identify and account for different types of intangible assets
- j. explain the nature and indicators of asset impairment, measure the impairment loss, and record the necessary accounting entries.

5.3 Non-Current Assets

5.3.1 Introduction

The assets of a business are classified as current assets or non-current assets.

IAS 1 (**Presentation of financial statements**) defines current assets and then states that all other assets should be classified as non-current assets.

Current assets include, cash, receivables, prepayments (see chapter 6) and inventory. They are all items that will be used or recovered in the short term.

A **non-current asset** is an asset which is used by the business over a number of years.

Non-current assets may be:

- a. **Tangible non-current assets.** These are physical assets, such as property (land and buildings), plant and equipment (including motor vehicles); or
- b. **Intangible non-current assets.** These are assets that do not have a physical existence such as patent rights.

5.3.2 IAS16: Property, plant and equipment

Rules on accounting for property, plant and equipment are contained in **IAS 16** *Property, plant and equipment*.

Definitions

Property, plant and equipment are tangible items that:

- a. Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- b. Are expected to be used during more than one period.

Initial measurement

Property, plant and equipment are initially recorded in the accounts of a business at their cost.

Definition

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

The cost of an item of property, plant and machinery consists of:

- a. its purchase price after any trade discount has been deducted, plus any import taxes or *non-refundable* sales tax; plus
- b. 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' (IAS 16 **Property, plant and machinery**). These directly attributable costs may include:
 - employee costs arising directly from the installation or construction of the asset;
 - the cost of site preparation;
 - delivery costs ('carriage inwards');
 - installation and assembly costs;
 - testing costs; and
 - professional fees directly attributable to the purchase.

A question might provide information about the installation cost of an asset. This is capitalised as part of the cost of the asset.

Example: Cost

A company has purchased large item of plant.
The following costs were incurred.

	₦
List price of the machine	1,000,000
Trade discount given to company	50,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
Administration expense	150,000

	₦
Purchase price of the machine (1,000,000 – 50,000)	950,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
	1,390,000

5.3.3 Capital and revenue items: capital and revenue expenditure

The difference between capital and revenue items, and between capital and revenue expenditure was explained in an earlier chapter.

Improvements are capitalised

Expenditure on a non-current asset after acquisition is treated as capital expenditure when it represents an improvement. This is added to the cost of the original asset.

Repairs

- a. Ongoing day-to-day repairs and maintenance: Expenditure on a non-current asset after acquisition is treated as revenue expenditure when it is incurred to make minor repairs that restore the asset to its original functionality.
- b. Major repairs and overhauls: Some assets, by their nature, might require major periodic repairs or overhaul. These costs are capital in nature and are capitalised. For example, an aircraft might need a major periodic engine service/overhaul. The cost of such an overhaul would be capitalised.

Advance payments

A business might make an advance payment towards a non-current asset.

This is recognised as a receivable known as an advance. It represents the right that the business has to receive an asset (or part of one) at some time in the future.

Illustration: Advance payments

	Debit	Credit
Receivable – Advance	X	
Cash (bank)		X

Advances are not depreciated. An advance will become part of the cost of an asset when it is purchased.

Illustration: Treatment of advance when asset is purchased

	Debit	Credit
Cost of the asset	X	
Receivable – Advance		X

The definition of 'cost' for property, plant and equipment has close similarities with the cost of inventories, although property, plant and equipment will often include more items of 'other expense' within cost.

For example when a business entity acquires a new building the cost of the building might include professional fees such as the fees for an architect and surveyor.

Costs are no longer recognised when the item is ready for use. This is when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

5.3.4 Depreciation and non-current assets

A business invests in assets in order to generate profit.

The accruals concept results in the recognition of revenue and the cost of earning that revenue in the statement of profit or loss in the same accounting period.

This is relatively straight forward for costs. For example, rent for a period enables a business to use premises that are used to make profit. The rent is charged to statement of profit or loss.

Examples: Recognition of costs in the statement of profit or loss

Rental expense Rental payments due in a period enable a business to use premises that are used to make profit.

The rent is charged to the statement of profit or loss.

Energy expense Energy used in a period enables a business to make profit. Energy is charged to the statement of profit or loss.

Inventory Items sold in the period are recognised in the statement of profit or loss at the same time as the revenue from selling those items.

Expenditure on non-current assets is also incurred to enable a business to generate a profit. A non-current asset will help a business generate profit over several accounting periods. The cost of the benefit received from the use of such an asset must be recognised in the statement of profit or loss in the same period that the benefit is recognised.

Depreciation

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 recognises the full cost associated with a non-current asset over the entire period that the asset is used. In effect, the cost of the asset is transferred to the statement of profit or loss over the life of the asset. This may be several years.

This section explains depreciation as an expense calculated at the end of the accounting period as an end-of-year adjustment. This might be the case for small businesses but larger businesses will often use software that is able to recognise depreciation on a monthly basis.

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5.4 Depreciation and carrying amount

5.4.1 Definition of depreciation

Depreciation is a method of spreading the depreciable amount of a non-current asset over its expected useful life (economic life), so that an appropriate portion of the cost is charged in each accounting period.

Definitions (from IAS 16)

Depreciation: The systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount: The cost of an asset (or its revalued amount, in cases where a non-current asset is revalued during its life) less its residual value.

Residual value: The expected disposal value of the asset (after deducting disposal costs) at the end of its expected useful life.

Useful life: The period over which the asset is expected to be available for use by the business entity.

Note that the revaluation of non-current assets is in this syllabus. It is mentioned above for completeness. You will learn about this in later syllabuses.

Example: Depreciation

An item of equipment cost ₦300,000 and has a residual value of ₦50,000 at the end of its expected useful life of four years.

Depreciation is a way of allocating the depreciable amount of ₦250,000 (= ₦300,000 - ₦50,000) over the four years of the asset's expected life.

Depreciation should be charged as an expense in the statement of profit or loss, each year, over the life of the asset.

Depreciation of a new asset commences from the date that an asset is available for use.

Most non-current assets must be depreciated, although there are some exceptions to this rule. For example, land is not depreciated because it has an indefinite useful life.

5.4.3 Accounting for depreciation

The double entry for depreciation is carried out using two accounts (for each category of non-current asset).

Illustration: Depreciation double entry

	Debit	Credit
Depreciation expense	X	
Accumulated depreciation		X

The balance on the depreciation expense account is taken to the statement of profit or loss as an expense for the period.

The accumulated depreciation account contains all of the depreciation recognised to date. When the final statement of financial position is prepared it is deducted from the cost of the assets. The non-current asset figure in the statement of financial position is made up of two figures, the cost less accumulated depreciation.

The balance on the accumulated depreciation account is carried forward as a (credit) balance at the end of the period and appears in the statement of financial position as a deduction from the cost of the non-current assets. The figure that appears in the statement of financial position is known as the **carrying amount** (or **net book value**).

Illustration: Carrying amount of a non-current asset

	£	
Non-current asset at cost	X	
Less accumulated depreciation	(X)	
Carrying amount (net book value)	X	This figure appears on the face of the statement of financial position

Accounts in the ledger for non-current assets and accumulated depreciation

There are separate accounts in the general ledger for each category of non-current assets (for example, an account for land and buildings, an account for plant and machinery, an account for office equipment, an account for motor vehicles, and so on) and the accumulated depreciation for each of these categories of non-current assets.

This means that each category of non-current assets can be shown separately in the financial statements.

Example: Accounting for depreciation

A company purchases a non-current asset in Year 1 for ₦90,000. In Year 1, the depreciation charge is ₦15,000.

These transactions should be recorded as follows:

Asset account			
<i>Year 1</i>	₦		₦
Cash/creditors	90,000	Balance c/f	90,000
	<u>90,000</u>		<u>90,000</u>
<i>Year 2</i>			
Balance b/f	90,000		
Accumulated depreciation account			
<i>Year 1</i>	₦		₦
Balance c/f	15,000	Depreciation account	15,000
	<u>15,000</u>		<u>15,000</u>
<i>Year 2</i>			
		Balance b/f	15,000
Depreciation account			
<i>Year 1</i>	₦		₦
Accumulated depreciation	15,000	Statement of profit or Loss	15,000
	<u>15,000</u>		<u>15,000</u>

At the end of Year 1, the carrying amount of the asset in the statement of financial position is:

	₦
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	<u>(15,000)</u>
Carrying amount	<u>75,000</u>

Example continued:

The depreciation charge In Year 2 is also ₦15,000. The ledger accounts in Year 2 will be as follows:

Assest account			
Year 2	₦		₦
Balance b/f	90,000	Balance c/f	90,000
	<u>90,000</u>		<u>90,000</u>
Year 3			
Balance b/f	90,000		

Accumulated depreciation account			
Year 2	₦		₦
		Balance b/f	15,000
Balance c/f	30,000	Depreciation account	15,000
	<u>30,000</u>		<u>30,000</u>
Year 3			
		Balance b/f	30,000

Depreciation account			
Year 2	₦		₦
Accumulated depreciation	15,000	Statement of profit or Loss	15,000
	<u>15,000</u>		
			₦
Non-current asset at cost (or valuation)	90,000		
Less: Accumulated depreciation	(30,000)		
Carrying amount	<u>60,000</u>		

Practice question**1**

An item of equipment cost ~~N~~40,000 at the beginning of Year 1. It has an expected life of 5 years.

The annual depreciation charge is ~~N~~8,000.

Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.

- a** Equipment account
- b** Accumulated depreciation of equipment account **c** depreciation of equipment account

5.4.4 The purpose of depreciation

It is important to understand the purpose of depreciation. Depreciation is an application of the accruals concept or matching concept.

When a non-current asset is purchased the cost is:

- a. taken to the non-current asset account at cost and
- b. shown in the statement of financial position.

The cost is capitalised. However this asset is used within the business in order to earn profits. Therefore some element of its original cost must be charged to the statement of profit or loss ('charged to profit and loss') each period in order to match the 'consumption' of the cost or value of the assets with the income that the asset is generating.

Depreciation is the element of the cost of the non-current asset that is charged to the statement of profit or loss each period.

There are several ways of calculating the depreciation charge for the year.

5.5 Methods Of Calculating Depreciation

5.5.1 Straight-line method

Definition: Straight line depreciation

Where the depreciable amount is charged in equal amounts to each reporting period over the expected useful life of the asset.

Formula: Straight-line depreciation

$$\begin{array}{l} \text{Depreciation charge} \\ \text{For the year} \end{array} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected useful life (years)}}$$

With the straight-line method, the annual depreciation charge is the same for each full financial year over the life of the asset (unless the asset is subsequently re-valued during its life).

This is the most common method in practice, and the easiest to calculate.

Example: Straight line depreciation

A machine cost ₦250,000. It has an expected economic life of five years and an expected residual value of ₦50,000 at the end of that time.

Annual depreciation is:

$$\text{Depreciation charge} = \frac{250,000 - 50,000}{5 \text{ years}} = \text{₦40,000 per annum}$$

An exam question might state that a full year's depreciation is charged in the year of acquisition. This would mean that a full annual charge would be recognised even if the asset was only owned for the last few months of the year.

Example: Straight line depreciation – mid-year acquisition

A machine cost ₦250,000. It has an expected economic life of five years.

It is expected that the machine will have a zero scrap value at the end of its useful life.

The machine was bought on the 1st September and the company has a 31st December year end.

The depreciation charge in the first year of ownership is:

$$\text{Depreciation charge} = \frac{250,000}{5 \text{ years}} \times \frac{4}{12} = \text{₦16,667}$$

Depreciation as a percentage of cost

Another way of stating straight-line depreciation is to express the annual depreciation charge as a percentage of the cost of the asset. For example, suppose that an asset has an expected life of 10 years and zero residual value. If straight-line depreciation is used, the annual depreciation charge will be 10% of the cost of the asset.

Similarly, if a non-current asset has an expected life of six years and a residual value equal to 10% of its cost, straight-line depreciation would be 15% of cost each year ($= (100\% - 10\%)/6$ years).

5.5.2 Reducing balance method

Definition: Reducing balance method

Where the annual depreciation charge is a fixed percentage of the carrying amount of the asset at the start of the period.

The annual depreciation charge is highest in Year 1 and lowest in the final year of the asset's economic life.

Formula: Reducing balance depreciation

$$\begin{array}{l} \text{Depreciation charge} \\ \text{For the year} \end{array} = \begin{array}{l} \text{Carrying amount at} \\ \text{the start of the year} \end{array} \times \text{Fixed \%}$$

Year	Carrying amount at start of year	charge (at (30% of the reducing balance)	Carrying amount at end of year
	₦	₦	₦
1	100,000	30,000	70,000
2	70,000	21,000	49,000
3	49,000	14,700	34,300
4	34,300	10,290	24,010

5.5.3 Calculating the reducing balance

The reducing balance reduces the cost of an asset down to its expected residual value over its expected useful life.

The reducing balance percentage can be calculated using the following formula.

Formula: Calculation of reducing balance percentage

$$X = \sqrt[n]{\frac{\text{residual value}}{\text{cost}}}$$

Where:

X = the reducing balance percentage
n = expected useful life

Example: Reducing balance

An asset cost ₦10,000 and has an expected residual value of ₦2,000 at the end of its expected useful life which is 5 years.

The reducing balance percentage is calculated as follows:

$$X = \sqrt[1-n]{\frac{\text{residual value}}{\text{cost}}} = X = \sqrt[1-5]{\frac{2,000}{10,000}} = 0.275 \text{ or } 27.5\%$$

This percentage reduces ₦10,000 to ₦2,000 over 5 years.

Year	Carrying amount at start of year	Annual depreciation charge (at (27.5% reducing balance)	Carrying amount at end of year
	₦	₦	₦
1	10,000	2,750	7,250
2	7,250	1,994	5,256
3	5,256	1,445	3,811
4	3,811	1,048	2,763
5	2,763	763	2,000

Note that the depreciation charge in year 5 contains a rounding difference of 3.

Practice questions

- 1 An item of equipment cost ~~N~~1,260,000. It has an expected useful life of six years and an expected residual value of ~~N~~240,000.

Required:

Using the straight-line method of depreciation:

- a. Ascertain the annual depreciation charge.
- b. Compute the carrying amount of the asset after four years.

- 2 The financial year of a company is 1st January to 31st December. A non-current asset was purchased on May 1, for ~~N~~60,000. Its expected useful life is five years and its expected residual value is zero. It is depreciated by the straight-line method.

Required:

Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.

- a. Equipment account
- b. Accumulated depreciation of equipment account
- c. Depreciation of equipment account

- 3 A non-current asset cost ~~N~~64,000. It is depreciated by the reducing balance method, at the rate of 25% each year.

Required:

Complete the following ledger accounts for Years 1, 2 and 3 and calculate the carrying amount of the asset at the end of each period.

- a Equipment account
- b Accumulated depreciation of equipment account
- c Depreciation of equipment account

- 4 An office property cost ~~N~~5 million, of which the land value is ~~N~~2 million and the cost of the building is ~~N~~3 million. The building has an estimated life of 50 years.

Required:

Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.

- a. Equipment account
- b. Accumulated depreciation of equipment account
- c. Depreciation of equipment account

5.6 Revaluation Of Property, Plant And Equipment

5.6.1 Introduction

Revaluation is the process of adjusting the carrying amount of a non-current asset so that it reflects its current market value.

5.6.2 Reasons for revaluation

Non-current assets, such as property, plant, and equipment may increase or decrease in **value over time** due to market conditions, inflation, or changes in usage. Revaluation ensures that the carrying amounts in the financial statements fairly represent the assets' current worth.

5.6.3 Principles of revaluation

- a. When an entity revalues an asset, all assets in the same class must be revalued simultaneously.
- b. Revaluation must be applied consistently to all similar assets.
- c. Revaluations should be done regularly to ensure that the carrying amounts do not differ materially from fair value.

5.6.4 Types of revaluation

There are two types of revaluation:

a upward revaluation:

- i. occurs when the market value of a non-current asset increases.
- ii. the carrying amount is increased to reflect the higher value.
- iii. the difference is recognised as a revaluation surplus or revaluation gain.

b downward revaluation

- i. occurs when the market value of a non-current asset decreases.
- ii. the carrying amount is reduced accordingly.
- iii. the difference is recognised as a revaluation loss.

c. Accounting treatment:

- i. A revaluation surplus (gain) is recorded in Other Comprehensive Income (OCI) and transferred to the revaluation surplus account under equity.
- ii. A revaluation loss is charged to the profit or loss account. However, if there is a previous revaluation surplus for that asset, the loss is first offset against that surplus.
- iii. After revaluation, the asset's fair value becomes its new carrying amount, which is then depreciated over its remaining useful life (unless the asset is non-depreciable, such as land).

Note: For simplicity, we focus at this level on the revaluation of non-depreciable assets, such as land.

Illustrations:

Illustration 1: Revaluation Gain

On January 1, 2025, a company revalues its land, which was originally purchased for ₦500,000. The revalued amount is ₦700,000. Prepare the journal entry for the revaluation adjustment and explain how to account for it in the financial statements.

Answer:

a) Journal Entry:

Debit: Land ₦200,000

Credit: Equity ₦200,000

Being record of revaluation gain on land

b) In the financial statements:

The land will be reported at its revalued amount of ₦700,000 in the statement of financial position.

The revaluation surplus of ₦200,000 will be reported in the statement of changes in equity.

Illustration 2

On January 1, 2025, a company revalues its land, which was originally purchased for ₦800,000. The land was previously revalued to ₦1,000,000, resulting in a revaluation surplus of ₦200,000. The new revalued amount is ₦900,000. Prepare the journal entry for the revaluation adjustment and explain how to account for it in the financial statements.

a) Journal Entry:

Debit: Equity ₦100,000

Credit: Land ₦100,000

Being the setting off revaluation loss of the current period against revaluation reserves.

5.7 De recognition of property, plant and equipment

5.7.0 Gain or loss on disposal of an on-current asset

Property, plant and equipment are eventually disposed of:

- a. by sale, or
- b. if they have no sale value, through disposal as scrap.

Disposal can occur at any time, and need not be at the end of the asset's expected useful life.

The effect of a disposal on the statement of financial position (or accounting equation) is that:

- a. the asset (at cost or valuation) is no longer in the statement of financial position, and
- b. The accumulated depreciation on the asset is also no longer in the statement of financial position.

The carrying amount of the asset is therefore removed from the accounting equation.

There is a gain or loss on disposal of the asset, as follows:

Illustration: Gain or loss on disposal

		₦
Sale proceeds on disposal		X
Less Disposal costs		(X)
Net disposal value		X
Asset at cost	X	
Less: Accumulated depreciation	(X)	
Carrying amount at date of disposal		(X)
Gain /loss on disposal		X

Example:

A non-current asset originally cost ₦75,000. Accumulated depreciation is ₦51,000.

The asset is now sold for ₦18,000. Disposal costs are ₦500. What is the gain or loss on disposal?

Gain or loss on disposal	₦	₦
Sale proceeds on disposal		18,000
Less Disposal costs		(500)
Net disposal value		<u>17,500</u>
Asset at cost	75,000	
Less: Accumulated depreciation	<u>(51,000)</u>	
Carrying amount at date of disposal		<u>(24,000)</u>
Loss on disposal		<u>(6,500)</u>

Practice question

A non-current asset cost ₦96,000 and was purchased on June 1, Year 1. Its expected useful life was five years and its expected residual value was ₦16,000. The asset is depreciated by the straight-line method.

The asset was sold on September 1, Year 3 for ₦68,000. There were no disposal costs.

It is the company policy to charge depreciation on a monthly basis. The financial year runs from January 1 to December 31.

What was the gain or loss on disposal?

3

Practice question

A non-current asset was purchased on 1 June Year 1 for ₦216,000. Its expected life was 8 years and its expected residual value was ₦24,000. The asset is depreciated by the straight-line method. The financial year is from January 1, to December 31.

The asset was sold on September 1, Year 4 for ₦163,000. Disposal costs were ₦1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

5.7.1 Accounting for the disposal of property, plant and equipment

In the general ledger the gain or loss on disposal of a non-current asset is recorded in a **disposal of asset account**. The double entry transactions required are as follows – for an asset recorded at cost rather than at a re-valued amount.

Step 1: Transfer the cost of the non-current asset from the asset account to the disposal account:

Step 2: Transfer the accumulated depreciation on the asset from the accumulated depreciation account to the disposal account:

Illustration:

	Debit	Credit
Disposal account	X	
Non-current asset account (cost of the asset)		X
Accumulated depreciation account (or Allowance for depreciation account)	X	
Disposal account		X

The carrying amount of the asset is now in the disposal account.

Step 3: Record the disposal costs in the disposal account.

Illustration:

	Debit	Credit
Disposal account (disposal expenses)	X	
Bank or Payables account		X

Step 4: Record the sale proceeds in the disposal account:

Illustration:

	Debit	Credit
Bank or Receivables account	X	
Disposal account (sale)		X

Step 5: The balance on the disposal account is the gain or loss on disposal. This is transferred to the statement of profit or loss.

Example:

A non-current asset cost ₦82,000 when purchased. It was sold for ₦53,000 when the accumulated depreciation was ₦42,000. Disposal costs were ₦2,000.

Required

Show the book-keeping entries to record the disposal.

Answer			
Disposal of asset account			
	₹		₹
Non-current asset account	82,000	Accumulated depreciation account	42,000
Disposal expenses (Bank)	2,000	Sales value (Receivables)	53,000
Gain on disposal (statement of profit or loss)	11,000		
	<u>95,000</u>		<u>95,000</u>
Non-current asset account			
	₹		₹
Opening balance	82,000	Disposal account	82,000
Accumulated depreciation account			
	₹		₹
Disposal account	42,000	Opening balance	42,000
Receivables account			
	₹		₹
Disposal account (sale value of disposal)	53,000		
Bank account			
	₹		₹
		Disposal account (disposal expenses)	2,000
Statement of profit or loss			
	₹		₹
		Disposal account (gain on disposal)	11,000

Non-current asset accounts in the general ledger are usually maintained for a category

Opening balance b/f	₦500,000	Disposal account	₦82,000
		Closing balance c/f	418,000
	500,000		500,000
Opening balance b/f	418,000		

Accumulated depreciation account

Disposal account	₦42,000	Opening balance b/f	₦180,000
Closing balance c/f	138,000		
	180,000		180,000
		Opening balance b/f	138,000

of assets rather than for individual assets. This means that when a non-current asset is disposed of, there will be a closing balance to carry forward on the asset account and the accumulated depreciation account.

Example:

In the previous example, suppose that the balance on the non-current asset account before the disposal was ₦500,000 and the balance of the accumulated depreciation account was ₦180,000.

The accounting entries would be as follows:

Property, plant and equipment account

Practice question

A motor vehicle cost ₦80,000 two years ago. It has been depreciated by the reducing balance method at 25% each year. It has now been disposed of for ₦41,000. Disposal costs were ₦200.

The balance on the motor vehicles account before the disposal was ₦720,000 and the balance on the accumulated depreciation of motor vehicles account was ₦250,000.

Show the book-keeping entries to record the disposal.

5.7.2 Disposal of property, plant and equipment: part-exchange of an old asset

Sometimes, a supplier will agree to take an old asset in part-exchange for the sale of a new asset. This practice is quite common, for example, with motor vehicles. A business entity may buy a new motor vehicle from a car dealer, and the car dealer will take an old motor vehicle in part-exchange for the new one. This arrangement is known as a "trade-in". (The business entity is said to be "trading-in" the old vehicle and the car dealer is said to be granting a "trade in allowance").

Disposals of assets in part-exchange for a new asset are accounted for in much the same way as disposals of property, plant and equipment for cash. The only difference is that:

- a. The disposal value of the old asset is the amount that the seller of the new asset allows in part-exchange for the new asset.
- b. The cost of the new asset is the full purchase price, but the double entry is partly to bank/payables (for the cash payment) and partly to the disposal account for the old asset (for the part-exchange value).

Example:

Entity X has several motor cars that are accounted for as property, plant and equipment.

As at 1 January Year 5, the cost of the entity's cars was ₦200,000 and the accumulated depreciation was ₦80,000.

On 2 January Year 5, Entity X bought a new car costing ₦50,000.

The car dealer accepted a car owned by Entity X in part-exchange, and the part-exchange value of this old car was ₦4,000.

This car originally cost ₦30,000 and its accumulated depreciation is ₦25,000.

Required:

- (a) Calculate the gain or loss on disposal of the old car
- (b) Show how the purchase of the new car and the disposal of the old car will be recorded in the ledger accounts of Entity X.

Answer

(a)

	₦	₦
Sale proceeds on disposal (part-exchange value)		4,000
Less Disposal costs		0
Net disposal value		4,000
Asset at cost	30,000	
Less: Accumulated depreciation	(25,000)	
Carrying amount at date of disposal		(5,000)
Loss on disposal		(1,000)

Answer (b)

Disposal of asset account

	₦		₦
Motor vehicles account	30,000	Accumulated depreciation account	25,000
		Motor vehicles account	
		(Trade-in value)	4,000
		Loss on disposal (statement of profit or loss)	1,000
	30,000		30,000

1 January	₹		₹	
Opening balance	200,000	Disposal account	30,000	
Bank (50,000 – 4,000)	46,000			
Disposal of asset account	4,000	Closing balance	220,000	
	<u>250,000</u>		<u>250,000</u>	
2 January				
Opening balance	220,000			

Accumulated depreciation account

1 January	₹		₹	
Disposal account	25,000	Opening balance	80,000	
Closing balance	55,000			
	<u>80,000</u>		<u>80,000</u>	
2 January				
		Opening balance	55,000	

Bank account

₹	₹
	Motor vehicles account
	46,000
	(Cash paid for new car)

Statement of profit or loss

₹	₹
Disposal account (Loss on disposal)	1,000

Practice question

A company has several motor cars that are accounted for as non-current assets. As at January 1, Year 2, the cost of the cars was ₦120,000 and the accumulated depreciation was ₦64,000.

During January the company bought a new car costing ₦31,000 and was given a part-exchange allowance against an old car of ₦8,000. The car being part exchanged originally cost ₦28,000 and its accumulated depreciation is ₦18,000.

Required

- (a) Calculate the gain or loss on disposal of the old car
- (b) Show how the purchase of the new car and the disposal of the old car will be recorded in the ledger accounts.

5.8 Disclosure requirements of IAS 16

5.8.1 Disclosure requirements of IAS 16

IAS 16 -**Property, Plant and Equipment** requires the following disclosures in the notes to the financial statements, for each major class of property, plant and equipment.

- a. The measurement bases used (cost or revaluation model (not in syllabus))
- b. The depreciation methods used
- c. The useful lives or depreciation rates used
- d. Gross carrying amounts and the accumulated depreciation at the beginning and at the end of the period
- e. A reconciliation between the opening and closing values for gross carrying amounts and accumulated depreciation, showing:
 - i. Additions during the year
 - ii. Disposals during the year
 - iii. Depreciation charge for the year
 - iv. Assets classified as held for sale in accordance with IFRS 5
 - v. Acquisitions of assets through business combinations
 - vi. Impairment losses (beyond the scope of this syllabus)

The following is an example of how a simple table for tangible non-current assets may be presented in a note to the financial statements.

Illustration: Property, plant and equipment note to the accounts

	Property	Plant and equipment	Total
Cost	₦m	₦m	₦m
At the start of the year	7,200	2,100	9,300
Additions	920	340	1,260
Disposals	(260)	(170)	(430)
At the end of the year	7,860	2,270	10,130
Accumulated depreciation			
At the start of the year	800	1,100	1,900
Depreciation expense	120	250	370
Accumulated depreciation on disposals	(55)	(130)	(185)
At the end of the year	865	1,220	2,085
Carrying amount			
At the start of the year	6,400	1,000	7,400
At the end of the year	6,995	1,050	8,045

5.9 Intangible Assets

5.9.1. Definition of Intangible assets and their characteristics

a Definition

Intangible assets are identifiable non-monetary assets without physical substance that can significantly impact a company's financial performance. Common examples include patents, copyrights, trademarks, and goodwill.

b Characteristics of intangible assets

The characteristics of intangible assets are as follows:

- i. lack of physical substance:
 - intangible assets do not have a physical form; they cannot be seen or touched.
 - examples include trademarks, patents, copyrights, goodwill, software, and brand names.
- ii. identifiability: An intangible asset is identifiable if it is either:
 - separately acquired or can be separated from the entity and sold, transferred, licensed, or exchanged; or
 - arises from contractual or legal rights, regardless of whether those rights are transferable or separable.
- iii. non-monetary nature:
 - intangible assets are non-monetary, meaning they do not involve a right to receive a fixed or determinable amount of money.
- iv. control by the entity:
 - the entity must have control over the asset, meaning it can restrict others from accessing the economic benefits arising from the asset.
- v. expected future economic benefits:
 - the asset is expected to provide future economic benefits, such as increased revenues, cost savings, or improved efficiency.
- vi. measurable cost or value:
 - the cost or fair value of the intangible asset must be measurable for it to be recognised on the financial statements.
- vii. finite or indefinite useful life:
 - intangible assets may have a finite useful life, in which case they are amortised, or an indefinite useful life, in which case they are not amortised but subject to annual impairment testing.

c. Difference between intangible assets and tangible assets

The main differences between intangible and tangible assets include:

- i. tangible assets (For example, land, buildings, equipment) have physical form, whereas intangible assets do not and cannot be physically touched;
- ii. tangible assets are typically easier to value based on cost or market value. The valuation of intangible assets is often more subjective, requiring expert

- judgement.;
- iii. tangible assets are usually purchased or constructed. Intangible assets may be purchased or developed internally through research and innovation.
 - iv. costs of intangible assets are capitalised if certain criteria are met. Internally developed intangible assets can only be capitalised if they meet recognition conditions set out in IAS 38.
 - v. Most tangible assets have a finite useful life and are depreciated. Intangible assets may have either a finite or indefinite useful life. Finite-life intangibles are amortised; indefinite-life intangibles are not amortised but are tested for impairment at least annually.

5.9.2 **Research and development (R&D) expenditure:**

R&D expenditure refers to the costs incurred in developing new or improved products, processes, or services. It is divided into:

- a. research expenditure: aimed at gaining new knowledge or understanding.
- b. development expenditure: involves applying research findings to create or improve products or processes.

According to IAS 38, all research costs must be expensed as incurred. Development costs can be capitalised only if specific recognition criteria are met.

5.9.3 **Recognition and measurement criteria**

a) **Recognition Criteria:**

Development expenditure can be capitalised as an intangible asset if **all** the following conditions are met:

- i. **Technical feasibility:** It must be technically feasible to complete the asset so that it will be available for use or sale.
- ii. **Intention to complete:** Management must have the intention to complete and use or sell the asset.
- iii. **Ability to use or sell:** The entity must demonstrate its ability to use or sell the asset once completed.
- iv. **Reliable measurement:** The expenditure attributable to the development of the asset can be reliably measured.
- v. **Future economic benefits:** The asset is expected to generate probable future economic benefits, in terms of revenue generation, cost savings, or other benefits arising from its use or sale.
- vi. **Availability of resources:** The entity must have adequate technical, financial, and other resources to complete the development and to use or sell the asset.

b) **Measurement Criteria:**

Intangible assets are initially measured at cost, which may include:

- i. direct development costs (labour, materials, overheads)
- ii. purchase price (for acquired intangibles)

c. Internally generated intangible assets:

Internally generated intangible assets can only be recognised if they arise from the development phase and meet the recognition criteria. Research phase costs are always expensed.

5.9.4 Types of intangible assets and accounting treatment

a) Types of intangible assets:

- i. **Patents:** Exclusive rights for inventions for a specified period.
- ii. **Copyrights:** Rights protecting original creative works (literary, dramatic, musical, and artistic).
- iii. **Trademarks:** Identifiers of brand or products (symbols, names, or phrases).
- iv. **Goodwill:** Excess of purchase consideration over the fair value of identifiable net assets in a business combination.

b. Accounting Treatment

- i. Capitalisation: Recognised as assets on the statement of financial position.
- ii. Amortisation: Applied to intangible assets with finite useful lives over the expected benefit period.
- iii. Impairment: All intangible assets must be tested for impairment. Those with indefinite useful lives must be tested at least annually.

c. Amortisation

Amortisation allocates the cost of an intangible asset over its useful life, similar to depreciation for tangible assets.

- i. If the pattern of economic benefits cannot be reliably determined, the straight-line method should be used.
- ii. Indefinite-life intangible assets are not amortised but must undergo annual impairment testing.
- iii. The carrying amount = Cost – Accumulated Amortisation – Accumulated Impairment Losses

5.9.5 Disclosure Requirements:

Entities must disclose the following for intangible assets:

- a. Description of each class of intangible assets.
- b. Amortisation method and useful life or rate used.
- c. Impairment losses recognised during the period, if any.
- d. Reconciliation of the carrying amount at the beginning and end of the period, including additions, disposals, amortisation, and impairment adjustments.
- e.

Illustration

Explain how the following expenditure incurred on intangible items will be treated.

- i) Testing of a production prototype
- ii) Search for alternatives for a production process
- iii) Implementation of an Advertising Campaign
- iv) A substantial amount incurred in creating a prototype of new heat-resistant suit.
- v) Testing to determine whether a substance found in Savannah will be waterproof.

Answer

- i) Expenditure incurred on testing a production prototype is recognised development expenditure if it meets the recognition criteria for an intangible asset, otherwise it should be treated as an expense.
- ii) Expenditure incurred on searching for alternatives for a production process is recognised as an expense because project is in a research phase, which outcome is uncertain.
- iii) Expenditure incurred on implementing an advertising campaign is recognised as an expense. It is not an intangible asset under IAS 38.
- iv) The expenditure would be considered a development expenditure as it relates to the application of research findings to develop a new product. However, the development expenditure must meet the recognition criteria.
- v) The expenditure incurred on testing to determine whether a substance found in the desert will be waterproof, should be expensed. The phase is aimed at discovering new knowledge, and it is uncertain whether the substance will be viable.

5.10 Impairment of assets

5.10 Definition of impairment of assets and its significance

a) Definition of Impairment

According to IAS 36 - Impairment of Assets, an asset is considered impaired when its carrying amount (the amount at which it is recognised in the financial statements after deducting accumulated depreciation/amortisation and any accumulated impairment losses) exceeds its recoverable amount.

In essence, the core principle of IAS 36 is to ensure that assets are not carried in the financial statements at more than the highest amount that can be recovered through their use or sale.

b) The Need for Impairment Test

An impairment test is necessary to ensure that assets are not carried at amounts exceeding their recoverable amounts, in line with the prudence concept and IAS 36.

5.10.1 Procedures for identifying impaired assets

An asset is considered impaired when its carrying amount exceeds its recoverable amount. An entity must assess at the end of each reporting period whether there are any indications that an asset may be impaired.

However, even if there is no indication of impairment, the following assets must be tested for impairment annually:

- a. Intangible assets with an indefinite useful life
- b. Intangible assets not yet available for use
- c. Acquired goodwill

Indicators of impairment

Indicators of impairment may include:

- i. significant decline in market value
- ii. adverse changes in the technological, market, legal, or economic environment
- iii. physical damage or obsolescence
- iv. plans to dispose of or restructure the asset

5.10.2 Procedures for testing intangible assets with indefinite useful life

Intangible assets with indefinite useful life must be tested for impairment annually, or more frequently if there are indications of impairment. The test involves comparing the asset's carrying amount with its recoverable amount.

An intangible asset is deemed to have an indefinite useful life if:

- a. there is no foreseeable limit to the period over which it will generate cash flows; and
- b. there are no legal, regulatory, or contractual constraints that would limit its useful life.

Examples: Brand names, trademarks, and copyrights.

5.10.3 Determination of recoverable amount

The recoverable amount of an asset is the higher of:

- a. fair value less costs to sell (FVLCTS); and
- b. value in use (VIU)

The higher of these two is used to assess whether the asset is impaired.

5.10.4 Fair value less costs to sell (FVLCTS)

FVLCTS is the amount that could be obtained from the sale of an asset in an arm's-length transaction, less the costs of disposal. It is determined by:

- a. estimating the fair value of the asset
- b. estimating the costs of disposal (For example, legal fees, removal costs, commissions)
- c. subtracting the disposal costs from the fair value

Illustration:1

Kako Ltd owns a property that can be sold for ₦5,000,000. The costs to sell are estimated to be ₦200,000. Calculate the FVLCTS:

- i) estimated fair value: ₦5,000,000
- ii) estimated costs of disposal: ₦200,000
- iii) subtract costs of disposal from fair value: $\text{₦5,000,000} - \text{₦200,000} = \text{₦4,800,000}$

5.10.5 Value in Use (VIU)

VIU is the present value of future cash flows expected to be derived from the continued use of the asset. It involves:

- a. estimating the expected future cash flows from the asset

- b. determining an appropriate discount rate
- c. calculating the present value of those cash flows

Illustration 2

Entity A owns a machine that is expected to generate net cash inflows of ₦10,000,000 per year for the next 5 years. The discount rate is 10%. Calculate the VIU:

i) estimated future cash flows: ₦10,000,000 per year for 5 years

ii) determined discount rate: 10%

iii) calculate present value:

Answer

Year 1: $\text{₦}10,000,000 / (1 + 0.10) = \text{₦}9,091,000$

Year 2: $\text{₦}10,000,000 / (1 + 0.10)^2 = \text{₦}8,264,000$

Year 3: $\text{₦}10,000,000 / (1 + 0.10)^3 = \text{₦}7,513,000$

Year 4: $\text{₦}10,000,000 / (1 + 0.10)^4 = \text{₦}6,830,000$

Year 5: $\text{₦}10,000,000 / (1 + 0.10)^5 = \text{₦}6,209,000$

VIU ₦38,007,000

Illustration 3

Ibed Ltd purchased a machine for ₦5,000,000. The machine has a useful life of 5 years and is depreciated using the straight-line method. At the end of year 3, the machine's carrying amount is ₦2,000,000.

However, due to a significant decline in demand for the product manufactured by the machine, Entity A expects the machine's future cash flows to be significantly lower than previously anticipated.

The machine's recoverable amount is estimated to be ₦1,250,000, based on its fair value less costs to sell.

Determine the impairment loss, if any, that Ibed Ltd should recognise.

Answer

i) Determine the machine's carrying amount: ₦2,000,000

ii) Determine the machine's recoverable amount: ₦1,250,000

iii) Compare the carrying amount with the recoverable amount:

Carrying amount (₦2,000,000) > Recoverable amount (₦1,250,000)

Impairment loss = Carrying amount - recoverable amount = ₦750,000

Illustration 4:

Subep Ltd purchased a machine for ₦10,000,000. The machine has a useful life of 5 years and is depreciated using the straight-line method. At the end of year 3, the machine's carrying amount is ₦4,000,000.

The machine's future cash flows are estimated as follows:

1	₦800,000
2	₦700,000
3	₦600,000
4	₦500,000
5	₦400,000

The discount rate is 10%. The discount factor of 10% is as follows:

Year	1	2	3	4	5
Present value	0.9091	0.8264	0.7513	0.6830	0.6209

The fair value of the machine is estimated to be ₦3,500,000, and the costs to sell are estimated to be ₦400,000.

Required:

- Determine the impairment loss of the machine.
- Determine the carrying amount of the machine after the impairment test.

Solution

$$\text{a) VIU} = \cancel{₦800,000} \times 0.9091 + \cancel{₦700,000} \times 0.8264 + \cancel{₦600,000} \times 0.7513 + \cancel{₦500,000} \times 0.6830 + \cancel{₦400,000} \times 0.6209 = \text{₦2,841,900}$$

The fair value of the machine is estimated to be ₦3,500,000, and the costs to sell are estimated to be ₦400,000. Therefore:

$$\begin{aligned}\text{FVLCTS} &= \cancel{₦3,500,000} - \cancel{₦400,000} \\ &= \text{₦3,100,000}\end{aligned}$$

Recoverable amount = Higher of VIU and FVLCTS

$$\begin{aligned}&= \text{Higher of } \cancel{₦2,841,900} \text{ and } \cancel{₦3,100,000} \\ &= \text{₦3,100,000}\end{aligned}$$

Carrying amount $\cancel{₦4,000,000} > \text{recoverable amount } \cancel{₦3,100,000}$

Impairment loss is $\cancel{₦900,000}$

b) The carrying amount of the machine after the impairment test is $\cancel{₦4,000,000} - \cancel{₦900,000} = \cancel{₦3,100,000}$. Therefore, the carrying amount must be equal to the recoverable value if the asset is impaired

5.10.6 Recognition of impairment loss

An impairment loss is recognised when the carrying amount of an asset exceeds its recoverable amount.

- a. The impairment loss is generally recognised in profit or loss for the period.
- b. However, if the asset has been revalued in accordance with other standards (For example, IAS 16 for property, plant, and equipment), the impairment loss is first treated as a revaluation decrease and recognised in other comprehensive income to the extent of any existing revaluation surplus for that asset.

5.10.7 Reversal of impairment loss

A previously recognised impairment loss may be reversed if there has been a change in the estimates used to determine the asset's recoverable amount. This could result from:

- a. Improvements in economic conditions
- b. Technological advancements
- c. Increased demand or usage
- d. Resolution of prior uncertainties

However:

- e. The revised carrying amount after the reversal must not exceed the carrying amount that would have been determined (net of depreciation or amortisation) had no impairment loss been recognised in previous periods.
- f. In simple terms, reversal cannot increase the carrying amount above the asset's depreciated historical cost.

5.10.8 Disclosure requirements under IAS 36 Entities must disclose the following in the notes to the financial statements:

- a. impairment losses recognised in profit or loss;
- b. impairment losses reversed in profit or loss;
- c. the line item(s) in the profit or loss where impairment losses or reversals are included; and
- d. The impairment losses recognised in other comprehensive income (For example, for revalued assets).



5.11 Assets Register

5.11.1 Introduction

A non-current assets register is a manual or electronic record containing detailed information about an entity's non-current assets. The creation and maintenance of this register is an essential step toward effective management and control of such assets.

5.11.2 Content of an Assets Register:

Well-maintained assets register typically includes the following details:

- a) Asset code or number
A unique identifier assigned to each asset for tracking and reporting purposes.
- b) Asset description
A detailed description of the asset, including its type, model, serial number, engine number, chassis number, and registration number.
- c) Date of acquisition
The date the asset was purchased, constructed, or leased.
- d) Initial cost of acquisition
The purchase cost of the asset, including all necessary expenses to bring the asset to its current location and condition.
- e) Accumulated depreciation
The total depreciation charged against the asset since acquisition.
- f) Carrying amount
The net book value at the reporting date or at the date of disposal, calculated as the original cost less accumulated depreciation and any impairment losses.
- g) Location of the asset
The physical location of the asset, such as the department or unit responsible for its use and upkeep.
- h) Supplier's details
Information about the asset's supplier, including name, address, and contact information.
- i) Revaluation details
Any revaluation history, including dates, revised values, and reasons for the revaluation.
- j) Depreciation method
The method used to depreciate the asset, such as the straight-line or reducing balance method.
- k) Rate of depreciation
The annual depreciation rate, expressed as a percentage.
- l) Useful life
The estimated useful life of the asset at the time it is available for use, subject to adjustment in accordance with IAS 8 (Accounting Policies, Changes in Accounting Estimates, and Errors).
- m) Disposal details
Information on asset disposals, including date, proceeds, and method of disposal.
- n) Capital expenditure budget
Details of budgeted capital expenditure for the asset, including purpose, timing, and amount.
- o) Asset transfer
Records of asset transfers, showing the date, recipient, and reason for transfer.

5.11.3 Usefulness of the non-current assets register

Non-current assets register serves multiple internal and external purposes. Its benefits include:

- a) Internal check
Provides a control mechanism for verifying the accuracy of general ledger balances through reconciliation.
- b) Supplier and maintenance tracking
Aids in locating suppliers or third parties (e.g., lessors) responsible for scheduled maintenance.
- c) Theft and insurance claims
Supplies necessary details for insurance claims or police reports in the event of theft or loss.
- d) Audit evidence
Assists auditors in verifying the existence, condition, and valuation of assets by comparing register records with physical checks.
- e) Management decision-making
Supports informed decisions on asset acquisition, disposal, and maintenance planning.
- f) Carrying amount computation
Facilitates accurate determination of carrying amounts for financial reporting.
- g) Depreciation tracking
Enables effective monitoring of cumulative depreciation over time.

5.11.4 Asset coding

Asset coding is a structured system used to classify and organise assets into categories for easier identification, tracking, and management. Codes often combine letters and numbers that reflect key information about the asset, such as its type, location, or acquisition year.

5.11.5 Types of asset coding systems

- a) Alphabetical coding
Uses letters to represent asset categories:
 - i. A: Buildings
 - ii. B: Vehicles
 - iii. C: Computer Equipment
 - iv. D: Furniture
- b) Numerical Coding
Uses numbers to classify asset categories:
 - i. 100: Buildings
 - ii. 200: Vehicles
 - iii. 300: Computer Equipment
 - iv. 400: Furniture
- c) **Alphanumeric Coding**
Combines letters and numbers for specificity:
 - i. A-100: Buildings
 - ii. B-200: Vehicles
 - iii. C-300: Computer Equipment
 - iv. D-400: Furniture

d. **Hierarchical Coding**

Applies a nested structure:

- i. 1: Assets
- ii. 1.1: Buildings
- iii. 1.2: Vehicles
- iv. 1.3: Computer Equipment
- v. 1.4: Furniture

e. **Block Coding**

Allocates number ranges for categories:

- i. 100–199: Buildings
- ii. 200–299: Vehicles
- iii. 300–399: Computer Equipment
- iv. 400–499: Furniture

f. **Group Code System**

Uses short abbreviations:

- i. BL: Buildings
- ii. VH: Vehicles
- iii. CE: Computer Equipment
- iv. FN: Furniture

This coding system enables fast identification, effective tracking, and efficient management of all categories of non-current assets.

Illustration: Sample Asset Coding

Suppose the following assets exist:

- **Computer Hardware** (laptops, desktops, printers)
- **Computer Software** (operating systems, productivity tools)
- **Office Furniture** (chairs, tables, desks)
- **Vehicles** (cars, trucks, vans)

A sample coding scheme may be structured as follows:

Category Codes:

- C = Computer Hardware
- S = Software
- F = Furniture
- V = Vehicles

Type Codes:

- LA = Laptop
- DE = Desktop
- PR = Printer
- CH = Chair
- TA = Table
- DK = Desk
- CA = Car
- TR = Truck
- VA = Van

Serial Number:

- A unique number for each item.

Examples:

- Laptop: C-LA-001
- Desktop: C-DE-002
- Chair: F-CH-003
- Car: V-CA-004

5.12 Chapter review

Chapter review

Before moving to the next chapter, check that you are now able to:

- identify the cost of an item of property, plant and equipment;
- revalue an item of property, plant and equipment;
- account for the derecognition of an item of property, plant and equipment;
- calculate profit or loss on the disposal of an item of property, plant and equipment;
- account for profit or loss on the disposal of an item of property, plant and equipment;
- calculate depreciation using the straight line and reducing balance methods;
- Account for depreciation expense ;
- Post journal entry to record depreciation expense;
- construct a simple PPE note for the financial statements;
- know the disclosure requirements under **IAS 16 – Property, Plant and Equipment**;
- account for intangible assets; and
- account for impairment loss.

5.13 End of chapter questions and suggested solutions

Question 1

Supeb Ltd. performed an impairment test on its machine on July 31, 2024, and recognised an impairment loss of ₦900,000. The carrying amount of the machine after the impairment test was ₦3,100,000.

The machine was originally purchased on August 1, 2021, for ₦10,000,000, with an estimated useful life of 5 years. The company uses the straight-line method for depreciation.

During the year ended July 31, 2025, due to changes in market conditions, the company re-evaluated the recoverable amount of the machine. The new estimate of the recoverable amount is:

FVLCTS = ₦2,800,000 (fair value) - ₦300,000 (costs to sell) = ₦2,500,000

VIU = ₦2,200,000 (calculated using the same method as before)

Required:

- Determine the recoverable amount of the machine. (2 marks)
- Calculate the reversal of impairment loss, if any. (4 marks)
- Prepare the journal entry to record the reversal of impairment loss, if any. (2 marks)
- Show the carrying amount of the machine after the reversal of impairment loss, if any. (2 marks)

Suggested solution

a) Recoverable amount = Higher of VIU and FVLCTS = Higher of ₦2,200,000 and ₦2,500,000 = ₦2,500,000

	₦	₦
b) The carrying amount would have been if there had been no impairment loss.		
Original cost of machine =		10,000,000
Accumulated depreciation (4 years) = ₦10,000,000 x 4/5		<u>8,000,000</u>
Carrying amount without impairment loss		<u>2,000,000</u>

Carrying amount after impairment.		3,100,000
Depreciation for the current year $\text{N}3,100,000/2$		<u>1,650,000</u>
Carrying amount without impairment this year =		<u>1,650,000</u>
Recoverable amount	2,500,000	
Carrying amount a year after impairment	<u>1,650,000</u>	
Total amount recoverable	<u>850,000</u>	
Supeb cannot carry the asset at more than $\text{N}2,000,000$, hence Supeb cannot recover more than $\text{N}2,000,000 - \text{N}1,650,000 = \text{N}350,000$		
c) Journal entry:		
Debit: Machine $\text{N}350,000$		
Credit: Profit or loss $\text{N}350,000$		

Question 2

- Explain the revaluation model for PPE, including revaluation adjustments in the financial statements.
- Explain the recognition criteria for PPE and intangible assets.
- State the differences between amortisation and depreciation.
- State the disclosure requirements for non-current assets in the financial statements.

Suggested solution

- Revaluation model for PPE: The revaluation model allows entities to measure PPE at its fair value, which is the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

Revaluation adjustments: When an entity revalues its PPE, any increase or decrease in the asset's carrying amount is recognised as a revaluation gain or loss.

Revaluation gain: An increase in the asset's carrying amount is credited to the revaluation surplus in equity, except to the extent that it reverses a previous revaluation decrease that was recognised in profit or loss.

Revaluation loss: A decrease in the asset's carrying amount is recognised in profit or loss, except to the extent that it reverses a previous revaluation increase that was recognised in the revaluation surplus.

The revaluation surplus is a separate component of equity that represents the cumulative revaluation gains and losses recognised on the entity's PPE.

In the financial statements:

The revaluation model is applied on a class-by-class basis, where a class of PPE is a grouping of assets of a similar nature and use in the business.

The revaluation gain or loss is disclosed in the statement of comprehensive income.

The revaluation surplus is disclosed in the statement of changes in equity

The carrying amount of the revalued asset is disclosed in the statement of financial position.

- Recognition criteria for PPE and intangible assets: An item of PPE or an intangible asset is recognised as an asset if it is probable that the future economic benefits will flow to the

entity and the cost of the asset can be measured reliably.

The recognition criteria are:

The asset is controlled by the entity.

The asset is expected to generate future economic benefits.

The cost of the asset can be measured reliably.

- c) Differences between amortisation and depreciation: Amortisation is the systematic allocation of the depreciable amount of an intangible asset over its useful life. Depreciation is the systematic allocation of the depreciable amount of a tangible asset over its useful life.

The main differences are:

Amortisation applies to intangible assets, while depreciation applies to tangible assets.

Amortisation is typically calculated using the straight-line method, while depreciation can be calculated using various methods, such as straight-line, reducing balance, or units of production.

Amortisation is applied only to intangible assets that have finite useful life, while depreciation is applied to all PPE except land.

- d) Disclosure requirements under IAS 38: Entities are required to disclose information about their intangible assets, in addition to the disclosure under IAS 16 and 36, as follows:
Whether useful lives are indefinite or finite, and if finite, the useful life or the amortization rates used;
The amortisation methods used.
The gross carrying amount and accumulated amortization and impairment losses at the beginning and end of the period
The line item in the statement of comprehensive income in which the amortization is included

Question 3:
Alpha Ltd. acquired a patent on 1 January 2022 for ₦500,000. The patent has a useful life of 5 years. The company decided to amortise the patent using the straight-line method.
Required:
a) Calculate the annual amortisation expense for the patent.
b) Prepare the journal entry to record the amortisation expense for the year ended December 31, 2024.
c) Show the patent account in the statement of financial position as at December 31, 2024. (4 marks)

Suggested solution

a) Annual amortisation expense = ₦500,000 / 5 years = ₦100,000 per year
b) Journal entry:
Debit: Amortisation expense ₦100,000
Credit: Accumulated amortisation ₦100,000
c) Patent account in the statement of financial position:

Patent	~~₦~~ 500,000
Less: Accumulated Amortisation	~~(₦200,000)~~
Carrying Amount	~~₦300,000~~

Question 4

TechCorp, a leading software development company, has acquired a rival company, Innovatech for ~~₦~~100million. The acquisition includes a portfolio of innovative software products, a trademark and a team of skilled developers. The identifiable assets acquired include:

A software platform with a finite useful life of 5 years, valued at ~~₦~~20 million.

A trademark with an indefinite useful life, valued at ~~₦~~15 million.

A team of skilled developers, valued at ~~₦~~14m.

Required

Explain the basis for recognition of intangible assets, including the criteria for recognising internally generated intangible assets and those acquired in a business combination.

Determine the initial recognition and measurement of the identifiable intangible assets acquired by TechCorp, including the software platform, trademark and the team of skilled developers.

Explain the accounting treatment for the software platform and the trademark over their useful lives.

Suggested solution

Basis for recognition of intangible assets:

Internally generated intangible assets:

Must meet the definition of an asset and be identifiable.

Must demonstrate technical feasibility and intention to use or sell.

Costs must be reliably measurable.

Can only be recognised if they meet the criteria for development costs (e.g., IAS 38).

Acquired intangible assets:

Recognised at fair value at the date of acquisition.

Must meet the definition of an asset and be identifiable.

Initial recognition and measurement:

Software platform should be recognised as an intangible asset, initially at ~~₦~~20 million. It should be recognised due to the following reasons:

It meets the definition of an asset as it is expected to generate future economic benefits.

It is identifiable as it has a specific value (~~₦~~20 million) and a finite useful life (5 years).

It can be reliably measured at fair value.

Trademark should be recognised as an intangible asset, initially at ~~₦~~15 million. It should be recognised due to the following reasons.

It meets the definition of an asset as it is expected to generate future economic benefits through brand recognition and customer loyalty.

It is identifiable as it has a specific value (~~₦~~15 million) and is separable from the company.

It can be reliably measured at fair value.

Team of skilled developers should not be recognised as an intangible asset. It should not be recognised due to the following reasons

The company cannot control the future employment or actions of the skilled developers.

The team of skilled developers is not separable from the company's workforce and cannot be sold, transferred, or licensed independently.

The value of the team (14 million) may not reflect the actual benefits or costs associated with the team.

Accounting treatment:

Software platform: Amortise ~~HK~~4,000,000 annually (2 million / 5 years) using the straight-line method.

Trademark: Test for impairment annually or when indicators of impairment exist.

ICAN 2025

SOLUTIONS TO PRACTICE QUESTIONS

YEAR 1	₦	₦	
Cash	40,000	Balance c/d	40,000
	<u>40,000</u>		<u>40,000</u>
YEAR 2			
Balance b/d	40,000	Balance c/d	40,000
	<u>40,000</u>		<u>40,000</u>
Balance b/d	40,000		
Equipment – accumulated depreciation			
YEAR 1	₦	₦	
		Depreciation	8,000
Balance c/d	8,000		<u>8,000</u>
	<u>8,000</u>		
YEAR 2			
		Balance b/d	8,000
Balance b/d	16,000	Depreciation	8,000
	<u>16,000</u>		<u>16,000</u>
		Balance b/d	16,000
Depreciation expense			
YEAR 1	₦	₦	
Acc. depreciation	8,000	Statement of profit or loss	8,000
	<u>8,000</u>		<u>8,000</u>
YEAR 2			
Acc. depreciation	8,000	Statement of profit or loss	8,000
	<u>8,000</u>		<u>8,000</u>
Carrying amounts at end of:	Year 1 (₦)	Year 2 (₦)	
Cost	40,000	40,000	
Accumulated depreciation	(8,000)	(16,000)	
Carrying amount	<u>32,000</u>	<u>24,000</u>	

- 1 Annual depreciation = $\text{₦}(1,260,000 - 240,000)/6 \text{ years} = \text{₦}170,000$.
After 4 years: ~~₦~~

Asset at cost	1,260,000
Less accumulated depreciation: ~~₦~~ 170,000 x 4)	680,000
Carrying amount	<u>580,000</u>

Annual depreciation = $\text{₦}(60,000 - 0)/5 \text{ years} = \text{₦}12,000$.

Charge in the year of acquisition = $\text{₦}12,000 \times 8 \text{ months}/12 \text{ months}$

= ~~₦~~8,000

Equipment account

YEAR 1	₦		₦
Cash	60,000	Balance c/d	60,000
	<u>60,000</u>		<u>60,000</u>
YEAR 2			
Balance b/d	60,000	Balance c/d	60,000
	<u>60,000</u>		<u>60,000</u>
Balance b/d	60,000		

Equipment – accumulated depreciation

YEAR 1	₦		₦
Balance c/d	8,000	Depreciation	8,000
	<u>8,000</u>		<u>8,000</u>
YEAR 2			
Balance b/d	20,000	Balance b/d	8,000
	<u>20,000</u>	Depreciation	12,000
			<u>20,000</u>
		Balance b/d	20,000

Depreciation expense

YEAR 1	₦		₦
Acc. depreciation	8,000	Statement of profit or loss	8,000
	<u>8,000</u>		<u>8,000</u>
YEAR 2			
Acc. depreciation	12,000	Statement of profit or loss	12,000
	<u>12,000</u>		<u>12,000</u>

Carrying amounts at end of:	Year 1 (₱)	Year 2 (₱)
Cost	5,000,000	5,000,000
Accumulated depreciation	(60,000)	(120,000)
Carrying amount	4,940,000	4,880,000

Carrying amounts at end of:	Year 1 (₱)	Year 2 (₱)
Cost	60,000	60,000
Accumulated depreciation	(8,000)	(16,000)
Carrying amount	52,000	44,000

Non-current assets and depreciation

Solutions (continued)

2

3 Working:	N
Cost of the asset	64,000
Year 1 depreciation (25%)	(16,000)
Carrying amount at the end of year 1	48,000
Year 2 depreciation (25%)	(12,000)
Carrying amount at the end of year 2	36,000
Year 3 depreciation (25%)	(9,000)
Carrying amount at the end of year 3	27,000

a	Equipment	account	
YEAR 1	N		N
Cash	64,000	Balance c/d	64,000
	64,000		64,000
YEAR 2			
Balance b/d	64,000	Balance c/d	64,000
	64,000		64,000
YEAR 3			
Balance b/d	64,000	Balance c/d	64,000
	64,000		64,000
Balance b/d	64,000		
b	Equipment – accumulated depreciation		
YEAR 1	N		N
Balance c/d	16,000	Depreciation	16,000
	16,000		16,000
YEAR 2			
Balance b/d		Balance b/d	16,000
Balance b/d	28,000	Depreciation	12,000
	28,000		28,000
YEAR 3			
Balance b/d		Balance b/d	28,000
Balance b/d	37,000	Depreciation	9,000
	37,000		37,000
		Balance b/d	37,000

Solutions(continued)
3 continued... c

YEAR 1	~~N~~	~~N~~	
Acc. depreciation	16,000	Statement of profit or loss	8,000
	<u>16,000</u>		<u>16,000</u>
YEAR 2			
Acc. depreciation	12,000	Statement of profit or loss	12,000
	<u>12,000</u>		<u>12,000</u>
YEAR 3			
Acc. depreciation	9,000	Statement of profit or loss	9,000
	<u>9,000</u>		<u>9,000</u>

Carrying amounts at end of:	Year 1 (~~N~~)	Year 2 (~~N~~)	Year 2 (~~N~~)
Cost	64,000	64,000	64,000
Accumulated depreciation	(16,000)	(28,000)	(37,000)
Carrying amount	<u>48,000</u>	<u>36,000</u>	<u>27,000</u>

- 4** Annual depreciation = $\text{N}(3,000,000)/50 \text{ years} = \text{N}60,000$.
(Land is not depreciated(except in certain circumstances

YEAR 1	~~N~~		~~N~~
Cash	5,000,000	Balance c/d	5,000,000
	<u>5,000,000</u>		<u>5,000,000</u>
YEAR 2			
Balance b/d	5,000,000	Balance c/d	5,000,000
	<u>5,000,000</u>		<u>5,000,000</u>

Land and buildings – accumulated depreciation

YEAR 1	~~N~~	~~N~~	
Balance c/d	60,000	Depreciation	60,000
	<u>60,000</u>		<u>60,000</u>
YEAR 2			
Balance b/d		Balance b/d	60,000
Balance b/d	120,000	Depreciation	60,000
	<u>120,000</u>		<u>120,000</u>
		Balance b/d	<u>120,000</u>

Non-current assets and depreciation

Solutions(continued)		2	
Depreciation expense			
YEAR1	₦		₦
Acc. depreciation	60,000	Statement of profit or loss	60,000
	60,000		60,000
YEAR 2			
Acc. depreciation	60,000	Statement of profit or loss	60,000
	60,000		60,000

Solution

3

Annual depreciation = $\frac{₦(96,000 - 16,000)}{5 \text{ years}} = ₦16,000$.

Monthly depreciation = $\frac{₦16,000}{12} = ₦1,333.33$.

	₦	₦
Disposal value less disposal costs		68,000
Cost of the asset	96,000	
Accumulated depreciation at the time of disposal (= 27 months $\times$ ₦1,333.33)	(36,000)	
Carrying amount at the date of disposal		<u>60,000</u>
Gain on disposal		<u>8,000</u>

Solutions**4**

Annual depreciation = ~~N~~(216,000 – 24,000)/8 years = ~~N~~24,000.

	~~N~~	~~N~~
Disposal value		163,000
Less disposal costs		(1,000)
		162,000
Accumulated depreciation at the time of disposal		
Year to 31 December Year 1: (~~N~~ 24,000 × 7/12)	14,000	
Years 2 and 3: (~~N~~ 24,000 × 2 years)	48,000	
Year to 31 December Year 4: (~~N~~ 24,000 × 8/12)	16,000	
	78,000	
Cost of the asset	216,000	
Carrying amount at the date of disposal		138,000
Gain on disposal		24,000

Non-current assets and depreciation

Solution

5

	₦	₦
Cost of the asset	80,000	
Year 1 depreciation (25%)	(20,000)	20,000
Carrying amount at end of Year 1	60,000	
Year 2 depreciation (25%)	(15,000)	15,000
Accumulated depreciation at date of disposal		35,000

Disposal account

	₦		₦
Motor vehicles account	80,000	Accumulated depreciation	35,000
Bank (disposal costs)	200	Receivables	41,000
		Statement of profit or loss (loss on disposal)	4,200
	80,200		80,200

	₦		₦
Opening balance b/d	720,000	Disposal of asset account	80,000
		Closing balance c/d	640,000
	720,000		720,000
Opening balance b/d	640,000		

	₦		₦
Disposal of asset account	35,000	Opening balance b/f	250,000
Closing balance c/d	215,000		250,000
	250,000	Opening balance b/d	215,000

Solution**6**

	₦	₦
Sale proceeds on disposal (part-exchange value)		8,000

Asset at cost	28,000	
Less: Accumulated depreciation	(18,000)	
Carrying amount at date of disposal		(10,000)
Loss on disposal		(2,000)

Disposal account

	₦		₦
Motor vehicles account	28,000	Accumulated depreciation account	18,000
		Motor vehicles account	
		(Trade-in value)	8,000
		Loss on disposal	2,000
	<u>28,000</u>		<u>28,000</u>

b Motor vehicles

	₦		₦
Opening balance	120,000	Disposal account	28,000
Bank (31,000 – 8,000)	23,000		
Disposal of asset account		Closing balance	123,000
	8,000		<u>151,000</u>
	<u>151,000</u>		
Opening balance	151,000		

c Accumulated depreciation on motor vehicles

	₦		₦
Disposal account	18,000	Opening balance	64,000
Closing balance	46,000		
	<u>64,000</u>		<u>64,000</u>
		Opening balance	46,000

BAD AND DOUBTFUL DEBTS

Contents

- 6.0 Learning objective
- 6.1 Learning outcomes
- 6.2 Bad debts and doubtful debts
- 6.3 Doubtful debts
- 6.4 Chapter review
- 6.5 End of chapter questions and answers

6. Bad and doubtful debt

6.0 Learning objective

This chapter explains the accounting treatment for bad and doubtful debts.

6.1 Learning outcomes

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

- a. account for the write off of bad debts;
- b. account for the recovery of bad debts;
- c. measure the balance on the allowance account for doubtful debts;
- d. account for the movement on the allowance account for doubtful debts; and
- e. understand the write off and recovery of debts against which an allowance has been made.

6.2 Bad debts and doubtful debts

6.2.1 Introduction

A business might make all its sales for cash but many businesses make some or even all their sales on credit. There is often no alternative to offering credit to customers. If competitors offer credit, then a business will have little alternative but to offer credit as well so as not to lose customers. A major benefit of offering credit is that it usually increases revenue, compared to what revenue would be if all sales were for cash.

If sales are made on credit, there is always a chance that some customers will fall into financial difficulty and be unable to pay what they owe.

It would be misleading to the users of the financial statements if a business continued to show receivables where there is no chance, or only a slight chance of collecting them.

The application of the concept of prudence would require that there should be an adjustment to reflect the fact that there are some receivables which the business thinks that it will not recover.

There are two categories of problem receivables for which adjustment might be required.

Bad debts (also known as irrecoverable debts or receivables)

A bad debt is an amount owed by a customer that the business believes it will never be able to collect.

Examples of circumstances that might lead to the conclusion that a receivable is irrecoverable include:

- a. the bankruptcy or insolvency of a customer;
- b. the death of a customer who has left insufficient assets to pay off his debts;
- c. a dispute with a customer over whether a contract has been fulfilled or not; and

- d. the dishonesty of a customer (where a person has obtained goods on credit with no intention to pay).

Doubtful debts

A doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so. For example, the business might know that the customer is in difficulty but that he might be able to work his way out of it. This casts doubt on the collectability of the receivable but it still might be possible if the customer is able to recover from his difficulties.

- A customer experiencing cash flow problems.
- A customer taking an unusually long time to settle a debt.
- A customer experiencing operational difficulties which might lead to financial problems (for example, strikes, natural disasters disrupting production, etc.).

Prudence

6.2.2 Accounting for bad debts

When a specific debt (receivable) is considered bad or irrecoverable, it is written off. This means that it is removed from the accounting system and supporting records.

Debit	Credit

BadanddoubtfuldebtsexpenseRec
eivables

X

X

Individual customer accounts

X

- The total value of receivables is reduced (reducing assets).
- The bad debt is recorded as an expense (reducing profit and hence capital).

Example: Write off of bad debt

A business has trade receivables of ₦750,000 but decides to write off a bad debt of ₦15,000

Receivables control account			
	₦		₦
Balance b/f	750,000	Bad and doubtful debts	15,000
		Closing balance c/f	735,000
	<u>750,000</u>		<u>750,000</u>
Opening balance b/f	735,000		

Bad and doubtful debts account (expense)			
	₦		₦
Receivables	15,000		

At the end of the financial period, the bad debt expense is transferred to the statement of profit or loss as an expense for the period.

General ledger

	₦	₦
Statement of profit or loss	Bad and doubtful debts	15,000
		15,000
(This reduces the balance on both accounts)		

The balance on the customer's account in the receivables ledger is reduced by ₦15,000 (in all probability, from ₦15,000 to ₦0.)

6.2.3 Bad debts recovered

On rare occasions cash in respect of a debt that had been written off as bad in a previous year is subsequently received in a later period. The double entry for recording the recovery of a bad debt is:

Illustration: Subsequent recovery of bad debt – double entry

Write off of bad debt	Debit	Credit
General ledger:		
Cash	X	
Bad debt recovered		X

The credit will be recognised as a reduction of the bad debt expense in the statement of profit and loss. This recognises that the business had previously recognised an expense when it first wrote off the debt where, in hindsight, it need not have done so.

6.3 Doubtful Debts

6.3.1 Basic double entry for doubtful debts

As stated above, a doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so.

The accounting treatment has to serve two objectives.

- The exercise of prudence requires that the value of the receivable should be adjusted downwards (perhaps to zero) and an expense recognised for the loss in value; but
- The receivable must stay in the accounting records so that the business continues to chase payment.

This is achieved in the following way. Instead of writing off the debt (which would remove it from the records) a business sets up an allowance account.

Illustration: Accounting for doubtful debts—basic double entry

	Debit	Credit
General ledger:		
Bad and doubtful debts expense	X	
Allowance for doubtful debts		X
Receivables ledger:		
No entry		X

Note that the **allowance account** might also be called the **provision for doubtful debts account**.

The allowance is a credit balance which is then set against the carrying amount of the receivables in the statement of financial position.

Illustration: Presentation of receivables in statement of financial position

In the statement of financial position:	£
Trade receivables (net of bad debts written off)	X
Allowance for doubtful debts	(X)
Figure shown for trade receivables on the face of the statement of financial position	<u>X</u>

6.3.2 Measurement of the allowance

An allowance is only recognised for a debtor (receivable) if the business knows that the debtor might not pay. Therefore, when a business has information about the financial difficulties of specific debtors it would set up an allowance account for these.

In addition, a business with many debtors would know from experience that at each year end some of the debtors are in difficulty but it does not know who these are yet. In such cases a business might recognise a further general amount in the allowance. Note that the business would have to justify this amount; it cannot recognise a general allowance as it pleases. This must be based on verifiable experience.

Example: Measuring allowance for doubtful debts

The Acure Cocoa Company has receivables at the year-end of ₦1,500,000.

It has carried out a year-end review of its receivables and discovered that a customer owing ₦75,000 has suffered a fire at their factory which will stop production for 3 months. The chief accountant believes that this casts doubt on their ability to pay their debt.

In addition, it is practice of the Acure Cocoa Company to recognise an allowance for 5% of its receivables. This is based on experience and the treatment has been approved by the company's auditor.

The Acure Cocoa Company would recognise the following allowance:

Allowance for specific receivable

General allowance:	75,000
Total receivables	1,500,000
Less amount for which there is a specific allowance	(75,000)
	1,425,000
General allowance @ 5%	71,250
Total allowance required	146,250

In the statement of financial position:

Trade receivables	1,500,000
Allowance for doubtful debts	(146,250)
Figure shown for trade receivables on the face of the statement of financial position	1,353,750

In summary, when a bad debt is written off, receivables are reduced. An allowance for irrecoverable debts is different from bad debts. When an allowance for irrecoverable debts is created, total receivables are not reduced. Instead, the allowance for irrecoverable debts is recorded in a separate account in the general ledger – an allowance for irrecoverable debts account. This always has a credit balance.

6.3.3 Accounting for changes in the allowance account

The double entry shown above is a little simplistic. In practice a business will recognise an allowance balance at each year end. When this is the case it is the movement on the allowance that is recognised as an expense.

Example: Accounting for change in the allowance A

business started on 1st January Year 1.

The balance on receivables and the required allowance for doubtful debts at the end of each of the first three years were as follows:

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	20,000	24,000	18,000

Example: Accounting for change in the allowance

Bad and doubtful debts expense account

YEAR 1		₤		₤
Allowance account (1)	20,000		Statement of profit or loss	20,000
	<u>20,000</u>			<u>20,000</u>
YEAR 2				
Allowance account (2)	4,000		Statement of profit or loss	4,000
	<u>4,000</u>			<u>4,000</u>
YEAR 3				
Statement of profit or Loss	6,000		Allowance account (3)	6,000
6,000				<u>6,000</u>

Allowance for doubtful debts

YEAR 1		₤		₤
Balance b/d	0		Expense account (1)	20,000
Balance c/d	20,000			
	<u>8,000</u>			<u>8,000</u>
YEAR 2				
			Balance b/d	20,000
Balance c/d	24,000		Expense account (2)	4,000
	<u>24,000</u>			<u>24,000</u>
YEAR 3				
Expense account (3)	6,000		Balance b/d	24,000
Balance c/d	18,000			
	<u>24,000</u>			<u>24,000</u>
			Balance b/d	18,000

Note that in year 3 there is a credit to the bad debt expense. This would reduce the expense recognised in the year (or may even be an item of income).

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	(20,000)	(24,000)	(18,000)
	<u>980,000</u>	<u>1,176,000</u>	<u>882,000</u>

It is not obvious in the above example but the way to calculate the expense in respect of the allowance account is to identify the movement on the allowance.

Remember that any balance on the allowance account is a credit balance.

Illustration: Change in the allowance

	Debit	Credit
Increase in allowance		
Bad and doubtful debts expense	X	
Allowance for doubtful debts		X
Decrease in allowance		
Allowance for doubtful debts	X	

Year 2

	Year 2	
Allowance required at the start of the year	20,000	Cr
Allowance required at the end of the year	24,000	Cr
	<u>4,000</u>	Cr

	Dr	Cr
Bad and doubtful debts expense	4,000	
Allowance for doubtful debts		4,000

	Year 3	
Allowance required at the start of the year	24,000	Cr
Allowance required at the end of the year	18,000	Cr
	<u>6,000</u>	Dr

6.3.4 Bad and doubtful debts together

Any question on this area will involve both bad debts and doubtful debts. This is best seen with an example.

Example:

A business has trade receivables of ₦75,000.

It identifies that ₦5,000 of these debts are irrecoverable and should be written off.

An allowance for irrecoverable debts of ₦2,000 should be created. It is the first time that the business has opened such an account.

These transactions will be accounted for as follows:
Receivables account

Opening balance b/f	₦ 75,000	Bad debt expense (1)	₦ 5,000
		Closing balance c/f	70,000
	<u>75,000</u>		<u>75,000</u>
Opening balance b/f	70,000		
	<u>70,000</u>		
Receivables (1)	₦ 5,000	Statement of profit or loss	₦ 7,000
Allowance (2)	2,000		
	<u>7,000</u>		<u>7,000</u>
	₦	B and DD expense(2)	₦ 2,000

Note: The balance on the trade receivables account is reduced by the bad debts written off, but not by the allowance for doubtful debts.

Example (continued into year 2)

In year 2, credit sales were ₦200,000, receipts from customers were ₦185,000 and bad debts written off were ₦8,000.

The allowance for irrecoverable debts is to be reduced from ₦2,000 to ₦1,500. These transactions can be summarised as follows:

Receivables (1)	₦ 8,000	Allowance (2)	₦ 500
		Statement of profit or loss	7,500
	<u>8,000</u>		<u>8,000</u>
Opening balance b/f	₦ 70,000	Bank	₦ 185,000
Sales	200,000	Bad debt expense (1)	8,000
		Closing balance c/f	77,000
	<u>270,000</u>		<u>270,000</u>
Opening balance b/f	77,000		
B and DD expense (2)	₦	Opening balance b/f	₦ 2,000
(2,000 – 1,500)	500		
Closing balance c/f	<u>1,500</u>		<u>2,000</u>
	<u>2,000</u>	Opening balance b/f	1,500

In the statement of financial position, trade receivables will be:

Trade receivables	₦ 77,000
Less: Allowance for irrecoverable debts	<u>1,500</u>
	<u>75,500</u>

Practice question**1**

Continuing the same example above, the following year (Year 3) sales (all on credit) were ₦250,000, receipts from customers were ₦252,000 and bad debts written off were ₦7,000.

It is decided to reduce the allowance for doubtful debts from ₦1,500 to ₦900. Record these transactions in the following ledger accounts:

- a) Receivables control account
- b) Bad and doubtful debts
- c) Allowance for doubtful debts

6.3.5

Doubtful debts recovered

The accounting treatment to record a receipt of cash in respect of a doubtful debt is the same as for any other debt.

Illustration: Subsequent recovery of doubtful debt—double entry

	Debit	Credit
General ledger:		
Cash	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

There is no special accounting treatment to reflect the fact that the business has received cash for a debt against which it has already recognised an expense.

Common sense suggests that the business should now recognise a credit to the statement of profit or loss but this happens automatically through the use of basic allowance accounting.

This is because the recovered amount will no longer be included as an allowance when this is re-estimated at the year-end. If all other things are equal this will cause the allowance account to fall. This fall results in a credit to the bad and doubtful debt expense account thus reducing the expense recognised in the statement of profit or loss.

Example: Doubtful debts recovered

At the start of a period a business has an allowance for doubtful debts made up as follows:

Allowance		
Allowance required for customer A receivable	6,000	Cr
Allowance required for customer B receivable	2,000	Cr
	<u>8,000</u>	<u>Cr</u>

Customer B pays in full during the period. The only necessary double entry is: Dr

Cash	2,000	Cr
Receivables control account		2,000

Allowance		
Allowance required at the start of the year	8,000	Cr
Allowance required at the end of the year	6,000	Cr
	<u>2,000</u>	<u>Dr</u>

At the period end the allowance for customer B's receivable is no longer required.

In order to change a credit balance of 8,000 to a credit balance of 6,000 we must:

	Dr	Cr
Allowance for doubtful debts	2,000	
Bad and doubtful debts expenses		2,000

Therefore, the credit to the statement of profit or loss to reflect the fact that an expense was previously recognised when, with hind sight, there was no need to do so, happens automatically when the year end allowance is remeasured.

6.3.6 Aged receivables analysis

Preparing an aged receivables analysis is a method of attempting to assess the likelihood of bad debts or to make an assessment of doubtful receivables. This is an analysis for each individual credit customer of their total debtor balance, showing how long each invoice has been outstanding. A typical format for an aged receivables analysis is given below:

Illustration: Aged debtors (receivables) analysis

<i>Customer</i>	<i>Credit limit ₦</i>	<i>Total owed ₦</i>	<i>< 30 days ₦</i>	<i>30 – 60 days ₦</i>	<i>60 – 90 days ₦</i>	<i>Over 90 days ₦</i>
X	20,000	5,500	3,000	–	2,500	–
Y	15,000	2,700	–	1,000	1,000	700

If a customer has old amounts outstanding, these should be investigated and an attempt should be made to collect payment. However the investigation may indicate that the amount should either be written off as a bad debt, or that an allowance should be made for an irrecoverable debt. (In other words, the debt is not written off yet, but the chances of it being paid look doubtful.)

6.3.7 Summary of the rules on bad and doubtful debts

The rules for dealing with bad debts and doubtful debts at the end of the financial year can be summarised as follows:

Illustration:

	₦
Annual charge in the statement of profit or loss:	X
Bad debts written off	X
Plus: increase in allowance for doubtful debts; or	(X)
Less: decrease in allowance for doubtful debts	X
	₦
In the statement of financial position	X
Trade receivables (net of bad debts written off)	X
Allowance for doubtful debts	
Figure shown for trade receivables on the face of the statement of financial position	X

6.4 Chapter review

Chapter review

Before moving to the next chapter, check that you are now able to:

- account for the write off of bad debts;
- account for the recovery of bad debts;
- measure the balance on the allowance account for doubtful debts;
- account for the movement on the allowance account for doubtful debts; and
- understand the write off and recovery of debts against which an allowance has been made.

6.5 End of chapter questions and suggested solutions

Question 1

Ashipu is a general merchant who operates as Ashipu Enterprises in Rubuka Market. The receivables ledger accounts, of the business, for the years ended December 31, 2024 and December 31, 2025, show the following balances:

Year	Receivables
2024	~~N~~ 100,000,000
2025	~~N~~ 120,000,000

Additional information:

- In 2024, bad debts written off were ~~N~~5,000,000. In 2025, bad debts written off were ~~N~~8,000,000.
- In 2025, Ashipu still considered that 2% of the closing receivables may never pay and should be written off.
- The company maintains an allowance for bad and doubtful debts at 5% of trade receivables at the end of each year.
- The allowance for bad and doubtful debts brought forward from 2023 was ~~N~~4,500,000.

Required:

- Calculate the allowance for bad and doubtful debts for each year 2024 and 2025.
- Calculate the bad and doubtful debt expense in the statement of profit or loss for each year.
- Show the ledger accounts for bad debt and doubtful debt accounts for each year.
- Show extracts of the statement of financial position for the trade receivables balance as at October 31, 2024 and 2025.

Suggested solutions

a. Calculations of Allowance for Doubtful Debts:

	N'000	N'000
2024: Allowance- : 5% of N100,000,000		5000
Balance b/f		<u>4,500</u>
Increase in allowance		<u>500</u>
2025: Trade receivables	120,000	
Additional bad debt written off 2% x N120m	<u>(2,400)</u>	
	<u>117,600</u>	
Allowance 5% x N117.4m		5,870
Allowance b/f		<u>(5,000)</u>
Increase in allowance		<u>870</u>

b. Calculation of bad debt expense

	'000	N'000
2024: Bad debt written off		5,000
Increase in allowance for doubtful debt		500
Bad debt expense		5,500
2025: Bad debt written off	8,000	
Additional written off	2,400	10,400
Increase in allowance for doubtful debt		870
Bad debt expense		11,270

Allowance for Bad and Doubtful Debts Account

Date	Particulars	N'000	Date	Particulars	N'000
Oct 31, 2024	Balance c/d	5,000	Nov 1, 2023	Balance b/f	4,500
			Oct 31, 2024	Profit or loss (increase in allowance)	500
		5,000			5,000

Date	Particulars	₦'000	Date	Particulars	₦'000
Oct 31, 2025	Balance c/d	5,870	Nov 1, 2024	Balance b/f	5,000
			Dec 31, 2025	Profit or loss (increase in allowance)	870
		5,870			5,870
				Nov. 1 2025 Balance b/f	5,870

Bad and doubtful debt expense account

Date	Particulars	₦'000	Date	Particulars	₦'000
Oct 31, 2024	Bad debts written off	5,000	Dec 31, 2022	Profit or loss	5,500
Oct 31, 2024	Increase in allowance	<u>500</u>			
		<u>5,500</u>			<u>5,500</u>
Oct 31, 2025	Bad debts written off	11,600	Oct, 2025	Profit or loss	12,420
Oct 31, 2023	Increase in allowance	<u>820</u>			
		<u>12,420</u>			<u>12,420</u>

Bad Debts Account

Date	Particulars	₦'000	Date	Particulars	₦'000
Oct 31, 2024	Trade receivables	<u>5,000</u>	Oct 31, 2024	Bad debt expense	<u>5,000</u>
Oct 31, 2025	Trade receivables	11,600	Dec 31, 2025	Bad debt expense	11, 600

	₦'000	₦'000
2024:		
Current assets:	100,000	
Receivables		
Less allowance for doubtful receivables	<u>5,000</u>	
		95,000
2025		
Receivables	120,000	
Additional bad debt written off	(2,400)	
Allowance for doubtful debt	<u>(5,780)</u>	
		111,820

Question 2

Ashipu Enterprises

Statement of financial position (Extracts) as at October 31, 2024 and 2025

Question 2

The trial balance of Jelco Enterprises at 31 December 20X4 includes the following:

- a. Receivables: ~~N~~850,000
 - b. Allowance for doubtful debts (1 January 20X4): ~~N~~40,000 (credit balance)
 - c. During the year:
 - i. Debts totalling ~~N~~18,000 were written off as irrecoverable.
 - ii. A previously written-off debt of ~~N~~5,000 was recovered.
- A review of receivables revealed:
- i. A customer owing ~~N~~12,000 is undergoing liquidation and should be written off.
 - ii. An allowance for doubtful debts of 5% of remaining receivables is to be maintained.

Required:

- i) Calculate the adjusted receivables to be reported in the statement of financial position.
- ii) Prepare the journal entries for:
 - The bad debt write-off,
 - The recovery of the previously written-off debt,
 - The adjustment to the allowance for doubtful debts.
- iii) Determine the amount to be charged or credited to the income statement for bad and doubtful debts for the year.

Suggested solution

- i) Adjusted Receivables in the Statement of Financial Position
Given:
 - Receivables before adjustments = ~~N~~850,000
 - Debts written off during the year = ~~N~~18,000
 - Further write-off: ~~N~~12,000 (customer in liquidation)
 - Remaining receivables = ~~N~~850,000 - ~~N~~12,000 = ~~N~~838,000
 - Allowance required @ 5% of ~~N~~838,000 = ~~N~~41,900
 - Adjusted receivables to report:
~~N~~838,000 - ~~N~~41,900 = ~~N~~796,100 ~~N~~838,000 - ~~N~~41,900 =
~~N~~796,100 ~~N~~838,000 - ~~N~~41,900 = ~~N~~796,100
- ii) Journal Entries
 - 1. Write-off of Additional Bad Debt (~~N~~12,000)
Dr Bad and Doubtful Debts Expense ~~N~~12,000
Cr Trade Receivables ~~N~~12,000
(To write off customer in liquidation)
 - 2. Recovery of Previously Written-off Debt (~~N~~5,000)
Dr Bank ~~N~~5,000
Cr Bad and Doubtful Debts Expense ~~N~~5,000
(To record recovery of a previously written-off debt)
 - 3. Adjustment to Allowance for Doubtful Debts

- Opening allowance = ~~N~~40,000
 - Required allowance = ~~N~~41,900
 - Increase = ~~N~~1,900
- Dr Bad and Doubtful Debts Expense ~~N~~1,900
 Cr Allowance for Doubtful Debts ~~N~~1,900
 (To increase allowance to ~~N~~41,900)

iii) Income Statement Impact – Bad and Doubtful Debts Expense

Description	Amount (N)
Bad debt written off (new)	12,000
Less: Recovery of previously written-off debt	(5,000)
Increase in allowance	1,900
Total expense charged to profit or loss	~~N~~ 8,900

Question 3

The finance team of **Elite Books Ltd** is reviewing year-end receivables. A customer who owes ~~N~~50,000 is going through a legal dispute with the company over the supply of goods. Legal advice suggests a 40% chance of recovering the debt. The head of accounts proposes making an allowance instead of a full write-off to keep the debt on record for possible future recovery. Another customer whose ~~N~~15,000 debt was included in the allowance last year has now paid half and refused to pay the rest.

Required:

- Evaluate whether the ~~N~~50,000 receivable should be written off or included in the allowance. Support your answer with reference to accounting principles.
- Discuss the correct accounting treatment for the partially recovered ~~N~~15,000 debt and its impact on both the allowance account and the profit or loss.
- Suggest how Elite Books Ltd should improve its credit and recovery policy based on these cases.

Suggested solution

i) Evaluation of the ~~N~~50,000 Receivable

Situation:

- The customer owes ~~N~~50,000 but is in a legal dispute with only a 40% chance of recovery (i.e., a 60% chance of loss).

Recommendation:

- Do not write off the entire amount. Since there is still a realistic chance (40%) of recovering part of the debt, it should not be written off fully.
- Create a specific allowance for the estimated irrecoverable portion (60%) of the debt, which amounts to:

$$\begin{aligned} \text{N}50,000 \times 60\% &= \text{N}30,000 \\ \text{N}50,000 \times 60\% &= \text{N}30,000 \end{aligned}$$

Accounting Principle Justification:

- Prudence (conservatism): The company should not overstate assets or income, so a provision (allowance) is needed.
- Faithful Representation: Financial statements should reflect the economic reality—that part of the receivable is doubtful.
- IFRS 9 (Expected Credit Losses Model) supports estimating losses based on available evidence.

Conclusion:

- Include the ~~N~~50,000 in receivables.
- Create a specific allowance of ~~N~~30,000, leaving a net receivable of ~~N~~20,000.

ii) Treatment of the Partially Recovered ~~N~~15,000 Debt

Situation:

- ~~N~~15,000 was included in the allowance last year.
- ~~N~~7,500 is now paid; the remaining ~~N~~7,500 is confirmed irrecoverable.

Accounting Treatment:

1. Recovery (~~N~~7,500):

Dr Bank	~~N~~ 7,500
Cr Receivables	~~N~~ 7,500

Write-off (~~N~~7,500):

Dr Allowance for Doubtful Debts	~~N~~ 7,500
Cr Receivables	~~N~~ 7,500

Impact:

- No new expense hits the current year's profit or loss because:
- The allowance already covered the ~~N~~15,000.
- The write-off is charged against the allowance, not as a new bad debt expense.
- The recovery of ~~N~~7,500 reduces the outstanding receivables and increases cash.

iii) Recommendations for Improving Credit and Recovery Policy
Based on the cases, the following improvements are advisable:

1. Tighten Credit Assessment Procedures:
 - Perform credit checks before granting terms.
 - Use credit scoring and financial history to assess risk.
2. Introduce Tiered Follow-Up Systems:
 - Automated reminders at due dates.
 - Escalate from internal follow-up to legal action promptly if payments are not received.
3. Review and Update Allowance Policy:
 - Include both specific and general provisions.
 - Regularly update the allowance based on historical data and customer behaviour.
4. Monitor Legal Disputes Closely:
 - Ensure legal risks are reflected promptly in accounting records.
 - Consider alternative dispute resolution to speed up settlements.
5. Train Staff on Ethical Reporting:
 - Reinforce the need for accurate, timely reporting of doubtful debts.
 - Ensure adherence to IFRS and professional ethical codes.
6. Use Key Performance Indicators (KPIs):
 - Track Days Sales Outstanding (DSO), bad debt ratio, and collection rate to monitor credit health.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

Receivables control account

	₦		₦
Opening balance b/f	77,000	Bad and doubtful debts	
Sales	250,000	(bad debts written off)	7,000
		Bank	252,000
		Closing balance c/f (=	
		balancing figure)	68,000
	<u>327,000</u>		<u>327,000</u>
Opening balance b/f	68,000		

Bad and doubtful debts expense

₦		₦	
Trade receivables (= bad		Allowance for doubtful	
Debts written off)	7,000	debts	
		(= reduction in allowance)	600
		Statement of profit or loss	
		(= balancing figure)	6,400
	<u>7,000</u>		<u>7,000</u>

Allowance for doubtful debts

	₦		₦
Bad and doubtful debts		Opening balance b/f	1,500
(= reduction in allowance)	600		
Closing balance c/f	900		
	<u>1,500</u>		<u>1,500</u>
		Opening balance b/f	900

ACCRUALS AND PREPAYMENTS

Contents

- 7.0 Learning objective
- 7.1 Learning outcomes
- 7.2 Accruals and prepayments introduced
- 7.3 Accruals
- 7.4 Prepayments
- 7.5 Unearned and accrued income
- 7.6 Chapter review
- 7.7 End of chapter questions and suggested solutions

7. Accrual and prepayment

7.0 Learning objective

This chapter explains the accounting treatment for accruals and prepayments.

7.1 Learning outcomes

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

- a. explain the meaning of an accrual;
- b. account for accruals using both methods;
- c. explain the meaning of a prepayment;
- d. account for prepayments using both methods;
- e. explain the meaning of accrued and unearned income; and
- f. account for accrued and unearned income

7.2 Accruals and prepayments introduced

7.2.1 The accruals concept (matching concept)

Financial statements are prepared using the accruals basis of accounting rather than on a cash basis. This means that:

- a. sales are recognised in the same period as the related cost of making the sale;
- b. income is recognised in the statement of profit or loss in the same period as the transaction that gave rise to it (not necessarily when cash is paid); and
- c. expenses are recognised in the statement of profit or loss as they arise (not as they are paid).

For example, the cost of rental charges on office accommodation should be spread over the period of time to which the rental payments relate, regardless of when the actual payment of rent occurs.

Illustration: Accruals basis

A business pays annual rental in advance on June 1, each year. Rent paid on June 1, 2018 = ₦240,000

Rent paid on June 1, 2019 = ₦300,000

The financial year ends on September 30.

The rental expense for the year ended September 30, 2019 is:

Period:	₦
October 1, 2018 to May 31, 2019	
8/12 of 240,000 (the last 8 months of the rental year)	160,000
June 1, 2019 to September 30, 2019	
4/12 of 300,000 (the first 4 months of the rental year)	100,000
	<u>260,000</u>

7.2.2 Accruals and prepayments

Accruals

A business might incur an expense before the year end but not receive an invoice until after the year-end. If this is the case the business must estimate the amount of the expense and recognise it as an expense and a liability.

The liability is known as an accrual. The business is said to be making an accrual for the expense or accruing for the expense.

Prepayments

A business might pay or at least be invoiced for some expenses in advance.

When the invoice is received the business will recognise the full liability as a debit in an expense account. It would be wrong to then clear all of this to the statement of profit or loss in the current period. Some of it relates to the next period. This part must be recognised as an asset (it represents a right to receive some kind of service in the next period) called a prepayment.

There are two approaches to accounting for both accruals and prepayments:

- a. Method 1 – using two accounts; and
 - b. Method 2 – using one account.
- Each of these will be explained in turn.

7.3 Accruals

7.3.1 Accruals (accrued expenses)

A business might incur expenses during a period but may not have been sent the invoice by the period end.

Since there has been no payment and no invoice, a financial transaction has not yet occurred and there is not yet anything to record as a book-keeping entry in the ledgers. However, to apply the accruals basis of accounting, the expense must be charged in the statement of profit or loss for the accounting period to which the expense relates. This is done by creating an accrued expense at the end of the accounting period.

An accrued expense (accrual) is an estimate of the cost that has been incurred in the financial period, and it is included in expenses in the statement of profit or loss for the period and recognised as a liability (called an accrual) in the statement of financial position.

Accruals are often necessary when expenses are paid in arrears (i.e. at the end of a period of expense).

Example:

Uche sets up in business on January 1, Year 1. The business has at December 31, year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 three months in arrears and telephone invoices received in Year 1 are as follows:

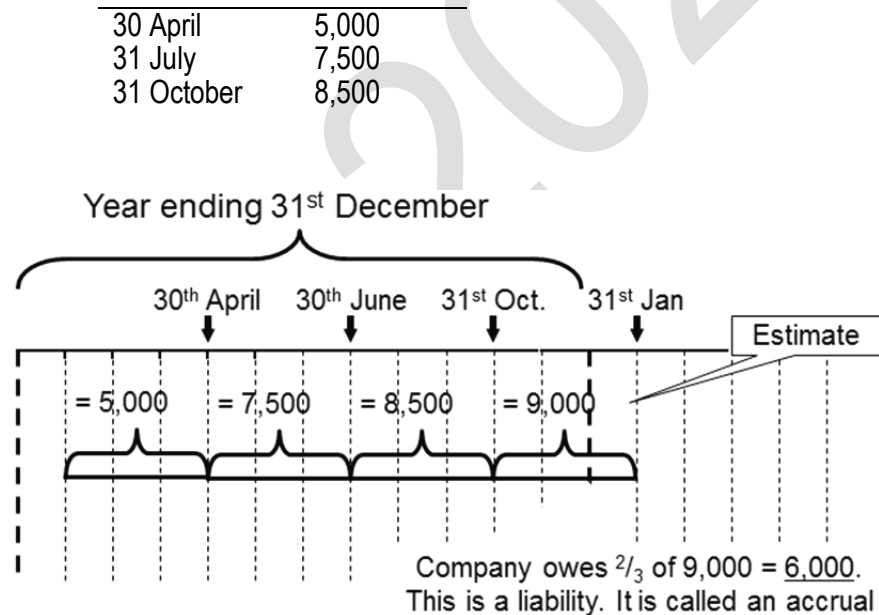
₦

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be ₦9,000.

The accrual for November and December Year 1 should be ₦6,000 (₦9,000 $\times$ $\frac{2}{3}$).

This can be represented as follows:



$\therefore$ Expense for the year = 5,000 + 7,500 + 8,500 + 6,000 accrued = 27,000

There are two ways of accounting for accruals at the end of an accounting period. These will be explained in turn.

7.3.2 Method 1: the 'two account' approach for accrued expenses (accruals)

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The accrued expense is recorded in an accrued expenses account. The double entry for this adjustment is as follows

Illustration: Accruals using two accounts.

	Debit	Credit
Expense account	X	
Accruals account		X

This adds the accrued expense to the expenses recognised as the result of having received invoices earlier in the current accounting period.

The credit balance on the accruals account is a liability, and is included in the statement of financial position as a current liability.

Example (continued): Year 1

Payments in the year were:

	£
30 April	5,000
31 July	7,500
31 October	8,500

Year 1	£		£
Bank	5,000	Statement of profit or loss	27,000
Bank	7,500		
Bank	8,500		
Accrued expense (accruals account)	6,000		
	<u>27,000</u>		<u>27,000</u>

The accrual for November and December Year 1 is £6,000 (£9,000 × 2/3).

Method 1: two account approach

Telephone expenses account

Accruals account

Year 1	£		£
Closing balance c/d	6,000	Telephone expenses	6,000
	<u>6,000</u>		<u>6,000</u>
Year 2		Opening balance b/d	6,000

Reversal of the accrual

There is a complication. At the year end the expense account is cleared to the statement of profit or loss and there is a credit balance carried down on the accruals account.

Assume that the invoice that arrives in January is ~~N~~9,500. The accounting system will record the following double entry:

Example: January invoice received

	Debit	Credit
Expense account	9,500	
Liability		9,500

However, an expense of ~~N~~6,000 and a liability of ~~N~~6,000 has already been recognised in respect of this invoice. If no further adjustment is made the 6,000 is being included twice.

There is a simple way to prevent this. The double entry that set up the accrual at the end of the last period is reversed:

Example: Reversal of the accrual (start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Accruals account	6,000	
Expense account		6,000

This removes the accrual so that it is not counted twice as a liability and the balance on the expense account is adjusted down to the amount that has not yet been expensed for this invoice.

Telephone expense account

Year 2

		Accruals (reversal)	6,000
Payables	9,500		

Accruals

Year 2 (at start of the year)

Telephone expense	6,000	Balance b/d	6,000

7.3.3 Accruals and prepayments

Example: Year 2

In Year 2, the telephone invoices are as follows:

₦

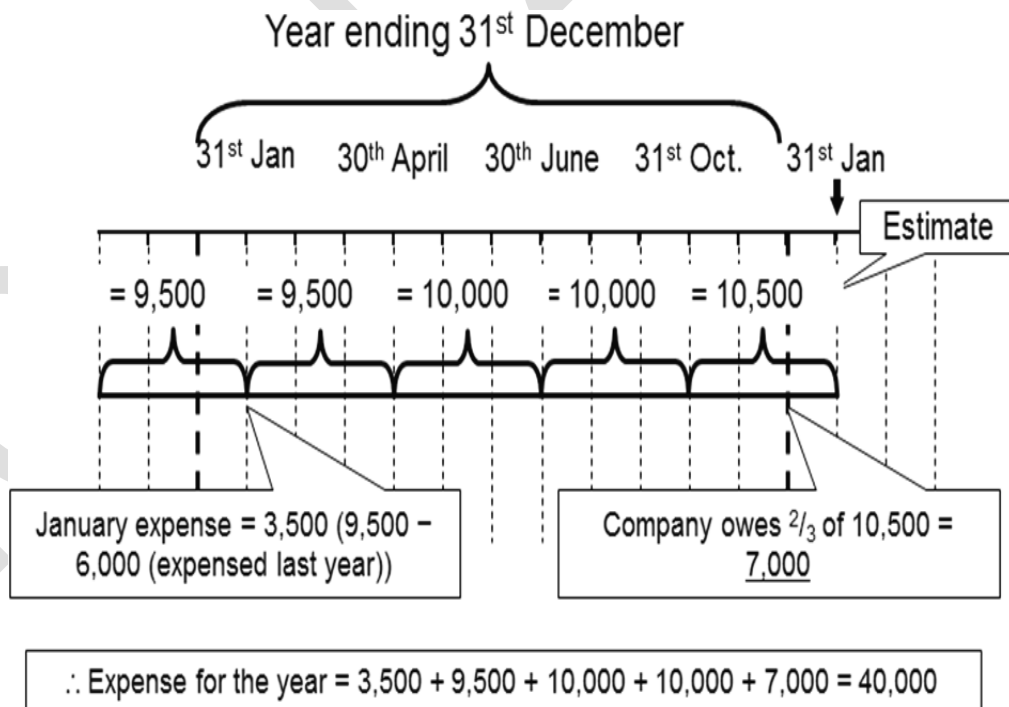
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be ₦10,500.

The accrual for November and December Year 1 should be ₦7,000 (₦10,500 $\times \frac{2}{3}$).

This can be represented as follows:



Example: Year 2

In Year 2, the telephone invoices are as follows:

	₦
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be ₦10,500.

The accrual for November and December Year 1 should be ₦7,000 (₦10,500 $\times$ $\frac{2}{3}$).

Method 1: two account approach

Telephone expenses account

Year 2	₦		₦
Telephone expense account (reversal of Year 1 accrual)	6,000	Opening balance b/d	6,000
Closing balance c/d	7,000	Telephone expenses account	7,000
	<u>13,000</u>		<u>13,000</u>
		Opening balance b/d	7,000

The expense in the statement of profit or loss for Year 2 is ₦40,000 and the accrued expense of ₦7,000 is included in the statement of financial position as a current liability at the end of Year 2.

Accruals account

Year 2	₦		₦
Bank	9,500	Accruals account (reversal of year 1 accrual)	6,000
Bank	9,500	Statement of profit or Loss	
Bank	10,000	(balancing figure)	40,000
Bank	10,000		
Accrued expense (accruals account)	7,000		
	<u>46,000</u>		<u>46,000</u>

7.3.2 Method 2: the 'one account' approach for accrued expenses (accruals)

This approach is trickier to understand. The accrual is recognised in the expense account.

There are two ways of achieving this.

- a. The total expense can be calculated and transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) leaving a balancing figure on the expense account as an accrual; or
- b. The accrual can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) as a balancing figure

Example: Year 1

Uche sets up in business on 1 January Year 1. The business has a 31 December year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 months in arrears and telephone invoices received in Year 1 are as follows:

	₦
30 April	5,000
31 July	7,500
31 October	8,500

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be ₦9,000.

The accrual for November and December Year 1 should be ₦6,000 ($\text{₦9,000} \times \frac{2}{3}$).

Method 2: one account approach

Telephone expenses account

Year 1	₦		₦
Bank	5,000	Statement of profit or loss	27,000
Bank	7,500		
Bank	8,500		
Closing balance (accrued expense) c/d	6,000		
	<u>27,000</u>		<u>27,000</u>
		Opening balance b/d	6,000

In order to make the above work either:

- 1) Calculate the expense transferred to the statement of profit or loss (27,000) and calculate the accrual taken as a balancing figure; or
- 2) Calculate the accrual needed (6,000) and then calculate the expense transferred to the statement of profit or loss (27,000) as a balancing figure (6,000). This is usually the easiest way.

There is no need to reverse the accrual using the one account method as it is already in the expense account at the start of the next year.

Example (continued): Year 2

In Year 2, the telephone invoices are as follows:

	₦
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be ₦10,500.

The accrual for November and December Year 1 should be ₦7,000 ($\text{₦}10,500 \times 2/3$).

Method 2: one account approach

Telephone expenses account

Year 2	₦		₦
Bank	9,500	Opening balance b/d	6,000
Bank	9,500	Statement of profit or loss	40,000
Bank	10,000		
Bank	10,000		
Closing balance (accrued expense) c/d	7,000		
	<u>46,000</u>		<u>46,000</u>
		Opening balance b/d	<u>7,000</u>

In order to make the above work either:

- 1) Calculate the expense transferred to the statement of profit or loss (40,000) and calculate the accrual taken as a balancing figure (7,000); or
- 2) Calculate the accrual needed (7,000) and then calculate the expense transferred to the statement of profit or loss (40,000) as a balancing figure. This is usually the easiest way.

Calculating the expense for the statement of profit or loss

Method 2 requires the calculation of either the closing accrual or the charge to the statement of profit or loss, the other number being taken as a balancing figure. **It is almost always easier to calculate the accrual.**

The amount charged to the statement of profit or loss can be calculated as follows. It is worth spending a little time trying to understand this.

Example: Charge to the statement of profit or loss

From first principles

	Year 1
January	0
February to April	5,000
May to July	7,500
August to October	8,500
November and December (accrual)	<u>6,000</u>
	<u>27,000</u>

	Year 2
November to January	9,500
Less amount already expensed last year for November and January	(6,000)
Therefore: January	3,500
February to April	9,500
May to July	10,000
August to October	10,000
November and December (accrual)	<u>7,000</u>
	<u>40,000</u>

In fact, what is going on above can be represented by the following:

Illustration:

	₦
Invoices/payments for the year	X
+ Closing accrued expense	<u>X</u>
	X
– Opening accrued expense	<u>(X)</u>
= Expense for the year	<u>X</u>

Example:

	Year 1	Year 2
Invoices/payments for the year:		
January	0	9,500
February to April	5,000	9,500
May to July	7,500	10,000
August to October	8,500	10,000
+ Closing accrued expense	<u>6,000</u>	<u>7,000</u>
	27,000	46,000
– Opening accrued expense	<u>0</u>	<u>(6,000)</u>
= Expense for the year	<u>27,000</u>	<u>40,000</u>

7.4 Prepayments

7.4.1 Prepayments (prepaid expenses)

Prepaid expenses are expenses that are recorded in the accounts in the current period, because a purchase invoice has been received or a payment has been made, but all or part of the expense relates to a future accounting period.

Prepaid expenses occur whenever payments are made in advance for an expense item.

To apply the accruals basis of accounting, the expenses that have been recorded in the accounts but that relate to a future accounting period should be:

- excluded from the expenses in the statement of profit or loss for the current year and recognised as an asset (a prepayment) at the year-end; and then
- included in the expenses for the next financial period (which is the period to which they relate).

Example: Year 1

Moses setup in business on January 1, Year 1 preparing financial statements to December 31, each year.

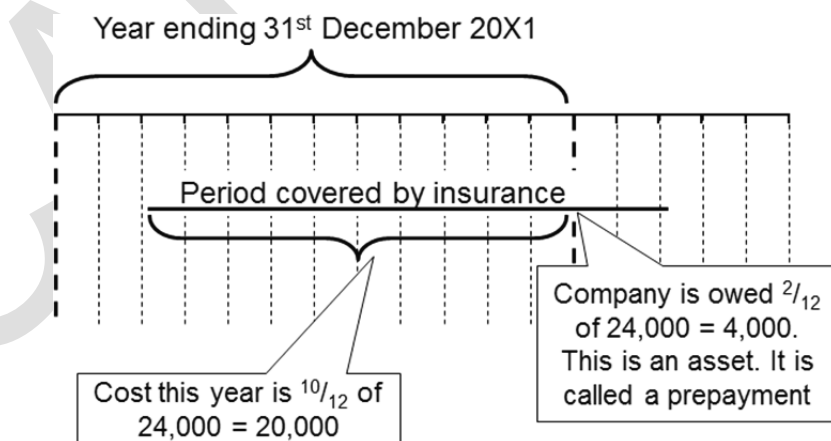
On March 1, he obtains annual insurance on his office building, starting from March 1, at cost of ₦24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of profit or loss for insurance in Year 1 should therefore be ₦20,000 ($\text{₦}24,000 \times \frac{10}{12}$).

The prepaid expense for Year 2 is ₦4,000 ($\text{₦}24,000 \times \frac{2}{12}$).

This can be represented as follows:



There are two ways of accounting for prepayments at the end of an accounting period. These will be explained in turn.

7.4.2 Method 1: the 'two accounts' method

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The prepayment is estimated and then transferred from the expense account to a prepayment account:

Illustration: Prepayment using two accounts.

	Debit	Credit
Prepayment account (an asset)	X	
Expense account		X

The prepayment is a credit entry in the expense account therefore reducing the expense recognised in the current period.

The debit balance on the prepayments account is included in the statement of financial position as a current asset.

Example: Year 1

Moses sets up in business on January 1, Year 1 preparing financial statements to December 31, each year.

On March 1, he obtains annual insurance on his office building, starting from March 1, at cost of ₦24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of profit or loss for insurance in Year 1 should therefore be ₦20,000 ($\text{₦}24,000 \times 10/12$).

The prepaid expense for Year 2 is ₦4,000 ($\text{₦}24,000 \times 2/12$).

Method 1: two accounts approach

Insurance expense

Year 1			
Bank	₦ 24,000	Prepayments	₦ 4,000
		Statement of profit or loss	20,000
	<u>24,000</u>		<u>24,000</u>

Prepayments account

Year 1			
Insurance expense	₦ 4,000	Closing balance c/d	₦ 4,000
	<u>4,000</u>		<u>4,000</u>
Opening balance b/d	4,000		

7.4.3 Reversal of the prepayment

At the beginning of the next accounting period, the balance in the prepayments account is transferred back to the expense account so that it will be recognised as an expense in the next accounting period.

Example (continued): Reversal of the prepayment (at the start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Insurance expense	4,000	
Prepayments		4,000

This reinstates the prepayment as an expense that relates to the second year.

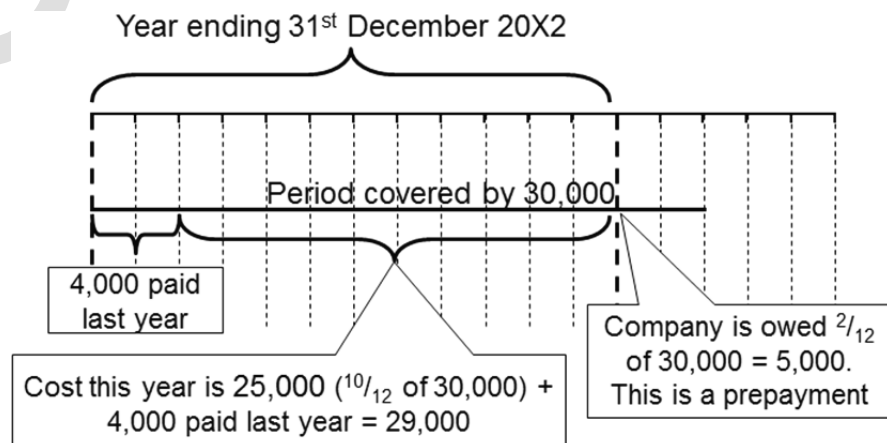
Insurance expense			
Year 2			
Prepayments(reversal)	4,000		
Prepayments			
Year 2 (at start of the year)			
Balance b/d	4,000	Insurance expense	4,000

Example (continued): Year 2

In Year 2, the annual insurance premium payable on March 1, is ~~N~~30,000 for the year to February 28, Year 3.

The prepaid expense at the end of Year 2 is therefore ~~N~~5,000 ($\text{N}30,000 \times \frac{2}{12}$) and the insurance expense in Year 2 is accounted for as follows:

This can be represented as follows:



Example (continued): Year 2

In Year 2, the annual insurance premium payable on March 1, is ~~N~~30,000 for the year to February 28, Year 3.

The prepaid expense at the end of Year 2 is therefore ~~N~~5,000 (~~N~~30,000 × 2/12) and the insurance expense in Year 2 is accounted for as follows:

Method 1: 'two accounts' approach

Insurance expense			
Year 2	N		N
Prepayments	4,000	Prepayments	5,000
Bank	30,000	Statement of profit or loss (balancing figure)	29,000
	<u>34,000</u>		<u>34,000</u>
Year 3			
Prepayments (reversal)	5,000		
Prepayments			
Year 2	N		N
Opening balance b/d	4,000	Insurance expenses	4,000
Insurance expenses account	5,000	Closing balance c/d	5,000
	<u>9,000</u>		<u>9,000</u>
Year 3			
Opening balance b/d	<u>5,000</u>	Insurance expenses (reversal)	5,000

The expense in the statement of profit or loss is ~~N~~29,000.

This consists of the prepayment at the beginning of the year (~~N~~4,000 for January and February) plus the expense for the 10 months from March to December ((~~N~~30,000 × 10/12) = ~~N~~25,000).

The prepaid expense of ~~N~~5,000 at the end of Year 2 is included in the statement of financial position as a current asset.

7.4.4 Method 2: the 'one account' method

This approach is trickier to understand. The prepayment is recognised in the expense account.

There are two ways of achieving this.

- The total expense can be calculated and transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) leaving a balancing figure on the expense account as a prepayment; or
- The prepayment can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) as a balancing figure.

Example: Year 1

Moses sets up in business on January 1, Year 1 preparing financial statements to December 31, each year.

On March 1, he obtains annual insurance on his office building, starting from March 1, at cost of ₦24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of profit or loss for insurance in Year 1 should therefore be ₦20,000 ($₦24,000 \times \frac{10}{12}$).

The prepaid expense for Year 2 is ₦4,000 ($₦24,000 \times \frac{2}{12}$).

Method 2: one account approach

Insurance expenses			
Year 1	₦		₦
Bank	24,000	Statement of profit or loss Closing balance c/d (prepayment)	20,000
	<u>24,000</u>		<u>4,000</u>
			<u>24,000</u>
Year 2			
Opening balance b/d	4,000		

The expense in the statement of profit or loss is ₦20,000 and the prepaid expense is included in the statement of financial position as a current asset at the end of Year 1.

There is no need to reverse the prepayment using the one account method as it is already in the expense account at the start of the next year.

Example (continued): Year 2

In Year 2, the annual insurance premium payable on March 1, is ₦30,000 for the year to February 28, Year 3.

The prepaid expense at the end of Year 2 is therefore ₦5,000 ($\text{₦30,000} \times \frac{2}{12}$) and the insurance expense in Year 2 is accounted for as follows:

Method 2: 'one account' approach

Year 2	₦		₦
Opening balance b/d	4,000	Statement of profit or loss	
Bank	30,000	(balancing figure)	29,000
		Closing balance c/d	5,000
	<u>34,000</u>		<u>34,000</u>
Year 3			
Opening balance b/d	5,000		

7.4.5 Prepaid expenses: calculating the expense for the statement of profit or loss

Method 2 requires the calculation of either the closing prepayment or the charge to the statement of profit or loss, the other number being taken as a balancing figure. **It is almost always easier to calculate the prepayment.**

The amount charged to the statement of profit or loss can be calculated as follows. It is worth spending a little time trying to understand this.

Example: Charge to the statement of profit or loss

	Year 1
January, February	0
March to December:	
$\frac{10}{12}$ of 24,000	<u>20,000</u>
	<u>20,000</u>
	Year 2
January, February:	
$\frac{2}{12}$ of 24,000	4,000
March to December:	
$\frac{10}{12}$ of 30,000	<u>25,000</u>
	<u>29,000</u>

The expense may also be calculated as follows:

Illustration:

	₦
Invoices/payments for the year	X
+ Opening prepaid expense	<u>X</u>
	X
– Closing prepaid expense	<u>(X)</u>
= Expense for the year	<u>X</u>

Example:

	₦	₦
Invoices/payments for the year	24,000	30,000
+ Opening prepaid expense	<u>0</u>	<u>4,000</u>
	24,000	34,000
– Closing prepaid expense	<u>(4,000)</u>	<u>(5,000)</u>
= Expense for the year	<u>20,000</u>	<u>29,000</u>

7.5.3 Accrued income

The method of calculating income for the year when there is accrued income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.

Example: Accrued income

A business rents out a part of its premises.

Rentals are payable each quarter in arrears on January 31, April 30, July 31 and October 31.

The company has a year end of December 31.

The annual rental was ~~N~~30,000 per year until October 31, 2019 (or ~~N~~2,500 per month received in 4 amounts of ~~N~~7,500 on January 31, April 30, July 31 and October 31).

The annual rental was increased to ~~N~~36,000 per year from November 1, 2019 (or ~~N~~3,000 per month received in 4 amounts of ~~N~~9,000 on January 31, April 31, July 31 and October 31).

Income for the year ending December 31, 2019 is: N

For the 10 months January 1, – October 31, 2019:

10/12x ~~N~~ 30,000	25,000

For the 2 months November 1, – December 31, 2019:

2/12x ~~N~~ 36,000	6,000

Rental income for the year to December 31	31,000

At December 31, 2018 there was rental earned but not yet received.

This is the rental income for November and December 2018, which will not be received until January 31, 2019.

The amount of the accrued income is ~~N~~5,000 ($\frac{2}{3}$ of 7,500 or 2 months at ~~N~~2,500 per month) and was included in last year's income and recognised as a current asset at the end of last year financial year.

At December 31, 2019 there is rental earned but not yet received.

This is the rental income for November and December 2019, which will not be received until January 31, 2020.

The amount of the accrued income is ~~N~~6,000 ($\frac{2}{3}$ of ~~N~~9,000 or 2 months at ~~N~~3,000 per month) and is included in income and recognised as a current asset at the end of the financial year.

Accrued income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used, the closing accrued income asset must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: 'Two accounts' method

Income has been earned in the current period. This amount must be recognised.

Example: Accrued income

	Debit	Credit
Accrued income (asset)	X	
Income		X

Example (continued): Accrued income

The double entry is as follows:

Rental Income			
Accrued income (reversal of 2018 accrued income)	£ 5,000	Cash (31 January 2019)	7,500
		Cash (30 April 2019)	7,500
		Cash (31 July 2019)	7,500
		Cash (31 October 2019)	7,500
		Accrued income (for November and December 2019)	
Statement of profit or loss	31,000		6,000
	<u>36,000</u>		<u>36,000</u>

Accrued income			
Balance b/d (at January 1, 2019)	5,000	Rental income (reversal of 2018 accrued income)	5,000
Rental income	6,000	Balance c/d	6,000
	<u>11,000</u>		<u>11,000</u>
Balance b/d	6,000		

Method 2: 'One account' method

The accrued income is brought down as an asset on the income account. There are two ways of achieving this.

The total income for the period can be calculated and transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) leaving a balancing figure on the expense account as the accrued income asset; or

The accrued income asset can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) as a balancing figure

Example (continued): Accrued income (One account approach)

The double entry is as follows:

	£	Rental income		£
Balance b/d	5,000		Cash (31 January 2019)	7,500
			Cash (30 April 2019)	7,500
			Cash (31 July 2019)	7,500
Statement of profit or loss	31,000		Cash (31 October 2019)	7,500
			Balance c/d	6,000
	<u>36,000</u>			<u>36,000</u>
Balance b/d	6,000			

7.5 Unearned and accrued income

7.5. Introduction

A business may have miscellaneous forms of income, for example, from renting out property.

When a business entity has income from sources where payments are made in advance or in arrears. The accruals basis of accounting applies, and the amount of income to include in the statement of profit or loss for a period is the amount of income that relates to that period. It may therefore be necessary to apportion income on a time basis and there may be unearned income or accrued income to account for.

Unearned income or income received in advance

This is where a business has received income in advance. For example, a business might rent out a property for which the tenant must pay in advance.

Only the income that relates to the period is recognised in the statement of profit or loss and the balance is recognised as a liability of the business. (Note that it is an asset of the tenant).

Accrued income

This is where a business receives income in arrears.

For example, a business might rent out a property for which the tenant must pay in arrears. The tenant might owe the business money at the business's year-end.

All of the income that relates to the period must be recognised in the statement of profit or loss. It is necessary to recognise the amount owed to the business as an asset at the year-end.

7.5.2 Unearned income or income received in advance

The method of calculating income for the year when there is unearned income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.

Example: Unearned income or income received in advance

A business rents out a part of its premises.

The rent is payable every six months, on May 1, and November 1, in advance. The company has a year end of December 31.

The annual rental for the year to April 30, 2019 was ~~N~~48,000 (received in two amounts of ~~N~~24,000 on May 1, 2018 and ~~N~~24,000 on November 1, 2018).

The annual rental for the year to April 30, 2020 was ~~N~~60,000 (received in two amounts of ~~N~~30,000 on May 1, 2019 and ~~N~~30,000 on November 1, 2019).
Income for the year ending December 31, 2019 is:

	~~N~~
For the 4 months January 1, – April 30, 2019:	
$\frac{4}{12} \times \text{N}48,000$	16,000
For the 8 months May 1, – December 31, 2019:	
$\frac{8}{12} \times \text{N}60,000$	40,000
Rental income for the year to December 31, 2019	<u>56,000</u>

At December 31, 2018 there was unearned rental income for the period January 1, – April 30, 2019.

The amount of unearned income is $\frac{4}{12}$ of the ~~N~~24,000 received on November 1, 2018 which came to ~~N~~16,000. (This represents 4 months at ~~N~~4,000 per month)

This was included as a current liability in the statement of financial position as at the end of the last financial year.

At December 31, 2019 there is unearned rental income for the period January 1, – April 30, 2020.

The amount of unearned income is $\frac{4}{12}$ of the ~~N~~30,000 received on November 1, 2019 which comes to ~~N~~20,000. (This represents 4 months at ~~N~~5,000 per month)

This is recognised as a current liability as at the end of the financial year.

Unearned income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used the closing unearned income liability must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: 'Two accounts' method

Income has been paid to the business but some of it relates to the next period. This amount must be transferred from the income account to a liability account

Example: Unearned income

	Debit	Credit
Income	X	
Unearned income (liability)		X

Example (continued): Unearned income

The double entry is as follows:

Rental income			
		Unearned income (reversal of 2018 unearned income)	16,000
		Cash (May 1, 2019)	30,000
Unearned income (to be recognised in 2020)	20,000		
Statement of profit or loss	56,000		
		Cash (November 1, 2019)	30,000
			76,000
Unearned income			
		Balance b/d (at January 1, 2019)	
			16,000
Rental income (reversal of 2018 unearned income)	16,000		
Balance c/d	20,000	Rental income	20,000
	36,000		36,000
		Balance b/d	20,000

Method 2: 'One account' method

The unearned income is brought down as a liability on the income account.

There are two ways of achieving this.

- The total income for the period can be calculated and transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) leaving a balancing figure on the expense account as the unearned income liability; or
- The unearned income liability can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) as a balancing figure

Example (continued): Unearned income (One account approach)

The double entry is as follows:

Rental income			
		Balance b/d	16,000
		Cash (May 1, 2019)	30,000
Statement of profit or loss	56,000	Cash (November 1, 2019)	30,000
Balance c/d	20,000		
	<u>76,000</u>		<u>76,000</u>
		Balance b/d	20,000

7.6 Chapter review

Chapter review

Before moving to the next chapter, check that you are now able to:

- explain the meaning of an accrual;
- account for accruals using both methods;
- explain the meaning of a prepayment;
- account for prepayments using both methods;
- explain the meaning accrued and unearned income; and
- account for accrued and unearned income.

7.7 End of chapter questions and suggested solutions

Question 1

A company pays ₦60,000 for electricity quarterly in advance on January 1, April 1, July 1, and October 1. The company's financial year ends on October 31.

Required

Prepare the adjusting entries for electricity expense and related accruals or prepayments at October 31 using:

- The two accounts method
- The one account method

Suggested solution

a) The Two Accounts Method

		Electricity	
₦		₦	
Jan 1 Electricity	60,000	Oct 31 Statement of profit or loss	200,000
Apr 1 Electricity	60,000		
Jul 1 Electricity	60,000	Oct 31 Prepayment	40,000
Oct 1 Electricity	<u>60,000</u>		
<u>240,000</u>			<u>240,000</u>
		Prepayment	
₦		₦	
Oct 31 Electricity	40,000		

b)

		Electricity	
		₦	₦
Jan 1 Electricity	60,000	Oct 31 Statement of profit or loss	200,000
Apr 1 Electricity	60,000	Oct 31 Balance c/d	40,000
Jul 1 Electricity	60,000		
Oct 1 Electricity	<u>60,000</u>		
	<u>240,000</u>		<u>240,000</u>
Nov 1 Balance b/d			
	40,000		

Workings
WK 1

		Bank	
		₦	₦
		Jan 1 Electricity	60,000
		Apr 1 Electricity	60,000
		Jul 1 Electricity	60,000
		Oct 1 Electricity	60,000

WK 2 Payment made on October 1 - ~~₦~~60,000. One month's electricity, that is, October will be treated as expense by October 31 while the payment for November and December will be treated as prepayment by October 31. Therefore, prepayment is $\frac{2}{3}$ of the rent paid for the period, that is, $\frac{2}{3}$ of ~~₦~~60,000 = ~~₦~~40,000

Question 2

A charity organisation received ~~₦~~120,000 in December for a one-year insurance policy covering the period from January to December next year. The charity's financial year ends on December 31.

Required:

- Explain the meaning of a prepayment
- How the organisation should account for this payment at the year-end using both methods.

Suggested solution

- A prepayment (or prepaid expense) occurs when a payment is made in advance for goods or services to be received in a future accounting period.
 - In this case, the charity has received cash in advance for an insurance policy that covers the entire next year.
 - At the current year-end (December 31), no insurance expense has been incurred yet, since the policy starts on January 1 of the next year.
 - Therefore, the amount received should not be recognised as income in the current year.
 - Instead, it should be recognised as a liability (unearned income) or prepaid income at the year-end, reflecting that the charity still owes the insurance service over the coming year.
 - The expense or income will be recognised progressively in the next accounting periods as the insurance coverage is consumed.

b) i) two accounts method

Receipt for Insurance	
₦	₦
Unearned income	Bank
120,000	120,000

Unearned income	
₦	₦
	Receipt for Insurance
	120,000

i) One account method

Receipt for Insurance	
₦	₦
Balance c/d	Bank
<u>120,000</u>	<u>120,000</u>
	Balance b/d
	120,000

Question 2

A business rents out a property for ₦48,000 annually, payable quarterly in arrears on 31 March, 30 June, 30 September, and 31 December. The business's financial year ends on 31 August.

Required

- Calculate the rental income to be recognised in the statement of profit or loss for the year ending September 30, and
- Prepare the adjusting entries for accrued or unearned income using both the **two accounts method** and the **one account method**.

Suggested solution

- Calculation of rental income to be recognise in the statement of profit or loss for the year ending September 30

	₦
Receipt on 31 March (for Jan, Feb & March)	12,000
Receipt on 30 June (for Apr, May & Jun)	12,000
Receipt on 31 September (for Jul & Aug) ($\frac{2}{3}$ of ₦12,000 = ₦8,000)	<u>8,000</u>
Rental Income to be recongize in the statement of profit or loss	<u>32,000</u>

b (i) two accounts method

Rental Income

	N		N
31 August Statement of Profit or Loss		31 March Bank	
32,000		12,000	
		30 June Bank	
		12,000	
		31 August Accrued income	
		<u>8,000</u>	
		<u>32,000</u>	
	=		
<u>32,000</u>			

Accrued income

	N		N
31 August Accrued income			
8,000			

ii) One account method

Rental Income

	N		N
31 August Statement of Profit or Loss	32,000	31 March Bank	12,000
		30 June Bank	12,000
		31 August Balance c/d	<u>8,000</u>
			<u>32,000</u>
1 September Balance b/d	<u>32,000</u>		
	8,000		

INVENTORY

Contents

- 8.0 Learning objective
- 8.1 Learning outcomes
- 8.2 End-of-year adjustments for inventory
- 8.3 Measurement of inventory
- 8.4 Chapter review
- 8.5 End of chapter questions and answers

8. Inventory

8.0 Learning objective

This chapter explains how inventory is accounted for. It covers both double entry and measurement

8.1 Learning outcomes

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

- a. explain periodic and perpetual inventory systems;
- b. post inventory entries at the end of the period in case of periodic inventory system;
- c. measure inventory at the lower of cost and net realisable value; and
- d. measure cost of inventory using cost formulas.

8.2 End-of-year adjustments for inventory

8.2.1 Recording inventory

In order to prepare a statement of profit or loss it is necessary to be able to calculate gross profit. This is done by comparing the sale proceeds from the sale of items of inventory to the cost of those items. This is an application of the accruals concept (matching principle).

In order to calculate gross profit it is necessary to record opening inventory, purchases and closing inventory.

There are two main methods of recording inventory.

- a. Periodic inventory method (period endsystem)
- b. Perpetual inventorysystem

Each method uses a ledger account for inventory but these have different roles.

A question on year-end adjustments for inventories will normally require you to use the periodic inventory method but the perpetual inventory system is examinable in its own right.

8.2.2 Periodic inventory method (period – end method):accounting proceduresThis system is based on the use of two ledger accounts:

- a. Purchases account which is used to record all purchases during the year; and
- b. Inventory account which is used to record the value of inventory at the beginning/end of the financialyear.

It operates as follows:

Year 1

business starts on 1 January Year 1. This business has no opening inventory. All inventory purchased in the year to 31 December Year 1 is recorded in the purchases account.

Illustration: Purchases through the year

	Debit	Credit
Purchases	X	
Cash or liabilities		X

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year.

This is transferred to cost of sales clearing the purchases account to zero.

Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales	X	
Purchases		X

At the end of the year cost of sales must be calculated. Purchases are not the same as cost of sales because the company still holds some of the items that it purchased.

The number of items of inventory still held is established through an inventory count. This involves the staff of the business counting every item of inventory and making a record of this. The inventory is then valued (usually at cost). This figure is the closing inventory.

It is recognised as an asset on the statement of financial position and as a credit entry on the statement of profit or loss (where it reduces the cost of sales expense).

Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of profit or loss)		X

The exact location of the credit entry might be to one of several accounts but ultimately it always achieves the same purpose, that is, to reduce cost of sales. Thus it might be a credit to a statement of profit or loss inventory account (which is later transferred to a cost of sales account or it might be a credit to the cost of sales account.

At the end of year 1 the purchases and the credit entry for closing inventory form part of the profit for the period. The debit entry for closing inventory is carried down into year 2 as an asset.

Year 2

The closing inventory in year 1 becomes the opening inventory in year 2

All inventory purchased in the year to 31 December Year 2 is recorded in the purchases account.

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year. Another of the balances is the opening inventory which has been there since the start of the year.

The purchases together with the opening inventory are what the business could have sold in the period. These are both transferred to the cost of sales.

ICAN 2025

Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales	X	
Purchases		X
Cost of sales	X	
Inventory (statement of financial position)		X

Note: that this is the transfer of the opening inventory to cost of sales)

At the end of the financial year, the closing inventory is physically counted and valued. The closing inventory double entry is then processed.

Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of profit or loss)		X

In summary

Opening inventory in the trial balance (a debit balance) and purchases (a debit balance) are both transferred to cost of sales.

Illustration: Carrying amount of a non-current asset

	£	
Non-current asset at cost	X	
Less accumulated depreciation	(X)	
Carrying amount (net book value)	X	This figure appears on the face of the statement of financial position

This clears both accounts.

Closing inventory is recognised in the inventory account as an asset (a debit balance) and the other side of the entry is a credit to cost of sales.

Cost of sales comprises purchase in the period adjusted for movements in inventory level from the start to the end of the period.

Illustration: Cost of sales

	Year 1	Year 2
	£	£
Opening inventory (a debit)	–	X
Purchases (a debit)	X	X
	X	X
Closing inventory (a credit)	(X)	(X)
Cost of sales	X	X

Example:

Port Harcourt Trading had opening inventory of ₦10,000. Purchases during the year were ₦30,000.

Closing inventory at the end of Year 2 was ₦12,000.

At the year end, the following entries are necessary

Purchases account

Balance b/d	₦ 30,000	(1) Cost of sales	₦ 30,000

Inventory account

Balance b/d	₦ 10,000	(2) Cost of sales	₦ 10,000
		Removal of opening inventory	
(3) Cost of sales	12,000		
Recognition of closing inventory		Closing balance c/d	12,000
	<u>22,000</u>		<u>22,000</u>
Opening balance b/d	12,000		

Cost of sales

(1) Purchases	₦ 30,000		₦
(2) Opening inventory	10,000	(3) Closing inventory	12,000
		Cost of sales c/f	28,000
	<u>40,000</u>		<u>40,000</u>
Cost of sales b/f	28,000		

The cost of sales total is then transferred to the statement of profit or loss.

The cost of sales is part of the statement of profit or loss and can be presented as follows:

	₦	₦
Sales		X
Opening inventory	10,000	
Purchases	30,000	
	<u>40,000</u>	
Closing inventory	(12,000)	
Cost of sales		(28,000)
Gross profit		<u>X</u>

Additional notes on the periodic inventory system

Under the periodic inventory system, it may not always be possible to conduct a physical inventory count exactly on the reporting date. The count may be done a few days before or after the reporting date. When this occurs, there is a need to reconcile the book value of inventory at the reporting date with the physical count.

If the Cut-off Date is *Before* the Reporting Date:

Adjustments are required as follows:

- a. **Sales** made after the cut-off date but before the reporting date should be **included** in the inventory at the reporting date (at the **lower of cost and NRV**).
- b. **Purchases** made after the cut-off date but **received before** the reporting date should be **included** in the inventory valuation.
- c. **Sales returns (returns inwards)** before the reporting date should be **included** in inventory at the cost.
- d. **Purchase returns (returns outwards)** should be **excluded** from the inventory valuation.
- e. **Goods on sale or return** received **by the entity** but not returned by the reporting date should be **included**.
- f. **Goods sent on sale or return** to a consignee should be **excluded** unless returned before the reporting date.
- g. **Over-casting** of inventory sheets should be **excluded**, while **under-casting** should be **included**.

ii. If the Cut-off Date is *After* the Reporting Date:

Adjustments are required as follows:

- a. **Sales** made between the reporting date and the cut-off date should be **added back** to the inventory value (at cost).
- b. **Purchases** made between these dates should be **excluded** from the inventory at the reporting date.
- c. **Returns outwards (purchases returns)** should be **included**, while **returns inwards (sales returns)** should be **excluded at cost**.
- d. **Goods on sale or return received by the entity** after the reporting date should be **excluded**.
- e. **Goods on sale or return sent to a consignee** should be **excluded** if not returned as at the reporting date.
- f. **Under-casting** of inventory sheets should be **included**, and **over-casting** should be **excluded**.

Illustration

Jaye Ltd has a reporting date of **March 31, 2025**. However, the **physical inventory count** was conducted on **April 14, 2025**, with inventory valued at **₦27,000,000**.

Transactions between April 1 and April 14, 2025:

a. Net sales: ~~₦5,520,000~~

- 75% sold at cost + 25% markup
- 25% sold at cost + 20% markup

b. Purchases: ~~₦2,100,000~~

- Goods worth ~~₦224,000~~ delivered **after** April 14 (on April 17)

c. Sales returns: ~~₦825,000~~

- 40% relate to sales at cost + 20% markup
- 60% relate to sales at cost + 25% markup

d. Goods received on a **sale or return** basis: ~~₦2,700,000~~

Required:

Prepare a statement showing the **value of inventory as at March 31, 2025**.

Note: The cut-off point (April 14) is **after** the reporting date.

Solution: Inventory Valuation as at March 31, 2025

Description	₦'000	₦'000
Inventory balance at April 14		27,000
Add: Cost of sales from April 1–14		
• 75% of ~~₦5,520,000~~ at cost ($100/125 \times 75\%$)	3,450	
• 25% of ~~₦5,520,000~~ at cost ($100/120 \times 25\%$)	<u>1,150</u>	4,600
Subtotal		31,600
Less: Purchases between April 1–14		
~~₦2,100,000~~ – ~~₦224,000~~ (delivered after April 14)		(1,876)
Less: Sales returns		
• 60% of ~~₦825,000~~ at cost ($100/125$)	(396)	
• 40% of ~~₦825,000~~ at cost ($100/120$)	(275)	<u>(671)</u>
Subtotal		29,053
Less: Goods received on sale or return (not owned)		(2,700)
Inventory value as at March 31, 2025		26,353

Remember the following:

- a. In a period-end system of accounting for inventory, the double entries are between the inventory account and the statement of profit or loss.
- b. The cost of opening inventory is included in the cost of sales. It is an expense, and expense is a debit entry. So debit the statement of profit or loss (and

credit the inventory account) with the cost of the opening inventory.

- c. The cost of closing inventory is included in the statement of financial position as an asset, so there must be a debit balance for the closing inventory. So debit inventory (and credit statement of profit or loss) with the valuation of the closing inventory

8.2.3 Perpetual inventory method: accounting procedures

Practice questions

1

The following trial balance has been extracted from the ledger of Kaduna Market Traders at June 30, 2019:

	Debit	Credit
	<u>₦000</u>	<u>₦000</u>
Salaries	10,500	
Drawings	3,000	
Lighting and heating	500	
Sales		30,000
Trade receivables	10,000	
Rent	2,000	
Office expenses	1,000	
Capital at 1 July 2018		27,500
Purchases	14,000	
Inventory at 1 July 2018	2,000	
Trade payables		4,000
Property, plant and machinery	17,500	
Cash	1,000	
	<u>61,500</u>	<u>61,500</u>

Closing inventory at June 30, 2019 has been valued at ₦1,500,000.

Required

Prepare the statement of profit or loss for the year to June 30, Year 3 and the statement of financial position as at that date.

A single account is used to record all inventory movements. The account is used to record purchases in the period and inventory is brought down on the account at each year-end. The account is also used to record all issues out of inventory. These issues constitute the cost of sales.

When the perpetual inventory method is used, a record is kept of all receipts of items into inventory (at cost) and all issues of inventory to cost of sales.

Each issue of inventory is given a cost, and the cost of the items issued is either the actual cost of the inventory (if it is practicable to establish the actual cost) or a cost obtained using a valuation method.

Each receipt and issue of inventory is recorded in the inventory account. This means that a purchases account becomes unnecessary, because all purchases are recorded

in the inventory account.

All transactions involving the receipt or issue of inventory must be recorded, and at any time, the balance on the inventory account should be the value of inventory currently held.

		Cost of sales	28,000
	30,000		
		Closing balance c/d	12,000
	40,000		40,000
Opening balance b/d	12,000		

Furthermore, all transactions involving any kind of adjustment to the cost of inventory must be recorded in the inventory account.

Example:

Ibadan Retail (IR) had opening inventory of ₦100,000.

Purchases during the year were ₦500,000. Inventory with a cost of ₦18,000 was returned to a supplier. One of the purchases in the above amount was subject to an express delivery fee which cost the company an extra ₦15,000 in addition to the above amount.

IR sold goods during the year which had cost ₦520,000. Goods which had cost ₦20,000 were returned to the company.

Just before the year end goods which had cost ₦5,000 were found to have been damaged whilst being handled by IR's staff.

The following entries are necessary during the period.

	₦		₦
Balance b/d	100,000	Returns to supplier	18,000
Cash or creditors			
(purchases in the year)	500,000	Cost of goods sold	500,000
Special freight charge	15,000	Normal loss	5,000
Returns from customers	20,000	Closing balance c/d	112,000
	635,000		635,000
Opening balance b/d	112,000		

8.2.4 Summary of journal entries under each system

Entry	Periodic inventory method	Perpetual inventory method
Opening inventory	Closing inventory as measured and recognised brought forward from last period.	Closing balance on the inventory account as at the end of the previous period
Purchase of inventory	Dr Purchases Cr Payables/cash	Dr Inventory Cr Payables/cash
Freight paid	Dr Carriage inwards Cr Payables/cash	Dr Inventory Cr Payables/cash
Return of inventory to supplier	Dr Payables Cr Purchase returns	Dr Payables Cr Inventory
Sale of inventory	Dr Receivables Cr Sales	Dr Receivables Cr Sales and Dr Cost of goods sold Cr Inventory
Return of goods by a supplier	Dr Sales returns Cr Receivables	Dr Sales returns Cr Receivables and Dr Inventory Cr Cost of goods sold
Normal loss	No double entry	Dr Cost of goods sold Cr Inventory
Abnormal loss	Dr Abnormal loss Cr Purchases	Dr Abnormal loss Cr Inventory
Closing inventory	Counted, valued and recognised by: Dr Inventory (statement of financial position) Cr Cost of sales (Cost of goods sold)	Balance on the inventory account

8.3 Measurement of Inventory

8.3.1 Introduction

Rules on accounting for inventory are set out in **IAS 2: Inventories**.

Basic rule

The valuation of inventory can be extremely important for financial reporting, because the valuation affects cost of sales, profit and total asset values in the statement of financial position.

Inventory must be measured in the financial statements at the **lower** of:

- a. cost; and
- b. net realisable value(NRV).

a. **Cost of inventory**

IAS2 states that 'the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

b. **Purchase cost**

The **purchase cost** of inventory will consist of the following:

- i. the purchase price
- ii. plus import duties and other non-recoverable taxes (but excluding recoverable value added tax)
- iii. plus transport, handling and other costs directly attributable to the purchase (carriage inwards), if these costs are additional to the purchase price.

The purchase price **excludes** any settlement discounts, and is the cost after deduction of trade discount.

Example: Purchase cost I

Kumo Consumer Electrics (KCE) buys goods from an overseas supplier.

It has recently taken delivery of 1,000 units of component X.

The quoted price of component X was ₦1,200 per unit but KCE has negotiated a trade discount of 5% due to the size of the order.

The supplier offers an early settlement discount of 2% for payment within 30 days and KCE intends to achieve this.

Import duties of ₦60 per unit must be paid before the goods are released through custom.

Once the goods are released through customs KCE must pay a delivery cost of ₦5,000 to have the components taken to its warehouse.

	₦
Purchase price (1,000 × ₦1,200 × 95%)	1,140,000
Import duties (1,000 × ₦60)	60,000
Delivery cost	5,000
Cost of inventory	<u>1,205,000</u>

The intention to take settlement discount is irrelevant.

Illustration 2. Determination of cost of inventory when there is VAT.

Gbadura Ltd, purchased 5,000 units of a product from Saka Ltd on credit for ₦60,000,000 on April 30, 2025. The company received a 5% trade discount, and VAT at 7.5% as paid. Additionally the company incurred additional ₦5,000,000 in transport and handling costs. Show how Gbadura Ltd should record the purchases in the journal.

First step is to show the schedule of costs for the goods purchased as follows:

	₦'000	₦'000
5,000 units of product	60,000	
Less trade discount at 5% -	(3,000)	
		57,000
Add VAT at 7.5% (7.5% x 57,000)	<u>4,275</u>	
Transport cost (cash)/(other payables)		<u>5,000</u>
Purchases account		<u>62,000</u>
Second step is to prepare the journal entry:		
Journal		
	Debit	Credit
Purchases	62,000	
VAT	4,275	
Trade payables		61,275
Cash or other payables (Transport cost)		5,000

Conversion costs

When materials purchased from suppliers are converted into another product in a manufacturing or assembly operation, there are also conversion costs to add to the purchase costs of the materials. Conversion costs must be included in the cost of finished goods and unfinished work in progress.

Conversion costs consist of:

- a. costs directly related to units of production, such as costs of direct labour (i.e. the cost of the labour employed to perform the conversion work)
- b. fixed and variable **production** overheads, which must be allocated to costs of items produced and closing inventories. (Fixed production overheads must be allocated to costs of finished output and closing inventories on the basis of the **normal production capacity** in the period)
- c. other costs incurred in bringing the inventories to their present location and condition.

You may not have studied cost and management accounting yet but you need to be aware of some of the costs that are included in production overheads (also known as factory overheads). Production overheads include:

- a. costs of indirect labour, including the salaries of the factory manager and factory supervisors
- b. depreciation costs of non-current assets used in production
- c. costs of carriage inwards, if these are not included in the purchase costs of the materials

Only production overheads are included in costs of finished goods inventories and work-in-progress. Administrative costs and selling and distribution costs must not be included in the cost of inventory.

Note that the process of allocating costs to units of production is usually called absorption. This is usually done by linking the total production overhead to some production variable, for example, time, wages, materials or simply the number of units expected to be made.

Example: Conversion costs

Kumo Consumer Electrics (KCE) manufactures control units for air conditioning systems.

The following information is relevant:

Each control unit requires the following:

1 component X at a cost of ₦1,205 each

1 component Y at a cost of ₦800 each

Sundry raw materials at a cost of

The company faces the following monthly expenses:

	₦
Factory rent	16,500
Energy cost	7,500
Selling and administrative costs	10,000

Each unit takes two hours to assemble. Production workers are paid ₦300 per hour.

Production overheads are absorbed into units of production using an hourly rate. The normal level of production per month is 1,000 hours.

The cost of a single control unit is as follows:

Materials:

Component X	1,205
Component Y	800
Sundry raw materials	150

2,155

Labour (2 hours @ ₦300)	600

Production overhead ($\frac{₦16,500 + 7,500}{1,000 \text{ hours}} \times 2 \text{ hours}$)	48

2,803

The selling and administrative costs are not part of the cost of inventory

8.3.5 Net realisable value

Definition: Net realisable value

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Net realisable value is the amount that can be obtained from selling the inventory in the normal course of business, less any further costs that will be incurred in getting it ready for sale or disposal.

- Net realisable value is usually higher than cost. Inventory is therefore usually valued at cost.
- However, when inventory loses value, perhaps because it has been damaged or is now obsolete, net realisable value will be lower than cost.

The cost and net realisable value should be compared for each separately-identifiable item of inventory, or group of similar inventories, rather than for inventory in total.

Example: Lower of cost and net realisable value

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	₦ Cost	₦ Sales price	₦ Selling costs
Inventory item A1	8,000	7,800	500
Inventory item A2	14,000	18,000	200
Inventory item B1	16,000	17,000	200
Inventory item C1	6,000	7,500	150

The value of closing inventory in the financial statements:

T	Lower of:	₦
A1	8,000 or (7,800 – 500)	7,300
A2	14,000 or (18,000 – 200)	14,000
B1	16,000 or (17,800 – 500)	16,000
C1	6,000 or (7,000 – 200)	6,000
Inventory valuation		<u>43,300</u>

Reasons why NRV of Inventories may be Lower than their Cost:

NRV of inventories may be lower than their cost due to the following reasons:

- the inventories are damaged;
- the inventories have become obsolete (For example, due to changes in technology or consumer preferences);
- the selling price of the goods have fallen;
- there were errors in production or purchasing processes, leading to defective or non-conforming items; and

- e. a strategic decision was taken by management to manufacture and sell products at a loss (For example, to maintain market share or eliminate competition).

a. Principles for writing down inventories to NRV

Inventories are written down to NRV based on the following principles:

- i. Raw materials and supplies are not written down below cost if the finished goods into which they will be incorporated are expected to be sold above cost.
- ii. This means: If the NRV of the finished goods is greater than their total cost, then the raw materials should be valued at cost.

Illustration

Frayo Ltd holds 1,000 units of a certain raw material as at 30 June 2025. The materials originally cost a total of ₦300,000. Since their purchase, the market price has fallen to ₦245,000. However, these materials are to be used in the production of finished goods expected to be sold for ₦550,000, after incurring the following additional costs:

- Conversion costs: ₦125,000
- Estimated selling costs: ₦40,000

Required:

At what amount should the inventory of raw materials be reported in the financial statements as at 30 June 2025?

Solution:

Item	₦
Cost of raw materials	300,000
NRV of raw materials (market value)	245,000
NRV of finished goods	385,000

Since the NRV of the finished goods (₦385,000) exceeds the cost of raw materials (₦300,000), the raw materials should be valued at cost, not at the lower market price. Answer: The inventory should be carried at ₦300,000

8.3.6 Cost formulae

With some inventory items, particularly large and expensive items, it might be possible to recognise the actual cost of each item.

In practice, however, this is unusual because the task of identifying the actual cost for all inventory items is impossible because of the large numbers of such items.

A system is therefore needed for measuring the cost of inventory.

The historical cost of inventory is usually measured by one of the following methods:

- a. First in, first out (FIFO)
- b. Weighted average cost (AVCO)

Example:

On January 1, a company had an opening inventory of 100 units which cost ₦50 each.

During the month it made the following

purchases: April 5: 300 units at ₦60 each

July 14: 500 units at ₦70 each

October 22: 200 units at ₦80 each.

During the period it sold 800 units as

follows: May 9: 200 units

July 25: 200 units

November 23: 200 units

December 12: 200 units

This means that it has 300 units left ($100 + 300 + 500 + 200 - (200 + 200 + 200 + 200 + 200)$) but what did they cost?

There are various techniques that have been developed to answer this question.

The easiest of these is called FIFO (first in first out). This approach assumes that the first inventory sold is always the inventory that was bought on the earliest date. This means closing inventory is always assumed to be the most recent purchased.

In the above example, a FIFO valuation would assume that the 300 items left were made up of the 200 bought on 22 October and 100 of those bought on July 14, giving a cost of ₦23,000 $\{(200 @ 80) + (100 @ 70)\}$

Example: Inventory ledger card (weighted average method)

Date	Receipts			Issues			Balance		
	Qty	@	₦	Qty	@	₦	Qty	@	₦
Jan 1 b/f	100	50	5,000				100	50	5,000
Apr 5	300	60	18,000				300	60	18,000
							400	57.5	23,000
May 9				200	57.5	11,500	(200)	57.5	(11,500)
							200	57.5	11,500
Jul 14	500	70	35,000				500	70	35,000
							700	66.43	46,500
Jul 25				200	66.43	13,286	(200)	66.43	(13,286)
							500	66.43	33,214
Oct 22	200	80	16,000				200	80	16,000
							700	70.31	49,214
Nov 23				200	70.31	14,062	(200)	70.31	(14,062)
							500	70.31	35,152
Dec 12				200	70.31	14,062	(200)	70.31	(14,062)
	1,100		74,000	800		52,910	300	70/80	21,090
Note:	1,100	minus	800	equals		300			
		74,000	minus	52,910	equals	21,090			

Each of these can be shown on an inventory ledger card as follows.

Example: Inventory ledger card (FIFO)									
Date	Receipts			Issues			Balance		
	Qty	@	₦	Qty	@	₦	Qty	@	₦
Jan 1 b/f	100	50	5,000				100	50	5,000
Apr 5	300	60	18,000				300	60	18,000
							400	50/60	23,000
May 9				100	50	5,000	100	50	5,000
				100	60	6,000	100	60	6,000
				200	50/60	11,000	(200)	50/60	(11,000)
							200	60	12,000
Jul 14	500	70	35,000				500	70	35,000
							700	60/70	47,000
Jul 25				200	60	12,000	(200)	60	12,000
							500	70	35,000
Oct 22	200	80	16,000				200	80	16,000
							700	70/80	51,000
Nov 23				200	70	14,000	(200)	70	(14,000)
							500	70/80	37,000
Dec 12				200	70	14,000	(200)	70	(14,000)
	1,100		74,000	800		51,000	300	70/80	23,000
Note: 1,100 minus 800 equals 300									
74,000 minus 51,000 equals 23,000									

The weighted average method calculates a new average cost per unit after each purchase. This is then used to measure the cost of all issues up until the next purchase.

8.3.7 Inventory and drawings

The owner of a sole trader business might decide to take some inventory for his or her personal use. For example, the owner of a local shop might take some of the goods bought for the shop and use them for personal consumption.

When this happens, it is important that the financial statements of the sole trader should provide a faithful representation of the financial performance of the business. In order to achieve this objective:

- Drawings by the business owner in the form of inventory should be accounted for as drawings (withdrawals of capital).
- The cost of sales should exclude the items taken by the owner as drawings.

Drawings of inventory might be common in small sole trader businesses, but are less common in bigger business entities, where stricter controls over inventory might be considered necessary. Small businesses normally use the period-end inventory system, and when the owner takes some inventory for personal use, the appropriate accounting entry in the main ledger is:

Illustration: Purchases through the year

	Debit	Credit
Drawings	X	
Purchases		X

The inventory taken by the owner is valued at cost (not selling price).

This accounting adjustment therefore reduces the total cost of purchases, so that the cost of sales will exclude the cost of the inventory taken.

If a perpetual inventory system is used, the appropriate accounting entry would be:

Example: Lower of cost and net realisable value

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	Debit	Credit
Drawings	X	
Inventory		X

8.4 Chapter review

Chapter review

Before moving on to the next chapter, check that you now know how to:

- explain periodic and perpetual inventory systems
- post inventory entries at the end of the period in case of periodic inventory system.
- measure inventory at the lower of cost and net realisable value
- measure cost of inventory using cost formulae

8.5 End of chapter questions and suggested solutions

Question 1

On January 1, Bako Ltd had no inventory. During January, the following purchases and issues of inventory were made:

Date	Transaction	Units	Unit Cost (₦)
Jan 5	Purchase	500	10

Date	Transaction	Units	Unit Cost (₦)
Jan 12	Purchase	300	12
Jan 20	Issue to production	400	?
Jan 28	Purchase	400	14
Jan 30	Issue to production	500	?

Required:

- Prepare an inventory ledger card using the FIFO method.
- Prepare an inventory ledger card using the Weighted Average (AVCO) method, rounding unit costs to 2 decimal places.

Suggested solution

a) FIFO Method – Inventory Ledger Card

Under **FIFO (First In, First Out)**, issues are charged at the cost of the oldest inventory available.

Date	Transaction	Qty In	Unit Cost	Total Cost	Qty Out	Unit Cost	Total Cost	Balance (Qty @ Cost)
Jan 5	Purchase	500	₦10.00	₦5,000				500 @ ₦10
Jan 12	Purchase	300	₦12.00	₦3,600				500 @ ₦10 300 @ ₦12
Jan 20	Issue				400	See below	₦4,200	100 @ ₦10 300 @ ₦12
	(400 units = 500 @ ₦10 → 400 issued: 500 - 400 = 100 left from ₦10)							
Jan 28	Purchase	400	₦14.00	₦5,600				100 @ ₦10 300 @ ₦12 400 @ ₦14
Jan 30	Issue				500	See below	₦6,200	200 @ ₦14
	(100 @ ₦10 = ₦1,000; 300 @ ₦12 = ₦3,600; 100 @ ₦14 = ₦1,600)							

Closing Inventory (after Jan 30):

→ 200 units @ ₦14 = ₦2,800

b) AVCO Method – Inventory Ledger Card

Under **AVCO (Weighted Average Cost)**, we recalculate average cost per unit after each purchase.

Date	Transaction	Qty In	Unit Cost	Total Cost	Qty Out	Unit Cost	Total Cost	Balance (Qty @ Cost)
Jan 5	Purchase	500	₦10.00	₦5,000				500 @ ₦10.00
Jan 12	Purchase	300	₦12.00	₦3,600				800 @ ₦10.75 = ₦8,600
	(New average = ₦8,600 ÷ 800 = ₦10.75)							
Jan 20	Issue				400	₦10.75	₦4,300	400 @ ₦10.75 = ₦4,300
Jan 28	Purchase	400	₦14.00	₦5,600				800 @ ₦12.38 = ₦9,900
	(New average = ₦9,900 ÷ 800 = ₦12.375 → ₦12.38)							
Jan 30	Issue				500	₦12.38	₦6,190	300 @ ₦12.38 = ₦3,710

Closing Inventory (after Jan 30):

→ 300 units @ ₦12.38 = ₦3,710

Question 2

Uzairu Ltd, a manufacturer of stainless steel cups, is based in Benin City, Edo State. On January 1, 2024, Uzairu Ltd held 32,000 stainless steel cups at ₦23,728,000. During the year ended December 31, 2024, Uzairu Ltd produced 240,000 stainless steel cups, compared to a normal production level of 300,000 stainless steel cups. 24,000 stainless steel cups were held at December 31, 2023.

Production costs for the year were as follows:

- Raw materials: ₦109,200,000
- Direct labour: ₦54,600,000
- Variable overheads: ₦36,504,000

d. Fixed overheads: ₦70,020,000

At the reporting date, the net realisable value of the stainless steel cups is higher than their cost.

Required:

Using the First-in-First-Out (FIFO) method within the context of IAS 2 Inventory, calculate the cost of stainless steel cups sold during the period.

Suggested solution

	Units	Unit price ₦	₦
Opening inventory	32,000	741.5	23,728,000
Steel cups produced during the year	<u>240,000</u>	1,068	256,320,000
	272,000		280,048,000
Closing inventory	<u>(25,000)</u>	1,068	<u>(109,665,000)</u>
Cost of sales	<u>72,000</u>		<u>173,383,000</u>

Cost per unit of steel cups:

Raw materials	109,200,000/240,000	455
Direct labour	54,600,000/240,000	227.5
Variable overhead	36,504,000/240,000	152.1
Fixed overhead	70,020,000/300,000	<u>233.4</u>
		<u>1,068</u>

Question 3

A growing wholesale company, Jasper Supplies Ltd, is considering implementing an inventory management system. Currently, the business performs a physical inventory count at the end of each quarter. However, management is interested in more real-time inventory information to improve control and reduce stockouts.

Required:

- Explain the differences between periodic and perpetual inventory systems.
- Recommend which system would be more suitable for Jasper Supplies Ltd, giving at least three justifications based on operational and financial reporting needs.

Suggested solution

a) Differences between Periodic and Perpetual Inventory Systems

Feature	Periodic Inventory System	Perpetual Inventory System
Inventory updates	Updated only at the end of a period via physical count	Continuously updated with each purchase and sale
Control over inventory	Limited control; discrepancies are discovered at period-end	Better control; discrepancies can be detected in real-time
Accounting entries	Uses purchases account; COGS determined at period-end	Purchases and COGS are recorded directly in the inventory account
Technology	Minimal; does not require	Requires inventory management software

Feature	Periodic Inventory System	Perpetual Inventory System
requirement	sophisticated systems	or ERP system
Suitability	Suitable for small businesses with low volume	Suitable for medium to large businesses or those needing tighter inventory control

b) Recommendation and Justification

Recommended System: Perpetual Inventory System

Justification:

1. Real-time inventory tracking and stock control
 - Jasper Supplies Ltd wants real-time information to reduce stockouts.
 - A perpetual system provides up-to-date inventory levels, helping ensure optimal stock levels are maintained and improving customer service.
2. Improved financial reporting and decision-making
 - Perpetual systems automatically update the cost of goods sold (COGS) and inventory balances, enhancing the accuracy and timeliness of management and financial reports.
 - This supports better business planning, forecasting, and cost control.
3. Reduced reliance on quarterly physical counts
 - By switching to a perpetual system, the company would reduce the operational disruption caused by quarterly physical counts.
 - Although physical counts may still be needed for verification, continuous tracking minimizes the risk of material discrepancies.

Conclusion:

Jasper Supplies Ltd should implement a perpetual inventory system. This will enhance operational efficiency, improve inventory control, and provide accurate real-time data for decision-making and financial reporting. The benefits will likely outweigh the initial investment in software and training.

Solutions To Practice Questions

Solution 1

Kaduna Market Traders: Income statement for the year to June 30, 2019

	N000	N000
Sales	2,000	30,000
Opening inventory		
Purchases	14,000	
	<u>16,000</u>	
Less: Closing inventory	<u>(1,500)</u>	
Cost of sales		<u>(14,500)</u>
Gross profit		15,500
Expenses		
: Salaries	10,500	
Lighting and heating	500	

Rent	2,000	
Office expenses	<u>1,000</u>	
		(14,000)
Net profit		<u>1,500</u>

Kaduna Market Traders: Statement of financial position as at June 30, 2019

	~~N~~ 000	~~N~~ 000
Non-current assets		
Property, plant and machinery		17,500
Current assets		
Inventory	1,500	
Trade receivables	10,000	
Cash	<u>1,000</u>	
		<u>12,500</u>
Total assets		<u>30,000</u>
Equity and liabilities		
Capital at July 1, 2018		27,500
Net profit for the year		<u>1,500</u>
		29,000
Less: Drawings		<u>(3,000)</u>
Capital at June 30, 2019		26,000
Current liabilities		
Trade payables		4,000
Total equity and liabilities		<u>30,000</u>

CONTROL ACCOUNTS AND CONTROL ACCOUNT RECONCILIATIONS

Contents

- 9.0 Learning objective
- 9.1 Learning outcomes
- 9.2 Receivables control accounts and receivables control account reconciliations
- 9.3 Payables control accounts and payables control account reconciliations
- 9.4 Supplier statements: reconciliation with ledger account
- 9.5 Chapter review
- 9.6 End of chapter questions and answers

9. Control Accounts and Control Account Reconciliation

9.0 Learning objective

This chapter explains the use of reconciliations to identify processing errors in the sales and purchases systems.

It also explains how balances generated by the accounting system might be reconciled to external statements.

9.1 Learning outcomes

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

- a. understand the relationship between control accounts and subsidiary ledger for accounts receivable and accounts payable
- b. prepare control accounts and corresponding subsidiary ledger from information provided
- c. perform control account reconciliation for accounts receivable and accounts payable
- d. identify errors and correct errors from control account reconciliations

9.2 Receivables Control Accounts And Receivables Control Account Reconciliations

9.2.1 Receivables control account

Chapter 5 explained that sales and purchases transactions are recorded in day books. The totals from the day books are posted to control accounts in the general ledger. These are supported by a separate record which is a list of individual balances that comprise the total in the general ledger.

A control account is an account which represents a total value of a number of separate balances.

The receivables control account

The receivables control account is an account for recording the value of transactions in total with credit customers. The balance on the receivables control account (debit balance) is the total amount currently owed by all customers.

The receivables control account will contain some or all of the totals to date for all of the following postings to the account.

Illustration: Receivables control account

Receivables control account			
Balance b/d	X	Cash	X
Sales	X	Sales returns	X
Dishonoured cheques	X	Bad debts	X
Revenue adjustment (Customer fails to take a discount when expected to do so)	X	Revenue adjustment (Customer takes a discount when not expected to do so)	X
		Contra	X
		Credit notes	X
		Balance c/d	X
	X		X
Balance b/d	X		

There must also be individual accounts for each credit customer in a separate receivables ledger.

9.2.2 Receivables control account reconciliation

Reconciliation means making sure that two figures or totals are consistent with each other and agree with each other. The control accounts in an accounting system can be used for control purposes, to make sure that transactions have been recorded correctly in the accounts.

This is because if the transactions have been recorded correctly the balance on the receivables control account in the general ledger should equal the total of the balances on all the individual customer accounts in the receivables ledger.

A reconciliation check can be made to make sure that these totals are the same. If they are different, the cause of the error (or errors) should be found and corrected.

A receivables control account reconciliation involves a comparison between the totals, looking for the reasons for any differences between them, and correcting errors that are discovered in the checking process.

Why might there be differences?

The balance on the receivables ledger control account might differ from the total of all the balances on the accounts in the receivables ledger for the following reasons:

The errors described above do not result in differences in the total of debit and credit entries in the general ledger. Consequently, the existence of an error will not be discovered by preparing a trial balance.

Illustration: Possible errors	Correction
Error	
1. The total of the credit sales in the sales day book is correctly debited to the receivables control account but one of the individual transactions is not posted from the sales day book to the individual accounts in the receivables ledger.	Adjust the individual customer's balance
2. The total of cash received from customers, recorded in the cashbook, has been posted correctly to the receivables ledger control account, but a receipt from a customer is not posted from the cash book to the individual accounts in the receivables ledger.	Adjust the individual customer's balance
3. The sales day book may be added up incorrectly so that the wrong amount is posted to the receivables ledger control but the individual accounts in the receivables ledger are correctly updated.	Adjust the receivables ledger control account in the general ledger.
4. A contra entry might be recorded in the general ledger but not in the receivables ledger (or vice versa) Balance b/d Cash Opening balance Purchases in the year	Adjust the appropriate record for the missing entry

However, these errors should be discovered by a control account reconciliation.

Preparing a receivables control account reconciliation

To make a control account reconciliation, the starting point is to compare the control account balance with the total of all the balances on the individual customer (receivables ledger) or supplier (payables ledger) accounts.

If the totals differ, the reasons for the difference need to be discovered. When the reasons are discovered, the errors must be corrected. A correction might involve:

- a. changing the control account balance; or
- b. changing one or more balances on individual customer or supplier accounts.

The two totals should be equal after all corrections have been made. If a difference still remains between the totals, this means that at least one error remains undetected.

Example: Receivables control account reconciliation

The balance on the receivables ledger control account in the general ledger of Entity Z is

~~N~~53,690.

The balances on the customer accounts in the receivables ledger are as follows:

~~N~~

Customer A	12,000
Customer B	8,000
Customer C	6,000
Customer D	11,000
Customer E	<u>15,000</u>
	<u>52,000</u>

An investigation is carried out into the difference between the total account balances in the receivables ledger and the balance on the receivables control account.

- (1) A sale on credit of ~~N~~1,700 to Customer A has not been recorded in the customer's account in the receivables ledger, but is included in the control account balance.
- (2) Customer B has supplied goods to Entity Z to the value of ~~N~~400, and these have not yet been paid for by Entity Z. It has been agreed that this amount should be offset against the money owed to Entity Z by Customer B. No entries have yet been made for this 'contra' adjustment in the general ledger or the receivables and payables ledgers.
- (3) Sales returns of ~~N~~550 by Customer C have been recorded in C's individual account in the receivables ledger, but the transaction was not posted to the general ledger.
- (4) Customer D took advantage of an early settlement discounts having ~~N~~240. Entity Z had not expected Customer D to take the discount. This has been recorded in D's individual account in the receivables ledger, but the transaction was not posted to the general ledger.
- (5) Sales returns of ~~N~~800 by Customer E have not been recorded in the customer's account in the receivables ledger, but are included in the control account balance.

	~~N~~		~~N~~
Balance b/d	53,690	(2) Contra entry	400
		(3) Sales returns	550
		(4) Discounts allowed	240
		Balance c/d	<u>52,500</u>
	<u>53,690</u>		<u>53,690</u>
Balance b/d	52,500		

Total balances in receivables ledger	52,000
(1) Sale (Customer A)	1,700
(2) Contra entry (Customer B)	(400)
(5) Sales returns (Customer E)	(800)
	<u>52,500</u>

Customer A: 12,000 + 1,700	13,700
Customer B: 8,000 - 400	7,600
Customer C	6,000
Customer D	11,000
Customer E: (15,000 – 800)	14,200
	52,500

Practice question 1

The balance on Yusuf's receivables ledger control account on 31 December was ~~N~~3,800,000 which did not agree with the net total of the list of receivables ledger balances at that date.

The following errors were found:

- Debit balances in the receivables ledger, amounting to ~~N~~103,000, had been omitted from the list of balances.
- A bad debt amounting to ~~N~~400,000 had been written off in the receivables ledger but had not been posted to the bad debts expense account or entered in the control account.
- An item of goods sold to Eric, ~~N~~250,000, had been entered once in the sales day book but posted to his account twice.
- Yusuf had expected Godwin to take advantage of a settlement discount of ~~N~~25,000. Godwin did not settle the account in time to qualify for the discount. This has been recorded correctly in Godwin's own account but not entered in the general ledger.

- e) No entry had been made in the control account in respect of the transfer of a debit of ~~N~~70,000 from Monday's account in the receivables ledger to his account in the payables ledger.
- f) The discount allowed column in the cash account had been undercast by ~~N~~140,000.

Required:

Make the necessary adjustments in the receivables control account and bring down the corrected balance.

Show the adjustments to the net total of the original list of balances to reconcile with this amended balance.

9.3 Payables Control Accounts And Payables Control Account Reconciliations

9.3.1 The payables control account

The payables control account is an account for recording the value of credit purchase transactions in total. The balance on the payables control account (credit balance) is the total amount currently owed to all suppliers.

There must also be individual accounts for each credit suppliers in a separate payables ledger.

The payables control account will contain some or all of the totals to date for all of the following postings to the account.

Illustration: Payables control account

Payables control account			
		Balance b/d	X
Cash	X	Purchases	X
Discounts received	X		
Purchase returns	X		
Contra	X		
Balance c/d	X		
	X		X
		Balance b/d	
			X

There must be individual accounts for each supplier in a separate payables ledger.

9.3.2 Payables control account reconciliation

A payables control account reconciliation involves a comparison between the totals on the payables control account and the list of balances in the payables ledger.

Why might there be differences? The balance on the payables ledger control account might differ from the total of all the balances on the accounts in the payables ledger for the following reasons:

Illustration: Possible errors

Error	Correction
1 The total of the credit purchases in the purchases day book is correctly credited to the payables control account but one of the individual transactions is not posted from the purchases day book to the individual accounts in the payables ledger.	Adjust the individual customer's balance
2 The total of cash paid to suppliers, recorded in the cashbook, has been posted correctly to the payables ledger control account, but a payment to a supplier is not posted from the cash book to the individual accounts in the payables ledger.	Adjust the individual customer's balance
3 The purchases day book may be added up incorrectly so that the wrong amount is posted to the payables ledger control but the individual accounts in the payables ledger are correctly updated.	Adjust the payables ledger control account in the general ledger.
4 A contra entry might be recorded in the general ledger but not in the payables ledger (or vice versa).	Adjust the appropriate record for the missing entry

Example: Payables control account reconciliation

The balance on the payables control account was ~~N~~971,860 as at December

31. Balances extracted from the payables ledger on this date totaled ~~N~~962,380.

- 1 The purchases day book was undercast by ~~N~~60,000.
- 2 A cash account total of ~~N~~108,580 was posted to the control account as ~~N~~90,580.
- 3 A credit balance of ~~N~~13,860 on the suppliers' ledger had been set off against a customer's ledger debit balance but no entry had been made in the control accounts.
- 4 A credit balance of ~~N~~37,620 had been omitted from the list of balances.

Payables control account

	N		N
(2) Cash error	18,000	Balance b/d	971,860
(3) Contra	13,860	(1) Purchasedaybook undercast	60,000
Balance c/d	1,000,000		
	<u>1,031,860</u>		<u>1,031,860</u>
		Balance b/d	1,000,000

The balances on the accounts in the receivables ledger in total are

Total balances in receivables ledger	~~N~~ 962,380
(4) Omission of balance	37,620
	<u>1,000,000</u>

9.4 Supplier Statements: Reconciliation With Ledger Account

9.4.1 Supplier statements

It is common business practice for suppliers to send monthly statements to their regular credit customers, listing the transactions that have occurred between the supplier and the customer during the month (such as sales, sales returns, payments and settlement discounts given). The statement ends with a balance showing the amount that, according to the supplier's accounting records, the customer currently owes.

9.4.2 Reconciliation of a statement with the supplier's ledger account

On receiving a statement from a supplier, a reconciliation check can be carried out. The purpose of this check is to compare the transactions and balance shown on the supplier's statement with the transactions and balance in the supplier's account in the payables ledger.

Any differences between the statement balance and the ledger account balance should be investigated and explained. Any problems, including errors, should be dealt with.

Reasons for differences

There are various reasons why the statement balance from a supplier might differ from the balance on the payables ledger account for the supplier.

- a. The supplier might have omitted a transaction from the statement, in which case the supplier's accounting records are incorrect.
- b. The customer might have omitted a transaction from its accounting records, in which case the customer's accounting records are incorrect.

Transactions that might have been omitted include sales/purchase transactions, payments, discounts, contra entries and returns/credit notes.

Carrying out a reconciliation

To carry out a reconciliation between the balance on a supplier's statement and the balance on the supplier's ledger account in the customer's payables ledger, the following steps should be taken.

- a. Compare the two totals. If they differ, the reasons for the difference should be discovered.
- b. The reasons for the difference can be identified fairly easily, by comparing the transactions listed in the supplier's statement with the transactions recorded in the ledger account for the supplier.
- c. If there is an omission or other error by the supplier, the supplier should be notified. For the purpose of making the reconciliation, the supplier's statement balance should be amended to allow for the error.

- d. If there has been an omission or error in the customer's accounting records, the error should be corrected and the balance on the supplier's account in the payables ledger will change.

If all the differences are identified, explained and where necessary corrected, the two balances should be equal – the amended balance on the supplier's statement and the amended balance on the supplier's account in the payables ledger.

Example: Reconciliation of statement to supplier's ledger account

Emmanuel received a statement of account from a supplier Akachi, showing a balance to be paid of ₦5,900. Emmanuel's payables ledger account for Akachi shows a balance due to Akachi of ₦3,360.

Investigation reveals the following:

- (1) Cash paid to Akachi ₦1,650 has not been allowed for by Akachi.
- (2) Sales returned to Akachi ₦780 have not been allowed for by Akachi.
- (3) Emmanuel's ledger account for Akachi has not been adjusted for ₦110 of cash discount disallowed by Akachi.

A reconciliation of the statement balance and the balance in the ledger account can be made, as follows.

Statement:		Ledger account:	
	₦		₦
Balance	5,900	Balance	3,360
Adjust for: Cash payment		Adjust for:	
	(1,650)	Discount disallowed	110
Sales returns	(780)		
Adjusted balance	<u>3,470</u>	Corrected balance	<u>3,470</u>

9.5 Chapter review

Chapter review

Before moving to the next chapter, check that you are now able to:

- a. understand the relationship between control accounts and subsidiary ledger for accounts receivable and accounts payable;
- b. prepare control accounts and corresponding subsidiary ledger from information provided;
- c. perform control account reconciliation for accounts receivable and accounts payable; and
- d. identify errors and correct errors from control account reconciliations

9.6 End of chapter questions and suggested solutions

Question 1

From the following information, prepare the Receivables Control Account and the corresponding Receivables Subsidiary Ledger for the month of March 2025:

- a. Opening balance of accounts receivable: ₦520,000
- b. Credit sales during the month: ₦1,200,000
- c. Receipts from customers: ₦900,000
- d. Sales returns: ₦50,000
- e. Discounts allowed: ₦30,000
- f. Bad debts written off: ₦20,000

Customer balances at month-end:

- a. Ada: ₦300,000
- b. Bello: ₦200,000
- c. Chike: ₦220,000

Required:

- a. Prepare the Receivables Control Account for March 2025.
- b. Show the balances in the Receivables Subsidiary Ledger for Ada, Bello, and Chike, and reconcile the control account with the total of the subsidiary balances.

Suggested solution

a) Receivables Control Account for March 2025

	₦		₦
Balance b/d		Sales returns	
520,000		50,000	
Credit sales		Receipts from customers	
1,200,000		900,000	
		Discounts allowed	
		30,000	
		Bad debts written off	
		20,000	
		Balance c/d	
		<u>720,000</u>	
<u>1,720,000</u>		<u>1,720,000</u>	

b) Receivables Subsidiary Ledger Balances

Customer	Closing Balance (₦)
Ada	300,000
Bello	200,000
Chike	<u>220,000</u>
Total	<u>720,000</u>

Reconciliation

Item	Amount (N)
Total per Control Account	720,000
Total per Subsidiary Ledger	720,000
Difference	Nil

The control account balance agrees with the total of individual customer accounts.

Question 2

The Payables Control Account in XYZ Ltd's general ledger shows a closing balance of N860,000 on 31 May 2025. A list of supplier balances extracted from the payables ledger totals N926,000.

Upon investigation, the following errors were discovered:

1. A payment of N20,000 to a supplier was entered only in the cash book but not in the supplier's ledger.
2. Purchases of N30,000 were posted to the supplier's ledger but not to the control account.
3. A supplier's credit note for N16,000 was recorded in the control account but not in the supplier's ledger.

Required:

- a. Prepare the Payables Control Account Reconciliation Statement, showing all adjustments and the corrected balance.
- b. Calculate the adjusted balance of the supplier ledger list after correcting the errors.

Suggested solution

- a) Payables Control Account Reconciliation Statement

	N
Control Account Balance as at 31 May 2025	860,000
Add: Purchases omitted from Control Account	<u>30,000</u>
Adjusted Payables Control Balance	<u>890,000</u>

- b. Adjusted Supplier Ledger Balances

	N
Original Supplier Ledger Total	926,000
Omitted payment not yet deducted	(20,000)
Credit note not yet deducted	<u>(16,000)</u>
Adjusted Supplier Ledger Total	<u>890,000</u>

Question 4

Amao Manufacturing Ltd is expanding rapidly and is experiencing difficulties managing its credit transactions. There have been instances of missed payments to suppliers and customer disputes over balances. The finance manager believes that an improved system for recording and reconciling receivables and payables is necessary.

Required:

- a. Explain the relationship between control accounts and subsidiary ledgers in managing accounts receivable and payable.
- b. Advise the company on how to structure its control account system, including key internal controls and the frequency of reconciliations to prevent and detect errors.

Suggested solution

- a. Relationship between Control Accounts and Subsidiary Ledgers in managing Accounts Receivable and Payable

Control accounts are accounts used to summarise entries in the general ledger that record the total balances of related individual accounts in a subsidiary ledger.

- i. The Receivables Control Account summarises all credit sales, customer receipts, sales returns, discounts allowed, and bad debts.
- ii. The Payables Control Account summarises credit purchases, payments to suppliers, purchase returns, and discounts received.

The subsidiary ledger (also called personal ledger) contains individual accounts for each customer (receivables) or supplier (payables), showing detailed transactions and balances.

Relationship:

- i. The control account provides a quick overview of the total amount owed to or by the company.
- ii. The subsidiary ledger provides the detailed breakdown of each transaction per customer or supplier.
- iii. They must be reconciled regularly to ensure that the total of the subsidiary ledger balances equals the balance in the control account.

This relationship enables efficient management of credit transactions and enhances the accuracy and reliability of financial reporting.

- b. Recommendations for structuring an effective Control Account System
To address the current challenges, Amao Manufacturing Ltd should implement the following strategies:

- i. Structure of the Control Account System
 - Maintain Receivables and Payables Control Accounts in the general ledger.
 - Maintain detailed subsidiary ledgers for individual customers and suppliers.
 - Ensure automated or manual posting of all credit transactions to both control and subsidiary ledgers in a timely manner.
- ii. Key Internal Controls
 - Segregation of duties: Separate responsibilities for authorising transactions, recording entries, and reconciling accounts.
 - Regular reconciliation: Ensure that control accounts are reconciled with the subsidiary ledgers at least monthly.
 - Approval of adjustments: Any journal entries or adjustments to control accounts must be reviewed and approved by a supervisor.
 - Audit trail: Maintain proper documentation for all transactions (e.g., invoices, credit notes, receipts).
 - Use of accounting software: Automate posting and reconciliation to minimize human errors.

- iii. Frequency of Reconciliations
 - Perform monthly reconciliations as a minimum standard.
 - In high-volume environments or during periods of rapid growth (like in Amao Manufacturing), consider weekly reconciliations to ensure accuracy and early error detection.
 - Perform year-end reconciliations as part of the final accounts preparation.

Conclusion:

By understanding and leveraging the relationship between control accounts and subsidiary ledgers, and by implementing a robust reconciliation and control framework, Amao Manufacturing Ltd can reduce errors, improve cash flow management, and strengthen supplier and customer relationships.

Solutions To Practice Questions

Solutions

1

Receivables control account

	₦		₦
Balance b/d	3,800,000	(b)Bad debt	400,000
(d) Revenue adjustment due to failing to qualify for expected discount	25,000	(e) Contraentry	70,000
		(f) Discount allowed	140,000
		Balance c/d	3,215,000
	3,825,000		3,825,000
Balance b/d	3,215,000		

The balances on the accounts in the receivables ledger in total are

	₦
Total balances in receivables ledger (balancing figure)	3,362,000
(a) Omitted balances	103,000
(c) Correction of double posting	(250,000)
	3,215,000

BANK RECONCILIATIONS

Contents

- 10.0 Learning objective
- 10.1 Learning outcomes
- 10.2 Bank reconciliations
- 10.3 Chapter review
- 10.4 End of chapter questions and suggested solutions

10. Bank Reconciliations

10.0 Learning objectives

This chapter explains how to reconcile the balance in a cash account in the general ledger to the balance on the bank statement.

10.1 Learning outcomes

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

- a. Identify the main reasons for differences between the cash book and bank statements;
- b. Prepare a bank reconciliation from information provided; and
- c. Post journal entries to correct cash book errors identified by the bank reconciliation.

10.2 Bank Reconciliations

10.2.1 The cash book (bank account in the general ledger) and bank statements

Chapter 3 explained that the cash book is a book of prime entry used to record all receipts and payments of cash.

There are many different methods by which a business might make payment to suppliers and receive payment from customers.

Methods include:

- a. Cash (this is quite rare in all but the smaller businesses);
- b. Cheques;
- c. Bank transfers – An amount transferred directly from a bank account holder's account to the bank account of another party on the instruction of the first person;
- d. Credit and debit cards – People often use these to pay for goods and services purchased from businesses. Once a sale is made the business asks the credit (debit) card company to make the payment on behalf of the card holder. The credit (debit) card company then recovers the cash from the cardholder;
- e. Many modern businesses now accept online payment for sales of goods and provision of services. Payment is often received through the use of credit cards and debit cards in the usual way or through the action of a third party (for example, Pay pal);
- f. Standing order – An instruction a bank account holder (the payer) gives to their bank to pay a set amount at regular intervals to another party's (the payee's) account;
- g. Direct debit – A method of payment in which, a person (payee) instructs their bank to collect funds from another party's (payer's) bank account. The payer must have instructed their bank to allow this before it can happen; and
- h. Banker's draft – A cheque from a bank. The payer transfers funds to the bank (either from its account at the bank or in cash) and the bank issues the draft which can then be used to pay a third party. The third party presents the draft to a bank and receives funds immediately.

Both standing orders and direct debits are very common methods of making monthly payments. A standing order allows for payment of the same amount on each payment date as the payer instructs the bank to pay this amount. A direct debit allows for different payments at each payment date as the payer instructs the bank to pay the amount the payee asks for.

Banker's drafts have certain advantages for the payee. Firstly, the payee does not have to wait for a cheque to clear as payment is immediate. Furthermore, the receipt is less risky as the draft is to be paid by a bank. Banker's drafts continue to be useful for large commercial purchases especially in new trading relationships but the advent of electronic banking (including cash transfers) is reducing their importance.

Posting

Periodically, totals are posted from the cash book to the general ledger accounts. One of these accounts is the cash account. For the purposes of this section we will describe this more specifically as the cash at bank account. (A business usually also has a cash in hand account to record cash amounts physically held but the majority of cash receipts and payments are usually through the cash at bank account).

The cash at bank account in the general ledger is used to record receipts and payments of cash through the bank account. The balance on this account is the amount that the business believes that it has in its bank account (debit balance) or the size of its bank overdraft (credit balance).

The bank sends regular bank statements to a business entity. A bank statement lists all the transactions that the bank has recorded in the account for the entity since the previous statement and the current balance on the account.

Many businesses now have on-line access to their bank statements so can access a bank statement at any time.

Reconciliation

The term reconciliation refers to a process that compares two sets of records (usually the balances of two accounts, in this case the balance on the cash at bank account and the balance on the bank statement) and explains the reason for any difference between them.

A bank reconciliation compares the balance on the general ledger cash at bank account to the balance on the bank statement at a given point in time. This should be done at regular intervals (say at the end of each month).

Often the balance on the cash at bank account is referred to as the balance on the cash book. This can be confusing but remember that the reconciliation always agrees the balance on the cash at bank account to the balance on the bank statement.

Bank reconciliations are a useful check on the accuracy of accounting records for cash. In principle, the balance in the cash at bank account or cash book in the general ledger and the balance shown in the bank statement should be the same but there are often differences and some of these might relate to transactions which the business has not yet accounted for or errors which must be corrected.

10.2.2 Differences and the need for a reconciliation

The balance on the general ledger cash at bank account and that shown for the business in its bank statement, at a point in time, will rarely be the same.

Differences between might be caused by any of the following:

- a. Items recorded in the cash at bank account are not (yet) shown in the bank statement.
- b. Items in the bank statement that have not been recorded in the cash at bankaccount.
- c. Errors by the bank (these are quite rare but do happen).
- d. Errors in the cashbook.

Each of these will be considered in turn.

Items recorded in the cash at bank account that have not (yet) shown in the bank statement

Some transactions might have been recorded in the cash at bank account in the general ledger, but have not yet been recorded by the bank.

Cheques received from customers, recorded in the cash book and paid into the bank and may not have been processed yet by the bank. Processing payments through the banking system might take two or three days, perhaps even longer. These are known as outstanding lodgements.

Cheques paid to suppliers are recorded as payments in accounting system of the business but they may not yet have been presented to the bank for payment (i.e. paid into the bank by the business's supplier). These are known as unpresented cheques.

Even if the cheques have been presented for payment by our supplier the bank may not have processed the deduction from the business's account yet.

These are timing differences. The transactions will eventually be processed by the bank. There are no errors or omissions in the cash book, and no further action is needed.

Items in the bank statement that have not been recorded in the cash at bank account

A business might not know about some items until they receive a bank statement.

Examples include:

- a. Bank charges;
- b. bank interest on an overdrawn balance;
- c. a payment from a customer that has been rejected by the bank (for example, the customer's cheque has been dishonoured);
- d. a bank transfer where a payment has been made directly into the business's account; and
- e. a bank might make a mistake either crediting or debiting an incorrect amount into an account (these are rare but they do happen).

The general ledger cash at bank account should be amended to include these transactions.

When a cheque is dishonoured the business must reverse the entries that were made originally when the business thought that an amount had been received.

Illustration: Double entry for dishonoured cheque

Write back of receivable **Debit** **Credit**

General ledger:

Receivables	X	
Cash at bank		X

Receivables ledger:

Individual customer accounts	X

The business should also consider whether the receivable should be written off as a bad debt or whether an allowance should be recognised for a doubtful debt (see chapter 7)

Errors by the bank

The bank might sometimes make an error. If so, it should be notified and asked to correct its mistake. No further action is then needed.

Errors in the cash book

Possibly, an error has been made in the cash book. This should be identified during the reconciliation of the bank statement with the cash at bank account balance. Any such errors must be corrected when discovered.

10.2.3 Possible cause of confusion

The bank statement presents information as recorded in the accounting system of the bank. It always shows the bank's view of things.

When a business has a positive cash balance that is an asset and as far as the business is concerned it is a debit balance. From the bank's point of view they owe the business money. Therefore they show the business as having a credit balance on the bank statement.

Similarly a bank account is overdrawn, the business owes money to the bank and shows this as a liability (a credit balance) in its financial statements. However, from the bank's point of view they have an asset and show this as a debit balance on the bank statements.

10.2.4 Format of a bank reconciliation statement

The purpose of a bank reconciliation is to show that the cash at bank account balance in the general ledger agrees with the bank statement balance after taking account of timing differences and making adjustments for any omissions or errors.

There is no single correct format for a bank reconciliation.

A useful approach is to correct the cash at bank balance for any omissions or errors and then adjust the balance per the bank statements for uncredited lodgements and unrepresented cheques. The resultant balances should be the same.

Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank account:	X
Items in bank statement not in cashbook:	
Bank charges	(X)
Dishonoured	(X)
	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	<u>X¹</u>
 Balance per bank statement	 X
Items in general ledger not in bank statement Add:	
Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	<u>X¹</u>
The balances (X ¹) should now agree	

Alternative presentations are possible.

Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of ₦4,500.

Cheques for ₦2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling ₦6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged ₦700 in bank charges.

A cheque for ₦300 from a customer, customer X, has been dishonoured. The balance in the account according to the bank statement is ₦7,700. A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	~~N~~
Items in bank statement not in cash book	4,500
Bank charges	(700)
Dishonoured cheques	(300)
	(1,000)
Corrected cash at bank figure	3,500
 Balance per bank statement	 7,700
Items in general ledger not in bank statement	
Add: Outstanding lodgements	2,000
Deduct: Unpresented cheques	(6,200)
Corrected balance per bank statement	3,500

Alternative format

This approach corrects the general ledger cash at bank account and then shows the differences between that figure and the balance as per the bank statement.

Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank:	X
Items in bank statement not in cashbook:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	X ¹
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(X)
Add: Unpresented cheques	X
Balance per bank statement	<u>X¹</u>

Example

The bank statement and cash book of Junior Ltd were provided to you on March 31, 2019. It was found that there is a difference in the balances of both documents. You are required to prepare a bank reconciliation statement as at March 31, 2019. Below is the extract for cash book and bank statement for the month of March 2019.

Cash book (Bank column) as at March 31, 2019 for Junior Ltd

Date	Particulars	Amount N'000	Date	Particulars	Amount N'000
March 1	Balance b/f	1000	March 3	Gadafi	400
March 10	Wahum	300	March 20	Keaton	200
March 21	Teraculture	100	March 29	Shoprite	400
March 30	Samantha	600	March 31	Balance c/d	1000

Bank statement as at March 31, 2019 for Junior Ltd

Date	Details	Dr N'000	Cr N'000	Balance N'000
March 1				1000
March 7	Cheque 0451	400		600
March 10	Dividend		100	700
March 14	Cheques		300	1000
March 24	Cheque 0452	200		800
March 24	Cheques		100	900
March 25	Insurance premium	200		700
March 31	Bank charges	100		600

Solution

Step 1 : identify the common items in both the cash book and bank statement

Particulars	Amount N'000
Wahum	300
Teraculture	100
Gadafi	400
Keaton	200

Step 2: The balance items which do not appear on the above table would appear in the bank reconciliation statement

Junior Ltd

Bank reconciliation statement as at March 31, 2019

Particulars	Amount N'000	Amount N'000
Balance as per bank statement		600
Add cheque deposited but not collected (Samantha)	600	
Insurance premium	200	
Bank charges	100	
		900
Less: Cheques issued but not presented for payment (Shoprite)	400	
Dividend recorded only in bank statement	100	
		(500)
Balance as per cash book as at March 31, 2019		1,000

Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of ~~N~~4,500.

Cheques for ~~N~~2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling ~~N~~6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged ~~N~~700 in bank charges.

A cheque for ~~N~~300 from a customer, customer X, has been dishonoured. The balance in the account according to the bank statement is ~~N~~7,700.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank:	N
Items in bank statement not in cash book	4,500
Bank charges	(700)
Dishonoured cheques	(300)
	(1,000)
Corrected cash at bank figure	3,500
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements (2,000)	
Add: Unpresented cheques 6,200	
Balance per bank statement	7,700

10.2.5 Bank reconciliations and overdrawn balances

For a company with a bank account, money in the bank is an asset and the cash balance in the cash book is a debit balance. If there is a bank overdraft, the cash book has a credit balance, indicating that money is owed to the bank.

For the bank, the situation is the opposite way round.

- Money held by the bank in a bank account for a customer is money that belongs to the customer. For the bank, deposits are therefore liabilities and an account is said to be in credit when there is money in it.
- If a bank allows an overdraft to a customer, the customer owes the bank. The amount of the overdraft is a form of receivable for the bank, and is an asset. To the bank, an overdraft balance on a customer's account is therefore a debit balance (=asset).

A bank statement might therefore indicate that a customer's account has a 'debit balance', such as ~~N~~5,250 Dr. This debit balance means 'overdraft' and for the customer it is a liability and credit balance item in their financial records.

Preparing a bank reconciliation with an overdraft balance

If you are given a question in which there is an overdraft balance in the bank statement, it is useful to make the negative balance clear by putting brackets around the balance.

Illustration: Bank reconciliation

The following assumes that the cash balance is negative (i.e, the business has a credit cash balance).

Balance per general ledger cash at bank:	(X)
Items in bank statement not in cashbook:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	(X ¹)
 Balance per bank statement	 (X)
Items in general ledger not in bank statement Add:	
Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	(X ¹)
The balances (X ¹ should now agree)	

Example: Bank reconciliation

A company receives a bank statement showing an overdraft balance of ₦20,000. The balance recorded in the company's cash book is a credit balance of ₦12,100.

- (1) Lodgements not yet cleared by the bank (That is, payments into the account but not recorded in the bank statement) ₦24,300
- (2) Cheques not yet presented (That is, payments from the account recorded in the cash book but not yet processed through the bank) ₦18,900
- (3) Bank charges of ₦1,300
- (4) A dishonoured cheque from a customer ₦1,200.

Items (3), (4) and (5) have not yet been recorded in the cashbook. A bank reconciliation statement could be prepared as follows:

	N
Balance per general ledger cash at bank:	(12,100)
Items in bank statement not in cash book:	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	(2,500)
Corrected cash at bank figure	(14,600)
Balance per bank statement	(20,000)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	24,300
Deduct: Unpresented cheques	(18,900)
Corrected balance per bank statement	(14,600)

Example: Bank reconciliation

Alternatively, the bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank:	(12,100)
Items in bank statement not in cash book:	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	(2,500)
Corrected cash at bank figure	(14,600)
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(24,300)
Add: Unpresented cheques	18,900
Balance per bank statement	(20,000)

Practice question

On June 30, the cash account of Akachi's business showed a balance at bank of ₦1,500,000.

The balance in Austin's cash account at June 30, showed an asset of ₦1,660,000.

His bank statement showed an overdraft of ₦450,000.

On reconciling the cash account, he discovers the following bank statements showed that cheques for ₦70,000, ₦90,000 and ₦100,000 had not been presented for payment and that lodgements totalling ₦210,000 had not been cleared.

The balance on the bank statement at June 30, was ₦1,550,000.

Required:

Prepare a bank reconciliation statement.

Practice question

2

The balance in Austin's cash account at 30 June showed an asset of ₦1,660,000.

His bank statement showed an overdraft of ₦450,000.

On reconciling the cash account, he discovers the following:

- The debit side of the cash account had been undercast by ₦200,000.
- A total on the receipts side of the cash account of ₦2,475,000 had been brought forward as ₦4,275,000.
- A cheque received by Austin for ₦220,000 had bounced.
- Bank charges of ₦184,000 had been omitted from the cash account.
- Unpresented cheques totalled ₦520,000 and uncleared lodgements ₦626,000.

Required:

Prepare a bank reconciliation statement.

10.3 Chapter review

Chapter review

- Before moving on to the next chapter, check that you are now ~~know how~~ able to:
- identify the main reasons for differences between the cash book and bank statements;
- prepare a bank reconciliation from information provided; and
- post journal entries to correct cash book errors identified by the bank reconciliation.

10.4 End of chapter questions and suggested solutions

Question 1

On February 6, 2025, Renew Ventures received its bank statements for the month ended January 31, 2025. The bank statement showed a balance of ~~N~~41,740,000 (overdraft) as at January 31, while the cash book showed a balance of ~~N~~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 ~~N~~201,000 had not been recorded in the cash book;
- (ii) Renew Ventures exceeded its overdraft limit during the month of January. The bank had therefore charged a default penalty of ~~N~~250,000. This was not reflected in the cash book;
- (iii) A sum of ~~N~~1,250,000 had been credited to Renew Ventures' bank account in error;
- (iv) A cheque for ~~N~~1,230,000 had been returned by the bank as dishonoured, in effect, the bank charged Renew Ventures ~~N~~15,000. This was not reflected in the cash book;
- (v) Cash receipts of ~~N~~3,740,000 were posted as cash payments of ~~N~~4,730,000 in the cash book;
- (vi) On January 21, Renew Ventures transferred cash of ~~N~~650,000 to its personal bank account. This was credited to the business bank account in error by the bank;
- (vii) Standing orders and direct debits of ~~N~~1,115,000 had not been posted to the cash book;
- (viii) Customers had transferred ~~N~~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 ~~N~~5,120,000 lodged to the bank account on January 31, 2025, had not been credited by the bank; and
- (x) The following cheques, drawn on the bank account, had not been presented to the bank for payment as at January 31, 2025:
 - Cheque Number 4528, dated January 11, 2025: ~~N~~840,000
 - Cheque Number 4535, dated January 28, 2025: ~~N~~1,740,000
 - Cheque Number 4537, dated January 31, 2025: ~~N~~3,670,000

Required:

- a. Prepare the adjusted cash book for the month of January, 2025.
- b. Prepare a statement on February 7, 2025 reconciling the bank statement balance with the adjusted cash book balance

Suggested solution
In the books of Renew Ventures

a. Adjusted cash book

	N'000		N'000
Direct credit	2,170	Balance b/f	52,599
Cash receipt posted as payment	8,470	Bank charges	201
Balance c/f	44,770	Default penalty	250
		Dishonoured cheque	1,230
		Penalty on dishonoured cheque	15
		Standing order	<u>1,115</u>
	<u>55,410</u>		<u>55,410</u>
		Balance b/f	44,770

Bank reconciliation statement as at February 7, 2025

	N'000	N'000
Balance as per cash book		(44,770)
Add cheque written not yet presented		
Cheque number:		
• 4528	840	
• 4535	1,740	
• 4537	3,670	<u>6,250</u>
		(38,520)
Less lodgement made not yet credited	5,120	<u>5,120</u>
Correct bank statement balance		(43,740)
Add the following bank errors:		
• Wrong credit to the account	1,250	
• Proprietor's account wrongly credited	650	<u>1,900</u>
Balance as per bank statement		(41,740)

:Alternative solution to

Renew Ventures

Bank reconciliation statement as at February 7, 2025

	N'000	N'000
Balance as per bank statement		(41,740)
Add uncredited lodgement		5,120
		(36,620)

Lees cheques written not yet presented:

Cheque number:

- 4528 840

• 4535	1,740	
• 4537	<u>3,670</u>	<u>6,250</u>
		(42,870)
Less the following bank errors:		
• Wrong credit to the account	1,250	
• Proprietor's account wrongly credited	<u>650</u>	<u>1,900</u>
Balance as per cash book		<u>(44,770)</u>

Question 2

Chioma & Sons operates a single business bank account and prepares monthly bank reconciliations. On reviewing the June 2025 bank reconciliation, the new accountant noticed the following unexplained differences:

Customer payments of ₦12,000 were received and recorded but not yet credited by the bank. Bank charges and interest of ₦750 were debited in the bank statement without any entry in the cash book.

The bank returned a cheque of ₦2,500 from a debtor as unpaid, but no adjustment was made in the cash book.

A direct credit from a customer of ₦5,000 was recorded in the bank but omitted from the cash book.

Required:

- Identify and explain the main reasons for the differences between the cash book and the bank statement.
- Suggest how each difference should be treated during reconciliation.

Suggested solution**a) Reasons for the differences between the Cash Book and the Bank Statement**

Item	Explanation
~~N~~ 12,000 customer payments not yet credited by the bank	These are outstanding lodgements — payments recorded in the cash book but not yet reflected in the bank statement due to processing delays.
~~N~~ 750 bank charges and interest not recorded in the cash book	These are bank entries (charges and interest) initiated by the bank and not yet captured in the cash book, causing a difference.
~~N~~ 2,500 dishonoured cheque not adjusted in the cash book	This is a returned cheque — it was initially recorded as a receipt in the cash book but later rejected by the bank. The reversal hasn't been recorded in the cash book.
~~N~~ 5,000 direct credit from a customer omitted from the cash book	This is a direct bank receipt — recorded by the bank but not yet updated in the cash book, creating a difference.

b) Treatment of each difference during reconciliation

Item	Reconciliation Treatment
~~N~~ 12,000 outstanding lodgements	Shown as a deduction in the bank reconciliation statement (added back to the bank statement balance to reconcile to the cash book).
~~N~~ 750 bank charges and interest	Update the cash book by debiting bank charges and crediting the bank account.
~~N~~ 2,500 dishonoured cheque	Update the cash book by debiting the debtor's account and crediting the bank account.
~~N~~ 5,000 direct credit	Update the cash book by debiting the bank account and crediting the customer account (or relevant income account).

Question 3

Benji Enterprises maintains a bank account with Eco Bank. At the end of May 2025, the cash book showed a balance of ~~N~~840,000. Upon receiving the bank statements, the following discrepancies were noted:

A cheque payment of ~~N~~350,000 to a supplier was recorded as ~~N~~530,000 in the cash book.

The bank statements showed charges of ~~N~~60,000 not recorded in the cash book.

A direct debit of ~~N~~120,000 for electricity was not entered in the cash book.

A lodgement of ~~N~~700,000 made on May 30th was not credited by the bank until June 2nd.

Cheques issued totalling ~~N~~480,000 had not yet been presented for payment.

A cheque received for ~~N~~200,000 was returned unpaid and debited by the bank.

Required:

- Prepare journal entries for the errors and omissions identified.
- Prepare the adjusted cash book for Benji Enterprises.
- Prepare a bank reconciliation statement as at 31st May 2025.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

	~~—N~~
Balance per general ledger - cash at bank:	<u>1,500,000</u>
Balance per bank statement	1,550,000
Items in general ledger not in bank statement	
Add: Outstanding lodgements	210,000
Deduct: Unpresented cheques	<u>(260,000)</u>
Corrected balance per bank statement	<u>1,500,000</u>

Alternative presentation:

Balance per general ledger - cash and bank account:	1,500,00 0
Corrected cash at bankfigure	
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(210,000)
Add: Unpresented cheques	<u>260,000</u>
Balance per bank statement	<u>1,550,00 0</u>

Solutions

2

Balance per general ledger cash at bank account: 1,660,000

Items in bank statement not in cash book

(a) Correction of undercast	200,000
(b) Correction of mistake	(1,800,000)
(2,475,000 – 4,275,000)	)
(c) Dishonoured cheque	(220,000)
(d) Bank charges	(184,000)
	<u>(2,004,000)</u>
Corrected cash at bank figure	<u>(344,000)</u>

Balance per bank statement (450,000)

Items in general ledger not in bank statement Add: Outstanding lodgements 626,000

Deduct: Unpresented cheques (520,000)

Corrected balance per bank statement (344,000)

Alternative presentation:

Balance per general ledger cash at bank account: 1,660,000

Items in bank statement not in cash book

(a) Correction of undercast	200,000
(b) Correction of mistake	(1,800,000)
(2,475,000 – 4,275,000)	)
(c) Dishonoured cheque	(220,000)
(d) Bank charges	(184,000)
	<u>(2,004,000)</u>
Corrected cash at bank figure	<u>(344,000)</u>

Items in general ledger not in bank statement Deduct: Outstanding lodgements (626,000)

Add: Unpresented cheques 520,000

Balance per bank statement (450,000)

CORRECTION OF ERRORS, PROVISIONS, CONTINGENT

Contents

- 11.0 Learning objective
- 11.1 Learning outcomes
- 11.2 Trial balance
- 11.3 Correcting errors
- 11.4 Suspense accounts
- 11.5 Provisions, contingent liabilities and contingent assets
- 11.6 Chapter review
- 11.7 End of chapter questions and suggested solutions

11. Correction of Errors, Provisions, Contingent Liabilities and Contingent Assets

11.0 Learning objective

This chapter distinguishes between two types of errors: those that disrupt the double entry system and are revealed by the preparation of a trial balance, and those that do not affect the agreement of the trial balance and are therefore not detected in this way. It further explains the role of a suspense account as a temporary tool used to complete incorrect or incomplete entries, and how the suspense account is subsequently cleared as the underlying errors are identified and corrected.

11.1 Learning outcomes

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

- a. Identify the types of error which may occur in a record keeping system;
- b. Calculate and understand the impact of errors on the financial statements within a reporting period;
- c. Complete incorrect or incomplete double entry to a suspense account; and
- d. Prepare journal entries to correct errors including those that led to the creation of a suspense account and other.

11.2 Trial Balance

11.2.1 The purpose of a trial balance

A trial balance is a list of all the debit balances and all the credit balances on the accounts in the general ledger. A trial balance can be 'extracted' from the general ledger simply by listing the balances on every account. The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.

- a. Accounts with debit balances will be asset accounts and expense accounts
- b. Accounts with credit balances will be liability accounts, capital account (or share capital and reserve accounts in the case of a company) and income accounts.

Since the accounting system uses double entry principles, the total of debit balances and the total of credit balances should be equal, because for every debit entry in the general ledger there should be a matching credit entry.

A trial balance has two main purposes.

It is a starting point for producing a statement of profit or loss and a statement of financial position at the end of an accounting period. A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts (which are recorded as journal entries before being entered in the general ledger). Year-end adjustments include adjustments for opening and closing inventory, depreciation charges, accruals and prepayments, writing off bad debts and adjusting the allowance for irrecoverable debts.

When the year-end adjustments have been made, a statement of profit or loss and then a statement of financial position can be prepared, using the balances in the general ledger accounts.

A second purpose of a trial balance is **to check for errors in the accounting system**. Errors must have occurred if the total of debit balances and total of credit balances on the general ledger accounts are not equal. Having identified that an error (or more than one error) exists, the task of the bookkeeper is to find the cause of the error and correct it.

11.2.2 Errors in the double entry accounting system

Errors can occur in a book-keeping system, because individuals make mistakes.

The types of error that will appear in the accounting records can be classified into four broad categories:

- a. Errors of transposition
- b. Errors of omission
- c. Errors of commission
- d. Errors of principle
- e. Errors of original entry
- f. Compensating errors

Errors of transposition (transposition errors)

This involves getting the digits in a number the wrong way round, for example recording ~~₦~~9,700 as ~~₦~~7,900.

Error of original entry

Sometimes, the error will be made in both the debit and the credit entries in the ledger. For example a purchase invoice might be recorded as ~~₦~~1,650 instead of ~~₦~~1,560 in both the purchases account and the payables ledger control account. The trial balance will not reveal this sort of error.

Compensating error

Sometimes, the error of transposition will be made in one account but not the other. For example, a payment of ~~₦~~1,980 from a customer might be recorded correctly in the cash book but posted incorrectly as ~~₦~~1,890 in the receivables ledger control account.

Errors of omission

This is where a transaction or entry is missed out. Sometimes a transaction is missed out of the ledger entirely because the bookkeeper forgets about it or is not informed about it.

A transaction may be omitted from one location only.

Errors of commission

This means putting an entry in the wrong account, for example recording a

telephone expense in the electricity expenses account.

Errors of principle

This is where an entry is recorded in the wrong type of account, e.g. recording capital expenditure as revenue expenditure.

For example the purchase of a machine might be entered in the machinery repairs and maintenance account. Unless corrected, this error will result in an incorrect computation of depreciation charges, running costs, profit and statement of assets for the period.

11.2.3 Errors highlighted by the extraction of a trial balance

As stated earlier, one way of finding some errors in the accounting records is to extract a trial balance from the general ledger. If the total of the debit balances does not equal the total of the credit balances on the general ledger accounts then an error or several errors have been made.

If the trial balance does not balance then this will be due to an error where the debits and credits are not the same, so that the error results in the debit entry in one account in the general ledger not being equal to the matching credit entry in another account.

Types of error which affect the balancing of the trial balance are as follows:

- g. A transaction might be recorded with a debit entry in one account, but the corresponding credit entry is omitted. Similarly, a transaction might be recorded with a credit entry in one account, but the corresponding debit entry is omitted. For example a payment might be recorded as a credit entry in the cash book but omitted from the payables ledger control account.
- h. There could be a transposition error in one account. For example, the debit entry might be ₦1,234 and the corresponding credit entry might be ₦1,324. One of the entries must be incorrect.
- i. A transaction might be recorded as a debit entry in two accounts, instead of as a debit entry in one account and a credit entry in the other account. For example, rental income might be recorded as a debit entry in the cash book and, in error, as a debit entry in the rental expense account.
- j. Similarly, a transaction might be recorded as a credit entry in two accounts, instead of being a debit entry in one account and a credit entry in the other. For example, discounts received might be recorded as a credit entry in the discount received account and, in error as a credit entry in the payables ledger control account.
- k. There might be a mistake in casting one or another side of an account. This would lead to the extraction of an incorrect balance.

You need to be able to:

- l. identify errors in a double entry accounting system, and
- m. know how to correct them.

Corrections to errors in an accounting system are recorded as journal entries and then posted from the journal to the relevant accounts in the general ledger.

11.2.4 Errors not highlighted by the extraction of a trial balance

A trial balance is only useful in helping to identify errors where the debit and credit entries in the general ledger accounts do not match. It does not help with the identification of errors where there has not been a mismatch between debit and credit entries.

There are some types of error that do not result in a difference between total debit and total credit entries and therefore do not affect the balancing of the trial balance. For example:

- n. A transaction might have been omitted entirely from the general ledger, with no debit entry and no credit entry.
- o. The wrong figure might be double entered.
- p. Transactions might be recorded in the wrong account. For example, the cost of repairing a machine might be recorded incorrectly as a debit in the machinery at cost account instead of recording it as a debit in the machine repairs account. The amount of the debit entry is correct; the error is to post the transaction to the wrong account.
- q. There might be compensating errors. For example one error might result in debits exceeding credits by ₦2,000 but another error might result in credits exceeding debits by ₦2,000. If this happens, the errors will 'cancel each other out' and will not be apparent from a check on the trial balance totals for debits and credits.

11.3 Correcting Errors

11.3.1 An approach to correcting errors

Errors should be corrected when they are found.

- r. Transactions that have been omitted from the general ledger entirely should be recorded in the accounts. The omitted item can be recorded in the journal, and posted from the journal to the relevant accounts in the general ledger and, if required, the receivables or payables ledger.
- s. Entries that have been made incorrectly in the accounts must be corrected by means of suitable debit and credit entries in the accounts. The correction of an error should be recorded in the journal and then posted from the journal to the relevant accounts.

In order to correct errors properly, you need to be able to:

- t. identify an error;
- u. recognise what the correct entry in the accounts should have been; and
- v. work out how to make the correction by means of double entry adjustments.

One approach to correcting errors is to compare the entry that has been processed to the entry that should have been processed. This allows you to see what adjustment is needed. Memorandum T accounts can be used to do this.

For each account affected by an error, you can prepare two sets of memorandum T accounts for:

- i. What accounting entries have been made in the accounts, and
- ii. What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

Some examples will help to illustrate the approach.

Example:

The total from a sales day book was ~~£~~1,800. This has been posted in correctly as ~~£~~1,080.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

What has been recorded		(2)What should have been recorded	
Receivables		Receivables	
~~£~~ 1,080		~~£~~ 1,800	
Sales		Sales	
	~~£~~ 1,080		~~£~~ 1,800

The receivables control account has a debit entry of ~~£~~1,080 for the transaction but it should have been ~~£~~1,800.

To remove this error and increase the account balance to ~~£~~1,800 for the transaction, we need to debit the receivables control account with ~~£~~920.

The sales account has a credit entry of ~~£~~1,080 for the transaction but it should have been ~~£~~1,800.

To remove this error and increase the account balance to ~~£~~1,800 for the transaction, we need to credit the sales account with ~~£~~920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Sales		920

Or using ledger accounts:

Receivables control account		
	~~£~~	~~£~~
Before adjustment	1,080	
Sales account	920	
Sales account		

	~~N~~		~~N~~
920	Before adjustment		1,080
	Receivables		920

Example:

A business has recorded a repair cost of ~~N~~15,000 to a machine as a debit in the machinery at cost account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded Machinery (at cost) account	(2) What should have been recorded Machine (at cost) account
15,000	0
Machine repairs account	Machine repairs account
0	15,000

The machinery (at cost) account has a debit entry of ~~N~~15,000 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to ~~N~~0 for the transaction, we need to credit the machine (at cost) account with ~~N~~15,000.

The machine repairs account has nothing recorded for the transaction, but there should be a debit balance of ~~N~~15,000.

To correct his account, we need to debit the account with ~~N~~15,000. Therefore, the correcting entry is:

	Dr	Cr
Machine repairs	15,000	
Machinery cost		15,000

Example:

A business has recorded rental income of ₦21,800 as a credit in the rental expense account.

(1) What has been recorded

Rental expense
21,800

(2) What should have been recorded

Rental expense
0

Rental income

0

Rental income

21,800

The rental expense account has a credit of ₦21,800 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to ₦0 for the transaction, we need to debit the rental expense account with ₦21,800.

The rental income account has nothing recorded for the transaction, but there should be a credit balance of ₦21,800.

To correct this account, we need to credit the account with ₦21,800. Therefore, the correcting entry is:

	Dr	Cr
Rental expense	21,800	
Rental income		21,800

Example:

A business recognised a sale to a customer in the amount of ~~N~~515,000, not expecting the customer to take advantage of a 2.5% early settlement discount.

The customer did take advantage of the discount (saving ~~N~~20,600) and the business correctly adjusted the receivables balance but incorrectly recorded the other side of the entry as a debit in the discounts received account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded	(2) What should have been recorded
Revenue	Revenue
0	20,600
Discounts received	Discounts received
20,600	0

The revenue account has nothing recorded for the transaction, but a debit of ~~N~~20,600. A debit of ~~N~~20,600 is required to correct this.

The discounts received account has a debit entry of ~~N~~20,600 when there should be nothing in the account for the transaction. To remove this error and reduce the account balance to ~~N~~ nil for the transaction, we need to credit the discounts received account with ~~N~~20,600.

To correct the error, the required double entry is:

	Dr	Cr
Revenue	20,600	
Discounts received		20,600

11.3.2 The effect of errors on profit

Unless they are corrected, accounting errors will have an effect on the reported profit for the period.

A question might ask you to quantify this effect for a given error. In a typical question of this sort, the error might involve recording a capital expenditure item as a revenue expenditure item, or a revenue expenditure item as capital expenditure.

Alternatively, a capital expenditure item might be recorded at an incorrect amount.

Example:

A bookkeeper in error recorded the purchase cost of a new item of equipment as ~~£~~36,000 when it should have been ~~£~~360,000.

A draft profit of ~~£~~2,560,000 for the period was calculated before the discovery of the error. This included a depreciation charge of 10% (~~£~~3,600) for the equipment.

What is the correct figure for profit?

Draft profit	~~£~~ 2,560,000
Add back: Depreciation incorrectly charged	3,600
	2,563,600
Deduct: Correct depreciation charge (10% ~~£~~ 360,000)	(36,000)
Adjusted figure for profit	2,527,600

Draft profit	300,000
Add back: Repair costs incorrectly charged	60,000
	360,000
Deduct: Depreciation charge (20% ~~£~~ 60,000)	(12,000)
Adjusted figure for profit	348,000

11.4 Suspense Accounts

11.4.1 Trial balance: differences in total debits and total credits

The examples of correcting errors in the previous section involve errors where the amount of the debit entry and the amount of the credit entry were the same. These errors would not be identified by extracting a trial balance.

When errors are made where the amount of the debit entry differs from the amount of the credit entry, total debit balances and total credit balances in the general ledger accounts will differ. A trial balance will demonstrate the existence of such errors.

These errors must be discovered and corrected. Until they are discovered, the first step should be to open a suspense account.

- w. When errors have resulted in total debit entries and total credit entries being different, the errors are corrected using a suspense account.
- x. A suspense account is a short-term account that is required only until the errors have been identified and corrected.

11.4.2 Opening a suspense account

A suspense account is opened with either a debit balance or a credit balance.

The balance entered into the suspense account should be an amount that makes the total debit balances equal to total credit balances on all the general ledger accounts (including the balance on the suspense account).

Example:

A business has prepared a trial balance of the general ledger account balances.

This shows total debit balances of ₦456,000 and total credit balances of ₦488,000.

A suspense account must be opened.

The balance on the account to make total debit and total credit balance equal is a debit balance of ₦32,000 (₦488,000 credits less ₦456,000 debits).

Suspense account		
	₦	₦
Opening balance	32,000	

Opening the suspense account in effect completes the missing and incorrect double entries but to the wrong place (the suspense account). The errors should be investigated and corrected. This usually involves a double entry to the suspense account.

Once the errors have been fully corrected the balance on the suspense account will be reduced to zero.

11.4.3 Correcting errors where a suspense account is opened

When it is clear that an error has occurred, it is often helpful to decide the answer to two questions:

- y. Has the error resulted in different total amounts for debit and credit entries?
 - If the answer is yes, making the correction will involve the suspense account.
 - If the answer is no, the correction should be made, but will not involve the suspense account.
- z. If the error has resulted in different total amounts for debit and credit entries, think about the general ledger account or accounts containing the error, and decide what needs to be done to correct the balance on that account.

The same approach used in the previous section for correcting errors can be used. For each account affected by an error, you can prepare two sets of memorandum T accounts for:

- i. What accounting entries have been made in the accounts, and
- ii. What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

However, when the error involves different total amounts of debits and credits, a debit or credit entry in the suspense account is needed as a 'balancing figure' to make the total debits and credits equal.

Example:

A debit entry in the rent expense account has been entered as ~~£~~5,000 when it should have been ~~£~~5,500, but the entry in the cash book (bank account) for the payment was entered correctly as ~~£~~5,500.

The debit entry in the rent account is ~~£~~500 too low, resulting in a difference between total debits and total credits. The first step is to open a suspense account and enter a balance to make total debits and total credits equal.

Suspense account		
~~£~~		
Opening Balance	500	~~£~~

Note that this completes the entry by recognising the missing debit of 500 in the suspense account

We can now look at 'where we are' and 'where we want to be'

(1)What has been recorded

(2)What should have been recorded Rent

expense account	Rent expense account
5,000	5,500

The correcting double entry is:

Dr			Cr
Opening Balance	500	Rent account	500
Rent expense account			
Opening Balance	5000	Suspense account	500

Example:

The total from a sales day book was ~~£~~1,800.

This has been posted correctly to the sales account but ~~£~~1,080 has been posted in error to the receivables control account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

What has been recorded	(2) What should have been recorded
Receivables	Receivables
1,080	1,800
Sales	Sales
1,800	1,800
Suspense	Suspense
920	0

The sales account has the correct entry but the receivables control account has a debit entry of ~~£~~1,080, which should be ~~£~~1,800.

To remove this error and increase the account balance to ~~£~~1,800 for the transaction, we need to debit receivables control account with ~~£~~920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Suspense		920

Or using ledger accounts:

Receivables control account			
	₦		₦
Before adjustment	1,080		
Suspense account	920		
Suspense account			
	₦		₦
Before adjustment	920	Rent account	920

Example:

A revenue adjustment for an early settlement discount unexpectedly taken by a customer was correctly recorded as a credit to trade receivables but the otherside of the entry has been recorded as a credit entry in the discount received account by mistake.

(1) What has been recorded (2) What should have been recorded

Revenue		Revenue	
0		4,000	
Discounts received		Discounts received	
	4,000		0
Suspense		Suspense	
8,000		0	

As a result of this error, total credits are ~~₦4,000~~ higher than they should be, and total debits are ~~₦4,000~~ lower than they should be resulting in the total credits balances in the trial balance being 8,000 bigger than the total debits.

A suspense account with a debit balance of 8,000 would be opened.

Both the revenue account and the discount received account must be corrected.

This error is corrected as follows, with an entry in the suspense account to match total debits with total credits:

	Dr	Cr
Discounts received	4,000	
Revenue	4,000	
Suspense		8,000

Or using ledger accounts:

Suspense account			
	₦		₦
Before adjustment	8,000	Discounts received	4,000
		Revenue	4,000
			8,000

Discounts received			
	₦		₦
Suspense account	4,000	Balance b/d	4,000

Revenue	
	₦
Suspense account	4,000

Example:

A payment to a supplier of ₦23,500 has been recorded in the cash book/bank account in the general ledger, but has not been recorded in the trade payables account.

As a result, total credits exceed total debits in the trial balance by ₦23,500 and a suspense account must be opened with a debit balance of ₦23,500.

(1) What has been recorded

Trade payables account	
	0
Suspense account	
23,500	

(2) What should have been recorded

Trade payables account	
23,500	
Suspense account	
	0

This error would be corrected as follows.

	Dr	Cr
Trade payables	23,500	
Suspense		23,500

Practice question**1**

A trial balance has been prepared, and total debits are ₦459,100 and total credits are ₦459,700.

On investigation, the following errors are found:

- 1 Sales returns of ₦800 were recorded correctly in the receivables account in the general ledger, but they have been recorded incorrectly as a credit entry in the purchases returns account.
- 2 In the sales day book, the column for total sales has been added up incorrectly. The total should be ₦26,420, but the total was undercast by ₦1,000. (The total was added up as ₦25,420).

The correct total amount receivable was entered in the receivables account in the general ledger.

Open a suspense account and record the book-keeping entries required to correct the errors.

11.4.4 Unknown entry

A suspense account is opened in order to make a trial balance have equal debits and credits until the errors have been discovered.

In some instances however a suspense account will be opened deliberately by the bookkeeper if the bookkeeper is uncertain of where to post one side of the double entry.

Example:

A bookkeeper has received a cheque for ₦1,000 but does not know who the cheque is from or what it relates to.

Rather than putting the cheque to one side until it is known what it is for the bookkeeper may decide to record the debit entry in the cash book/bank account and then, not knowing where the credit entry should go, to credit the suspense account instead.

This can then be cleared at a later date.

11.5 Provisions, Contingent Liabilities, And Contingent Assets

11.5.1 Introduction

IAS 37 provides guidance on the accounting treatment for provisions, contingent liabilities, and contingent assets. The standard aims to ensure consistent and transparent recognition and disclosure of these items.

11.5.2 Provisions

a. Definition

Provisions are liabilities of uncertain timing or amount, arising from a present obligation resulting from past events. A provision is recognised when:

- i. it is probable that an outflow of economic resources will be required to settle the obligation.
- ii. a reliable estimate of the obligation can be made.

Note:

A *probable* outflow means it is more likely than not that the entity will incur the liability. If the outflow is only *possible*, no provision is recognised.

b. Recognition criteria for provisions

A provision is recognised when all the following conditions are met:

- i. there is a present obligation (legal or constructive) resulting from a past event.
- ii. it is probable that an outflow of economic benefits will be required to settle the obligation.
- iii. a reliable estimate can be made of the amount of the obligation.
- iv. the obligation must arise from a past event, not from expected future events.

c. Types of obligations

i) Legal obligation

A legal obligation arises from laws, regulations, or contracts.

Examples:

- Warranty claims – A company must repair or replace products under warranty.
- Environmental cleanup – A legal requirement to restore environmental damage.
- Contractual obligations – Payments due for breach of contract.

li Constructive obligation

A constructive obligation arises from the entity's actions, policies, or statements that create a valid expectation in other parties that it will fulfil certain responsibilities.

Examples:

- Published policy – refund policies for dissatisfied customers.
- Past practice – regular payment of redundancy benefits.
- Industry norms – common practices that companies in the sector adhere to.

d) Distinction between provisions and other liabilities

Provisions differ from other liabilities in terms of uncertainty:

Feature	Provisions	Other Liabilities
Timing and amount	Uncertain	Known or determinable
Example	Legal claims	Accounts payable, accrued expenses

Both are recognised on the statement of financial position, but provisions require greater use of judgement and estimation.

e) Measurement of provisions

Provisions are initially measured at the best estimate of the expenditure required to settle the present obligation at the reporting date.

- For a single obligation, the best estimate is the most likely outcome.
- For a large population of items, such as product warranties, use expected value (probability-weighted average).

Provisions must be reviewed at each reporting date and adjusted to reflect current estimates.

f. Accounting for provisions**Initial Recognition:**

	Debit	Credit
Relevant expense (e.g., warranty expense)	X	
Provision account		X

Increase in Provision:

	Debit	Credit
Relevant expense	X	
Provision account		X

Decrease in Provision:

	Debit	Credit
Provision account	X	
Relevant expense		X

Utilisation of Provision:

	Debit	Credit
Provision account	X	
Cash / payables		X

g) Presentation in the Financial Statements

Provisions are reported in the statement of financial position as liabilities:

- current liabilities: if settlement is expected within 12 months (**For example**, warranty claims).
- non-current liabilities: if settlement is expected beyond 12 months (**For example**, long-term environmental remediation).

Reimbursement (For example, by Insurers)

If an entity expects to be reimbursed for some or all of the expenditure required to settle a provision:

- The reimbursement is recognised separately as an asset when it is virtually certain.
- The provision and reimbursement are presented separately, not netted off.
- In the profit or loss, the expense may be shown net of the reimbursement:
- Dr Provision Expense
Cr Provision Liability
- Dr Reimbursement Receivable
Cr Income (or offset against expense)

Specific Situations

IAS 37 provides guidance on how to account for provisions in specific scenarios:

i) **Future operating losses:**

No provision is recognised for expected future operating losses, as they do not meet the definition of a liability arising from a past event.

ii) **Onerous contracts:**

A provision is recognised when a contract becomes onerous, that is, when the unavoidable costs of fulfilling the contract exceed the expected economic benefits. The provision should be measured at the lower of the cost of fulfilling the contract and the compensation or penalties for failing to fulfil it.

iii) **Restructuring:**

A provision for restructuring is recognised only when:

- there is a detailed formal plan for restructuring, and
- the entity has raised a valid expectation in those affected (**for example**, employees or suppliers) that it will carry out the restructuring through either announcing or beginning implementation.

Required Disclosures under IAS 37

Entities must disclose the following information for each class of provision:

- i. a description of the nature of the obligation and the expected timing of any outflows of economic benefits.
- ii. an indication of the uncertainties relating to the amount or timing of the outflows.
- iii. the amount of the provision at the beginning and end of the period, showing:
 - additions made during the period,
 - amounts utilised, and
 - amounts reversed as no longer required.

11.5.3 Contingent liabilities

a. Definition

Contingent liabilities are:

- possible obligations from past events, whose existence will be confirmed only by future events not wholly within the entity's control.
- present obligations that are not recognised because:
- it is not probable that an outflow of resources will be required, or
- the amount cannot be reliably measured.

b. Accounting treatment

Contingent liabilities are not recognised in the financial statements but are disclosed in the notes unless the possibility of outflow is remote.

Disclosure should include:

- i. the nature of the contingency.
- ii. an estimate of the potential financial effect.
- iii. the timing and amount of any expected outflow.
- iv. the likelihood of reimbursement, if any.

If at any point the outflow becomes more likely than not, the contingent liability must be reassessed and recognised as a provision.

11.5.4 Contingent assets

a. Definition

Contingent assets are possible assets that arise from past events, the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

b. Accounting treatment

Contingent assets are not recognised in the financial statements. However, if the inflow of economic benefits is probable, they are disclosed in the notes to the accounts. If the inflow is merely possible, no action is required.

An asset is recognised only when the realisation of income is virtually certain.

c. Required disclosure includes:

- i. The nature of the contingent asset;
- ii. An estimate of the financial effect, or
- iii. Where it is not practicable to disclose the above information, the fact should be stated.

Example:

A company disputes a tax assessment and expects a refund of previously paid taxes. Since the outcome is uncertain, the refund is not recognised as an asset until the dispute is resolved in the company's favour.

11.5.5 Illustrations on provisions and contingent liabilities

Scenario:

The following events occurred during the year in XYZ Ltd.

a. Warranty claim

The company offers a one-year warranty on its products and expects to incur warranty claims equal to 5% of sales based on past experience.

Provision should be made, as all recognition criteria are met:

- present obligation (from past sale of goods),
- probable outflow (warranty claims), and

- reliable estimate (5% of sales).
- ii. Amount of provision: $5\% \times \text{total sales for the year}$.

b. Lawsuit

A customer has filed a lawsuit for ₦100,000 due to a faulty product. The company's legal team assesses the likelihood of losing as remote.

- No provision should be made, as the likelihood of outflow is remote.
- Action: Disclose as a contingent liability with details, unless the chance of outflow is negligible.

c. Environmental damage

The company dumped waste into a nearby river. There is no law penalising such acts, but environmentalists are demanding an unspecified compensation.

- i. A provision may be appropriate if the company's actions create a constructive obligation (due to public pressure or past conduct).
- ii. If the cost of settlement is reliably estimable, a provision is recognised.
- iii. If the cost of settlement is not reliably estimable, disclose as a contingent liability.

11.5.6 Summary of the Section

This section explains the application of IAS 37 in recognising, measuring, and disclosing:

- i. Provisions: Liabilities of uncertain timing or amount. Recognised when an obligation from a past event exists, an outflow of resources is probable, and the amount can be reliably estimated.
- ii. Contingent Liabilities: Possible obligations not recognised because they depend on uncertain future events or cannot be measured reliably. Disclosed in the notes if the outflow is possible.
- iii. Contingent Assets: Possible assets that arise from past events and are disclosed only if the inflow of economic benefits is probable.

Measurement of provisions involves the best estimate of expenditure required to settle the obligation, reviewed and adjusted at each reporting date. Disclosures should provide clarity on the nature, timing, uncertainties, and changes in provisions.

Practice Question

Ajii Limited offers a 12-month warranty on all goods sold. The company has a policy of making a warranty provision of 5% of revenue annually.

During the year ended April 30, 2024, Ajii Ltd sold goods worth ₦998,000,000 on credit.

The average cost of rectifying warranty claims is 60% of the sales price.

A provision of ₦15,200,000 had already been recorded in the books.

Required:

Explain, with calculations, how this should be accounted for in Ajii's financial statements for the year ended April 30, 2024.

Solution

Under IAS 37, a provision is required since the warranty obligation meets the recognition criteria:

- Arises from a past event (sales),
- Outflow of resources is probable, and
- A reliable estimate can be made.

Calculation:

Estimated warranty cost = ₦998,000,000 × 5% × 60% = ₦29,940,000

Adjustment needed:

Existing provision already recorded = ₦15,200,000

Additional provision required = ₦29,940,000 - ₦15,200,000 = ₦14,740,000

Accounting treatment:

- The additional ₦14,740,000 will be recognised as administrative expense in the statement of profit or loss.
- The full updated provision of ₦29,940,000 will appear as a current liability in the statement of financial position.

Journal Entry:

Dr Administration Expenses	₦14,740,000
Cr Provision for Warranty	₦14,740,000

11.6 Chapter review

Chapter review

Before moving on to the next chapter check that you now know how to:

- identify the types of error which may occur in a record keeping system;
- calculate and understand the impact of errors on the financial statements within a reporting period;
- complete incorrect or incomplete double entry to a suspense account; and
- prepare journal entries to correct errors including those that led to the creation of a suspense account and others.

11.7 End of chapter questions and suggested solutions

Question 1

A business prepared its draft accounts and reported a net profit of ~~N~~3,150,000. Upon review, the following errors were identified:

- A payment of ~~N~~125,000 for office equipment was debited to the office expenses account.
- Repairs of ~~N~~60,000 to machinery were capitalised to the machinery cost account.
- Depreciation is charged at 10% per annum on office equipment and 20% on machinery using the straight-line method.

Required:

- Prepare journal entries to correct the above errors.
- Calculate the adjusted profit after correcting the errors.

Suggested solution

a) Journal entries to correct the errors

	Debit (N)	Credit (N)
i. Office Equipment (Non-current asset)	125,000	
Office Expenses		125,000
To correct error of posting cost of office equipment to office expense		
ii. Repairs and Maintenance Expense	60,000	
Machinery (at cost)		60,000
To correct error of posting cost of repairs to machinery		
iii. Depreciation on office equipment (~~N~~ 125,000 × 10%)	12,500	
Depreciation – Machinery (~~N~~ 60,000 × 20%)		12,000
Statement of profit or loss		500
Adjustment of depreciation for the corrected classification of assets		

b) Statement for calculation of adjusted Profit

	N	N
Profit as per draft statement of profit or loss		3,150,000
Adjustments:		
Add: Wrong charge to office expenses	125,000	
Excess depreciation on repairs	12,000	
	137,000	
Less: Wrongly capitalised machinery repair expense	60,000	
Depreciation on office equipment	<u>12,500</u>	64,500
Adjusted profit		3,214,500

Question 2

The trial balance of James Ltd did not balance. A suspense account with a debit balance of ~~N~~1,780,000 was opened. Investigation revealed the following errors:

- A credit purchase of ~~N~~4,500,000 from J. Benson was correctly recorded in the purchases day book but posted as ~~N~~5,400,000 to Benson's account.
- The total of the cash sales book of ~~N~~9,850,000 was posted to the debit of the bank account as ~~N~~8,950,000.
- A rent payment of ~~N~~630,000 was posted to the rent account as ~~N~~360,000.
- A payment of ~~N~~900,000 received from a customer was posted to his account as ~~N~~600,000.
- There was a casting error of ~~N~~10,000 understated in the receivables ledger.

Required:

- Show the journal entries to correct the above errors.
- Prepare the suspense account to show how it is cleared.

Suggested solution

a) Journal Entries to Correct the Errors

	Debit (N)	Credit (N)
i. Trade Payables (Benson)	900,000	
Suspense Account		900,000
To correct the wrong amount posted to Benson's account		
ii. Bank	900,000	
Suspense Account		900,000
To correct the wrong amount posted to the Bank		
iii. Rent Expense	270,000	
Suspense Account		270,000
To correct the wrong amount posted to rent expense		
iv. Suspense Account	300,000	
Receivables		300,000
To correct wrong amount posted to a customer account		
v. Receivable control account	10,000	
Suspense Account		10,000
To correct casting error in Receivables ledger		

b) Suspense Account

	N		N
Balance b/d		Trade payable (1)	
1,780,000		900,000	
Receivables (4)		Bank (2)	
300,000		900,000	
		Rental expense (3)	
		270,000	
		Receivables (5)	10,000
			<u>2,080,000</u>
<u>2,080,000</u>			

- a. The main objective of IAS 37 is to ensure that provisions, contingent liabilities and contingent assets are properly recognised, measured and disclosed in financial statements..

Required:

- In accordance with IASB Framework, explain what is meant by 'Liability'.
 - What is provision?
 - Differentiate between liability and provision.
 - Explain the THREE main information users of financial statements seek to understand about provision.
- b. IAS 37 provides specific guidelines on the recognition of contingent liabilities and contingent assets.

Required

Using the table below as a guide, provide specific requirements of IAS37 on the recognition of contingent liabilities and contingent assets in each of the situations provided.

Degree of probability	Contingent liabilities	Contingent assets
Probable		
Possible		
Remote		

Suggested solution

- a.
- According to the IASB Framework, a 'Liability' is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
 - A 'Provision' is a liability of uncertain timing or amount, recognised when an entity has a present obligation , legal or constructive, as a result of a past event and it is probable that an outflow of resources will be required to settle the obligation.

- iii. Users of financial statements typically seek to understand the following three key pieces of information about provisions:
- The nature and purpose of the provision; to understand the underlying reason for the provision.
 - The amount of the provision and the timing of its expected settlement; to assess the financial impact.
 - The uncertainties surrounding the provision and any potential impact on the entity's financial position and performance; to evaluate potential future cash outflows.

iv. **Difference between Liability and Provision:**

Liability:

- A present obligation arising from past events
- Expected to result in an outflow of economic benefits
- Certain or highly probable
- Can be measured reliably

Provision:

- A type of liability but with uncertainty about timing of settlement and the amount.
- Recognised when:
 - there's a present obligation due to a past event
 - outflow of resources is probable
 - amount can be estimated reliably

In essence, all provisions are liabilities but not all liabilities are provisions. Provisions are liabilities with inherent uncertainties that require estimation.

b. **Recognition of Contingent Liability and Contingent Asset**

Degree of Probability	Contingent Liabilities	Contingent Assets
Probable	Make provisions	Disclose by note
Possible	Disclose by note	Do not disclose
Remote	Do not disclose	Ignore

Question 4

ABC Ltd sells electrical appliances with a 12-month warranty. Based on past experience, the company expects warranty claims to be 4% of sales, and the average cost of settling each claim is 50% of the sales value.

The company also announced a restructuring plan on 31 December 2024 involving:

Redundancy payments of ~~N~~8 million

Lease termination penalties of ~~N~~4 million

Sales for the year ended 31 December 2024 amounted to ~~N~~300 million. No provision has yet been recorded for warranties or restructuring.

Required:

Prepare journal entries and calculate the:

- a. Provision for warranty claims
- b. Provision for restructuring
- c. Total liability to be disclosed in the statement of financial position as at 31 December 2024

Suggested solution

- a. Provision for Warranty Claims

Step 1: Calculate the value of warranty claims

Warranty claim rate = 4% of sales

Average cost to settle claim = 50% of sales value

Sales = ₦300 million

Warranty provision = ₦300 million × 4% × 50%

= ₦300,000,000 × 0.04 × 0.50

= ₦6,000,000

Answer: Provision for warranty claims = ₦6,000,000

Journal Entry:

Dr Warranty Expense (P/L) ₦6,000,000

Cr Provision for Warranty (SFP) ₦6,000,000

- b. Provision for Restructuring

IAS 37 requires that a provision for restructuring be recognised if:

There is a detailed formal plan (Yes, announced 31 December 2024)

A valid expectation has been created in affected parties (Assumed yes)

So the provision includes:

Redundancy payments = ₦8,000,000

Lease termination penalties = ₦4,000,000

Total restructuring provision = ₦8,000,000 + ₦4,000,000 = ₦12,000,000

Journal Entry:

Dr Restructuring Expense (P/L) ₦12,000,000

Cr Provision for Restructuring (SFP) ₦12,000,000

- c. Total Liability to be Disclosed in the Statement of Financial Position

Total provisions to be disclosed:

Provision for warranty claims = ₦6,000,000

Provision for restructuring = ₦12,000,000

Total provision (liability) = ₦18,000,000

Answer: ABC Ltd will disclose total provisions of ₦18,000,000 under liabilities as at 31 December 2024.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions 1

The opening balance on the suspense account is a debit balance, since total credits are higher than total debits by ~~4~~600.

Error 1

(1) What has been recorded

Purchase returns	
	800

Sales returns	

(2) What should have been recorded

Purchase returns	

Sales returns	
800	

Error 2

(1) What has been recorded

Sales	
	25,420

(2) What should have been recorded

Sales	
	26,420

The correcting double entries are:

Error 1

	Dr	Cr
Sales returns	800	
Suspense account		800
Purchases returns	800	
Suspense account		800

Error 2

Suspense account	1,000	
Sales		1,000

The suspense account is cleared as follows:

Suspense account

Balance b/d	600	Purchase returns	800
		Sales returns	800
Sales	1,000		
	<u>1,600</u>		<u>1,600</u>

12

PREPARATION OF FINANCIAL STATEMENTS

Contents

- 12.0 Learning objectives
- 12.1 Learning outcomes
- 12.2 Financial statements
- 12.3 Preparing financial statements
- 12.4 Chapter review
- 12.5 End of chapter questions and suggested solutions

12. Preparation of Financial Statements

12.0 Learning objectives

This chapter revisits the purpose and importance of financial statements, focusing on the structure of the basic statements of financial position and financial performance. It also explores various approaches that can be used to answer questions related to the preparation of accounts. Finally, the chapter introduces the concept of an extended trial balance and demonstrates how it is used in practice.

12.1 Learning outcomes

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

- a. understand the purpose of the statement of financial position
- b. Understand the purpose of the statement of profit or loss
- c. prepare financial statements from a trial balance, incorporating necessary adjustments
- d. prepare and explain an extended trial balance

12.2 Financial Statements

12.2.1 Purpose of financial statements

This section is a brief revision of topics covered in more detail in chapter 1.

Financial statements are prepared to provide information that is useful for decision making. The information is useful in different ways to different user groups.

User	Possible area of Interest
Owner	How the business has performed in the period. How much can be extracted from the business as drawings (or dividends for a company). How management has performed if the owners have appointed others to run the business for them.
Government	How much tax may be charged Analysis of performance of all businesses in a region gives
Employees	an indication of the health of the economy in that region. Whether a pay rise can be supported. Safety of employment of the loan.
Lenders	The safety of the loan. The ability of the business to meet future payments
Customers	The level of profit relative to prices charged. The ability of the business to continue to supply the customer in the future
Suppliers	Safety of the amounts owed to them leading to the level of credit that they are willing to give the business.

	Whether there may be scope to increase share of the businesses purchases. This is not an exhaustive list.

Components of financial statements

A full set of financial statements would include the following:

- a. 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;
- b. a statement of financial position;
- c. a statement of changes in equity;
- d. a statement of cash flows; and
- e. notes to the financial statements (not in this syllabus).

12.2.2 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.

In a statement of financial position, non-current assets are shown separately from current assets, and non-current liabilities are shown separately from current liabilities.

As a general rule, assets are current if they will be consumed or converted into cash within the next 12 months. Cash and cash equivalents are also current assets. (Cash equivalents are assets that can be converted into cash very quickly, such as money on deposit in a bank deposit account). There are some exceptions to this general rule but it is a very useful simplification.

Prepayments and accrued income are current assets.

Liabilities are current if they are payable within the next 12 months. It is therefore necessary to check the repayment dates on any bank loans or loan notes. Loans repayable within 12 months become current liabilities. Accrued expenses (and deferred income) are current liabilities.

Illustration:

If a company obtains a five-year bank loan, where none of the loan principal is repayable until the end of the loan period, the loan will be a non-current liability for the first four years and will then become a current liability in fifth year when it is repayable within 12 months.

Illustration: Statement of financial position

Bauchi Trading Company: Statement of financial position as at December 31, 2019

	Nm	Nm	Chapter
Assets			
Non-current assets			5
Land and buildings	56.2		
Plant and machinery	28.0		
		84.2	
Current assets			
Inventories	16.4		8
Trade and other receivables	17.0		4 and 6
Prepayments and accrued income	2.0		7
Cash	1.2		
		36.6	
Total assets		120.8	
Equity and liabilities			
Capital		67.8	
Non-current liabilities			
Long-term loans		30.0	
Current liabilities			
Trade and other payables	18.0		4
Accruals (and prepaid income)	1.5		7
Short-term borrowings (bank overdraft)	3.5		
		23.0	
Total equity and liabilities		120.8	

12.2.3 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 is not in your syllabus.

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.

Illustration: Statement of profit or loss

Bauchi Trading Company: Statement of profit or loss for the year-ended December 31, 2019

	₦m	₦m	Chapter
Revenue		120.0	
Cost of sales			8
Opening inventory	8.0		
Purchases	80.0		
	88.0		
Closing inventory	(10.0)		
		(78.0)	
Gross profit		42.0	
Other income:			
Rental income			
Expenses:			
Wages and salaries	8.0		
Depreciation	6.0		5
Rental costs	4.0		
Telephone charges	3.0		
Advertising costs	5.0		
Interest charges	1.0		
Bad debts	3.0		
		(30.0)	6
		<u>12.0</u>	

12.3 Preparing Financial Statements

12.3.1 Financial statements of a sole trader, partnership and company

The same basic accounting approach is used in recording the transactions of a sole trader, a partnership or a company. The preparation of the financial statements of all three proceeds along the same lines.

There are some differences.

The capital of each type of entity is different in structure.

- a. The capital of a sole trader represents his interest in the business.
- b. A partnership has more than one owner and this must be reflected in the capital where each has their own capital account or accounts (this is explained in detail in the next chapter).
- c. For companies, equity capital is represented by share capital and reserves, not simply by 'capital'.

Sole traders have no reason to comply fully with the requirements of international accounting standards. The financial statements of a sole trader are therefore usually limited to a statement of profit or loss and a statement of financial position.

This chapter explains approaches that might be used to answer preparation of accounts questions. The approaches apply to all types of entity. Later chapters explain issues of importance to specific types of organisation.

12.3.2 Year-end

Earlier chapters have explained how transactions are first entered into books of prime entry and how totals from these are transferred into ledger accounts in the general ledger.

At the year-end a trial balance is extracted and various year-end adjustments are then made to the accounts after which a statement of profit or loss and then a statement of financial position can be prepared, using these adjusted balances.

All such adjustments must also be recorded in the general ledger accounts so that these agree with balances on the financial statements.

At the end of the period there is another exercise performed in order to prepare the general ledger for use in the next accounting period. This involves transferring all income and expense items into a single account (perhaps via intermediate accounts like cost of sales and statement of profit or loss) in order to produce a single figure as profit or loss for the period which is then transferred to capital.

Earlier chapters have covered the year-end adjustments. They explained how each type of adjustment is measured and then explained the double entry

necessary to account for these amounts. The double entry explanation used “T” accounts in order to explain the full workings of the double entry system.

You may be expected to prepare a statement of financial position and statement of profit or loss from a trial balance. These questions are usually quite time pressured so you need to develop a good technique in order to execute such tasks in an effective way.

The rest of this chapter use the following example to illustrate how such questions might be approached. You will need to choose an approach and practice it.

Example:

ABC – Trial balance as at 31 December 2019

	₤	₤
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000	
Inventory as at 1 January 2019	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2019		121,600
	<u>627,600</u>	<u>627,600</u>

Further information:.

The journals

The business needs to process the following double entries to take account of the "further information" given above.

These journals are only given to explain the double entry required. You should never

Example: Closing journals

a)	Accrual	Debit	Credit
	Heating and lighting expense Accrual	400	
	Being: Accrual for heating and lighting expense		400
b)	Rent prepayment		
	Prepayment	700	
	Rent expense		700
	Being: Adjustment to account for rent prepayment		
c)	Bad and doubtful debt		
	Bad and doubtful debt expense	1,200	
	Receivables		1,200
	Being: Write off of bad debt		
	Bad and doubtful debt expense	500	
	Allowance for doubtful debts		500
	Being: Increase in the allowance for doubtful debts		
d)	Depreciation		
	Depreciation expense	14,600	
	Accumulated depreciation		14,600
	Being: Depreciation for the year (10% of 146,000)		
e)	Closing inventory		
	Inventory (asset)	16,500	
	Inventory (cost of sales)		16,500
	Being: Recognition of inventory at the year-end		

write something like this in a preparation of financial statements question. It uses up too much time. You want to do double entry rather than write journals.

The chapter continues to show two possible approaches that you might follow. You do not have to do either. If you decide on a way that suits you then use it.

If you attend courses your lecturers will show you how to do this. They are very experienced. Do as they advise.

12.3.3 Preparation of financial statements: Approach 1

Step 1: Perform double entry on the face of the question and open up new accounts as you need them in any space that you have.

(DO NOT COPY OUT THE TRIAL BALANCE).

After this your question paper should look something like the following (with the double entries are shown in bold italics):

Example: ABC – Trial balance as at December 31, 2019

	N	N
Sales	304,400	
Purchases		428,000
Wages and salaries	64,000	
Rent	14,000	700^b
Heating and lighting	5,000 + 400^a	
Inventory as at 1 January 2019	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000 + 500^c
Non-current assets	146,000	
Accumulated depreciation:		32,000 + 14,600^d
Trade receivables	51,000	1,200^c
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2019		121,600
	627,600	627,600
Accruals		400^a
Prepayments	700^b	
Bad and doubtful debt expense	1200^c + 500^c	
Depreciation expense	14,600^d	
Closing inventory (asset)	16,500^e	
Closing inventory (cost of sales)		16,500^e

Step 2: Draft pro-forma financial statements including all of the accounts that you have identified. (A pro-forma is a skeleton document into which you can copy numbers later)

Step 3: Copy the numbers from the trial balance into the pro-forma statements. Note that if a number copied onto the financial statements is made up of a number provided in the original trial balance that has been adjusted, you must show the marker what you have done. This may involve adding in an additional explanation below the main answer or may be shown on the face of the statements.

Step 4: Calculate profit for the year.

Step 5: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position		
	£	£
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

Example: ABC – Statement of profit or loss

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	<u>319,400</u>	
Closing inventory	(16,500)	
	<u>(302,900)</u>	
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation (W1)	14,600	
Rent (14,000 – 700)	13,300	
Heating and lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
	<u>(99,000)</u>	
		<u>26,100</u>

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

2.3.5 Preparation of financial statements using an extended trial balance

The syllabus also requires knowledge of the role of extended trial balances in the preparation of accounts.

An extended trial balance is a working paper that starts with one trial balance (the original as extracted from the accounting records) and then records double entries as appropriate alongside existing accounts or in new accounts opened for the purpose.

The various accounts can then be cross cast to produce a new trial balance which includes the adjustments. Numbers can then be lifted into the final financial statements.

This is best demonstrated with an example.

Example: Extended trial balance

ABC – Trial balance as at 31 December 2019

	₦	₦
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000	
Inventory as at 1 January 2019	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2019		121,600
	<u>627,600</u>	<u>627,600</u>

Further information:

- ~~₦~~400 is owed for heating and lighting expenses.
- ~~₦~~700 has been prepaid for rent.
- It is decided that a bad debt of ~~₦~~1,200 should be written off, and that the allowance for doubtful debts should be increased to ~~₦~~4,500.
- Depreciation is to be provided for the year at 10% on cost.
- Inventory at December 31, 2019 was valued at ~~₦~~16,500.



Example: ABC – Extended trial balance as at 31 December 2013

	Trial balance		Adjustments		New trial balance	
	Dr (₹)	Cr (₹)	Dr (₹)	Cr (₹)	Dr (₹)	Cr (₹)
Sales		428,000				428,000
Purchases	304,400				304,400	
Wages and salaries	64,000				64,000	
Rent	14,000			700 ^a	13,300	
Heating and lighting	5,000		400 ^a		5,400	
Inventory as at 1 January 2013	15,000				15,000	
Drawings	22,000				22,000	
Allowance for doubtful debts		4,000		500 ^a		4,500
Non-current assets	146,000				146,000	
Accumulated depreciation:		32,000		14,600 ^d		46,600
Trade receivables	51,000			1,200 ^a	49,800	
Trade payables		42,000				42,000
Cash	6,200				6,200	
Capital as at 1 January 2013		121,600				121,600
New accounts opened:						
Accruals				400 ^a		400
Prepayments			700 ^a		700	
Bad debts expense			1,200 ^a + 500 ^a		1,700	
Depreciation			14,600 ^d		14,600	
Closing inventory (asset)			16,500 ^a		16,500	
Closing inventory (P and L)				16,500 ^a		16,500
	627,600	627,600			659,600	659,600

The numbers can then be extracted to produce a statement of financial position and a statement of profit or loss as before.

Example

JBH Enterprises had the following trial balance as at December 31, 2018:

	DR N'000	CR N'000
Capital 1/1/18		85,000
Drawings:	5,500	
Purchases and revenue	100,000	160,000
Inventory 1/1/18	5,000	
Receivables and payables	27,500	15,780
Bad debts	500	
Electricity	300	
Postages and stamps	100	
Allowance for doubtful debts 1/1/18		3,000
Premises at cost	70,000	
Salaries and wages	10,000	
Leasehold property at cost	25,000	
Motor vehicles at cost	42,000	
3% bank loan		25,000
Furniture	3,200	
Provision for depreciation of furniture 1/1/18	-	320
	<u>289,100</u>	<u>289,100</u>

Additional information:

- 1) Closing inventory as at 31/12/18 was ~~N~~3,000,000
- 2) Allowance for doubtful debts is to be adjusted to 10% of debtors
- 3) Expenses accrued were: Electricity ~~N~~100,000 postages and stamps ~~N~~50,000
- 4) Depreciation of the furniture is at 10% per annum
- 5) The leasehold property is to be written off over ten years
- 6) Bank loan interest for the year is outstanding

Required:

With the aid of an extended trial balance, prepare the adjustments, trading, profit or loss account and statement of financial position as at 31/12/18.

Solution

JBH LTD

Extended trial balance as at December 31, 2018

	Original trial balance		Note	Adjustments		Statement of profit or loss		Statement of financial position	
	DR	CR		DR	CR	DR	CR	DR	CR
	N'000	N'000		N'000	N'000	N'000	N'000	N'000	N'000
Capital 1/1/18		85,000							85000
Drawings:	5,500							5000	
Purchases and revenue	100,000	160,000				100000	160,000		
Inventory 1/1/18	5,000					5000			
Receivables and payables	27,500	15,780						27,500	15,780
Bad debts	500					500			
Electricity	300		3	100		400			
Postages and stamps	100		3	50		150			
Allow. for doubtful debts		3,000	2	250					2750
Decrease in allow. for doubtful debts			2		250	250			
Premises at cost	70,000							70000	
Salaries and wages	10,000					10000			
Leasehold property at cost	25,000							25000	
Motor vehicles at cost	42,000							42000	
3% bank loan		25,000							25000
Loan interest			6	750		750			
Accrued loan interest			6		750				750
Furniture	3,200							3200	
Depreciation-furniture			4	320		320			
Dep.- leasehold property			5	2500		2500			

Provision for dep. leasehold property			5		2500				2500
Provision for dep. furniture	-	320	4		320				640
Closing inventory			1	3,000				3000	
Inventory 31/12/18			1		3,000		3000		
Accrued electricity			3		100				100
Accrued postage & stamp			3		50				50
Net profit						43130			43,130
	289100	289100		6970	6970	163000	163000	175700	175700

12.4 Chapter review

Chapter review

Before moving to the next chapter, check that you are now able to:

- understand the purpose of the statement of financial position;
- understand the purpose of the statement of profit or loss;
- prepare financial statements from a trial balance after adjusting it for information provided; and
- prepare and explain an extended trial balance.

12.5 End of chapter questions and suggested solutions

Question 1

You are provided with the following trial balance for Blessed Stores as at 31 December 2024:

	Dr (N)	Cr (N)
Sales		820,000
Purchases	530,000	
Inventory (1 January 2024)	90,000	
Wages and salaries	120,000	
Rent	40,000	
Insurance	15,000	
Trade receivables	100,000	
Trade payables		70,000
Motor Vehicles	300,000	
Accumulated Depreciation: M/V		60,000
Capital		300,000
Drawings	30,000	
Cash	25,000	
	1,250,000	1,250,000

Additional Information:

1. Inventory at 31 December 2024 was valued at N80,000.
2. Rent prepaid amounted to N5,000.
3. Wages outstanding: N10,000.
4. Provide depreciation on Motor Vehicles at 20% per annum (straight-line).
5. Create a doubtful debts allowance of 5% on trade receivables.

Required:

Prepare:

- a. The statement of profit or loss for the year ended 31 December 2024
- b. The statement of financial position as at 31 December 2024

Suggested solution

Blessed store

a. Statement of Profit or Loss for the Year Ended 31 December 2024

	N	N
Revenue:		
Sales Revenue		820,000
Less: Cost of Sales:		
Opening Inventory	90,000	
Add: Purchases	530,000	
Less: Closing Inventory	80,000	
Cost of Sales		<u>540,000</u>
Gross Profit		280,000
Less: Operating Expenses		
Wages and Salaries (120,000 + 10,000)	130,000	
Rent (40,000 – 5,000 prepaid)	35,000	
Insurance	15,000	
Depreciation on Motor Vehicles (20% × 300,000)	60,000	
Allowance for Doubtful Debts (5% × 100,000)	<u>5,000</u>	
Total Expenses		<u>245,000</u>
Profit for the Year		<u>35,000</u>

Blessed store
b) Statement of Financial Position as at 31 December 2024

	N	N
Assets		
Non-Current Assets:		
Motor Vehicles		300,000
Less: Accumulated Depreciation: (60,000 + 60,000)		<u>120,000</u>
Carrying amount		180,000
Current assets		
Inventory	80,000	
Trade Receivables less allowance (100,000-5,000)	95,000	
Prepaid rent	5,000	
Cash	25,000	
Total Current Assets		<u>205,000</u>
Total Assets		<u>385,000</u>
Equity and Liabilities		
Capital and Reserves:		
Capital		300,000
Net Profit		35,000
Drawings		(30,000)
Total capital and reserves		305,000
Current Liabilities:		
Trade Payables	70,000	
Accrued Wages	10,000	
Total liabilities		<u>80,000</u>
Total equity and liabilities		<u>385,000</u>

Question 2

Samson Traders provided the following balances as at 31 December 2023 (N in thousands):

- Capital: ~~N~~150,000 Cr
- Drawings: ~~N~~20,000 Dr
- Revenue: ~~N~~ 400,000 Cr
- Purchases: ~~N~~260,000 Dr
- Land: ~~N~~120,000 Dr
- Inventory at 1 January 2023: ~~N~~40,000 Dr
- Trade receivables/payables: ~~N~~70,000 Dr / ~~N~~ 60,000 Cr
- Electricity: ~~N~~ 6,000 Dr
- Postage: ~~N~~4,000 Dr
- Furniture: ~~N~~ 50,000 Dr
- Accumulated depreciation: ~~N~~10,000 Cr
- Salaries: ~~N~~50,000 Dr
- Closing inventory: ~~N~~38,000
- Depreciate furniture at 10% p.a.
- Accrue salaries of ~~N~~5,000
- Make an allowance for doubtful debts of 5% on receivables

Required:

Prepare an extended trial balance showing:

- Adjustments
- Statement of profit or loss
- Statement of financial position

Suggested solution

Samson Traders – Extended Trial Balance as at 31 December 2023

Account	Dr	Cr	Adj. (Dr)	Adj. (Cr)	Dr	Cr	P / L Dr	P / L Cr	Assets	Liabilities
	₦	₦	₦	₦	₦	₦	₦	₦	₦	₦
Capital		150,000				150,000				150,000
Drawings	20,000				20,000				-20,000	
Revenue		400,000				400,000		400,000		
Purchases	260,000				260,000	260,000				
Opening Inventory	40,000				40,000	40,000				
Closing Inventory							-38,000		38,000	
Trade Receivables	70,000		3,500		70,000	3,500			66,500	
Allowance for Doubtful Debts (5%)				3,500	3,500		3,500			
Trade Payables		60,000				60,000				60,000
Electricity	6,000				6,000	6,000				
Postage	4,000				4,000	4,000				
Land	120,000				120,000				120,000	
Furniture (Cost)	50,000				50,000				50,000	
Accum. Depreciation – Furniture		10,000		5,000		15,000				15,000

Depreciation (10%)			5,000		5,000		5,000			
Salaries	50,000		5,000		55,000		55,000			
Accrued Salaries				5,000		5,000				5,000
Total	620,000	620,000	13,500	13,500	633,500	633,500	335,500	400,000	274,500	210,000
Profit							64,500			64,500
Final Total	620,000	620,000	13,500	13,500	633,500	633,500	400,000	400,000	274,500	274,500

Notes

1. First two columns are the original balances as per the question
2. The second two columns are the adjustments, answer to a) in the question
3. The third two columns are the final trial balance figures after adjustments
4. The fourth two columns are the statement of profit or loss columns, answer to b) in the question
5. The last two columns are the statement of financial columns, answer to c) in the question.

Question 3

You are provided with the following trial balance of Glory Ventures as at 31 December 2024:

Account	Dr (R)	Cr (R)
Capital		300,000
Drawings	40,000	
Revenue		550,000
Purchases	320,000	
Returns Outwards		10,000
Inventory at 1 January 2024	45,000	
Building	200,000	
Salaries and Wages	80,000	
Rent and Rates	25,000	
Electricity	12,000	
Insurance	9,000	
Furniture and Fittings	80,000	
Accumulated Depreciation (Furn.)		15,000
Trade Receivables	70,000	
Trade Payables		40,000
Bank	34,000	
Totals	915,000	915,000

Additional Information:

1. Closing inventory as at 31 December 2024 is valued at ₦50,000.
2. Salaries of ₦5,000 are accrued.
3. Prepaid insurance amounts to ₦2,000.
4. Depreciation is to be charged on furniture and fittings at 10% per annum using the straight-line method.
5. Create an allowance for doubtful debts at 5% of trade receivables.

Required:

- (a) Prepare the Statement of Profit or Loss for the year ended 31 December 2024. (12 marks)
- (b) Prepare the Statement of Financial Position as at that date. (8 marks)

Suggested solution

(a) **Glory Ventures**

Statement of Profit or Loss for the Year Ended 31 December 2024

	₦	₦
Revenue:		
Sales Revenue		550,000
Less: Cost of Sales:		
Opening Inventory	45,000	
Add: Purchases	<u>320,000</u>	
	365,000	
Less returns outwards	<u>10,000</u>	
Total inventory available for sale	355,000	
Less: Closing Inventory	<u>50,000</u>	
Cost of Sales		<u>305,000</u>
Gross Profit		245,000
Less: Operating Expenses		
Salaries and wages (80,000 + 5,000)	85,000	
Rent and rates	25,000	
Electricity	12,000	
Insurance (9,000 – 2,000 prepaid)	7,000	
Depreciation on furniture (10% Of 80,000)	8,000	
Allowance for Doubtful Debts (5% × 70,000)	<u>3,500</u>	
Total Expenses		<u>140,500</u>
Profit for the Year		<u>104,500</u>

(b) **Glory Ventures**

Statement of Financial Position as at 31 December 2024

	Cost (₦)	Acc. depreciation (₦)	Carrying amount(₦)
Assets			
Building	200,000	0	200,000
Furniture & fittings	<u>80,000</u>	<u>23,000</u>	<u>57,000</u>
Total non-current assets	<u>280,000</u>	<u>23,000</u>	257,000
Current assets			
Inventory		50,000	
Trade receivables	70,000		

Less: Allowance for doubtful debts	<u>3,500</u>	
Net trade receivables		66,500
Prepaid Insurance		2,000
Bank		<u>34,000</u>
Total current assets		<u>152,500</u>
Total assets		<u>409,500</u>
Equity and liabilities		
Capital and reserves		
Capital		300,000
Net profit		104,500
Drawings		(40,000)
Total capital and reserves		364,500
Current liabilities		
Trade payables	<u>s</u>	40,000
Accrued salaries		<u>5,000</u>
Total liabilities		<u>45,000</u>
Total equity and liabilities		<u>409,500</u>

Workings

1. Acc. Depreciation on furniture	
Brought forward	15,000
Charge for the year	<u>8,000</u>
Total	<u>23,000</u>

PREPARATION OF COMPANY FINANCIAL STATEMENTS

Contents

- 13.0 Learning objective
- 13.1 Learning outcomes
- 13.2 The components of financial statements
- 13.3 Structure and content of the statement of financial position
- 13.4 Structure and content of the statement of profit or loss
- 13.5 Accounting for taxation
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- 13.7 Financial statements – specimen formats
- 13.8 IAS 8: Accounting policies, changes in accounting estimates and errors
- 13.9 IFRS 18: Presentation and disclosure in financial statements
- 13.10 Chapter review
- 13.11 End of chapter questions and suggested solutions

13. Preparation of Company Financial Statements

13.0 Learning objective

This chapter explains aspects of company financial statements.

13.1 Learning outcomes

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

- a. prepare a simple statement of financial position in accordance with the guidance in IAS 1 from data and information provided;
- b. prepare a simple statement of profit or loss in accordance with the guidance in IAS 1 from data and information provided;
- c. account for taxation expense;
- d. account for share issues, and
- e. understand the content of IFRS 18: Presentation and Disclosure in Financial Statements.

13.2 The Components Of Financial Statements

13.2.1 Preparing financial statements

The basic approach to preparing a statement of financial position and a statement of profit or loss in practice can be summarised as follows.

- a. The balances on all the accounts in the general ledger (nominal ledger or main) are extracted into a trial balance (a list of balances on all ledger accounts for assets, liabilities, capital, income and expenses).
- b. Adjustments are made for 'year-end' items, such as:
 - i. depreciation charges for non-current assets;
 - ii. accruals and prepayments for expense items;
 - iii. adjusting the allowance for bad (irrecoverable) debts;
 - iv. closing inventory; and
 - v. other items and transactions not yet recorded or incorrectly recorded.
- vi. The adjusted income and expense balances are entered into a statement of profit or loss to establish the profit or loss for the period.
- vii. The adjusted asset, liability and capital balances, together with the retained profit for the year, are entered into a statement of financial position as at the end of the reporting period.

It is likely that you will be given a trial balance with information about missing or incorrectly treated items. You will then be asked to construct a statement of financial position and a statement of profit or loss.

The same process is used to prepare the statement of profit or loss and statement of financial position of a sole proprietor, a partnership or a company. However, companies are subject to greater regulation in many areas including financial reporting. This chapter explains the more specific financial reporting demands placed on companies.

The chapter also explains certain double entry that is specific to companies.

13.2.2 The format of published accounts

Some entities must publish financial statements in accordance with **International Financial Reporting Standards** and **International Accounting Standards**).

IAS 1: Presentation of Financial Statements, sets out the rules on the form and content of financial statements which such entities must comply with.

IAS 1 specifies what published general-purpose financial statements should include, and provides a format for a statement of financial position, statement of profit or loss and other comprehensive income and a statement of changes in equity.

The objective of general-purpose financial statements is to provide information about the financial position of the company, and its financial performance and cash flows that is useful to a wide range of users in making economic decisions.

A complete set of financial statements consists of:

- a. a statement of financial position as at the end of the period;
- b. a statement of profit or loss and other comprehensive income for the period (made up of a statement of profit or loss and a statement of other comprehensive income);
- c. a statement of changes in equity for the period;
- d. a statement of cash flows (dealt with in a later chapter); and
- e. notes to these statements, consisting of a summary of significant accounting policies used by the entity and other explanatory notes.

Further requirements include:

- f. Financial statements should present fairly the financial position, financial performance and cash flows of the entity.
- g. Comparative information for the immediately preceding accounting period should be disclosed (you will not be asked to provide comparative information).
- h. Each component of the financial statements must be properly identified with the following information displayed prominently:
 - i. the name of the reporting entity
 - ii. the date of the end of the reporting period or the period covered by the statement, whichever is appropriate
 - iii. the currency in which the figures are reported
 - iv. the level of rounding used in the figures (for example, whether the figures are in thousands of naira or millions of naira).

Note: IAS 1 does not specify what the statements must be called and allows the use of other terminology. For example a statement of financial position is often called a balance sheet and a statement of profit or loss is often called an income statement.

13.3 Structure and Content of the Statement of Financial Position

13.3.1 Introduction

IFRS uses terms which are incorporated into this study text. However, it does not forbid the use of other terms and you might see other terms used in practice.

IAS 1 sets out the requirements for information that must be presented in the statement of financial position or in notes to the financial statements, and it also provides implementation guidance. This guidance includes an illustrative format for a statement of financial position. This format is not mandatory but you should learn it and use it wherever possible.

13.3.2 Current and non-current assets and liabilities

Current and non-current items should normally be presented separately in the statement of financial position, so that:

- a. current and non-current assets are divided into separate classifications; and
- b. current and non-current liabilities are also classified separately.

As a general rule, an amount is 'current' if it is expected to be recovered or settled no more than 12 months after the end of the reporting period.

13.3.3 Current assets

IAS 1 states that an asset should be classified as a current asset if it satisfies **any** of the following criteria:

- a. The entity expects to realise the asset, or sell or consume it, in its normal operating cycle.
- b. The asset is held for trading purposes.
- c. The entity expects to realise the asset within 12 months after the reporting period.
- d. It is cash or a cash equivalent unless the asset is restricted from being used for at least 12 months after the reporting date. (Note: An example of 'cash' is money in a current bank account. An example of a 'cash equivalent' is money held in a term deposit account with a bank.)

All other assets should be classified as non-current assets.

This definition allows inventory or trade receivables to qualify as current assets, even if they may not be realised into cash within 12 months, provided that they will be realised in the entity's normal operating cycle or trading cycle.

The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. This is almost always the case.

13.3.4 Current liabilities

IAS 1 also states that a liability should be classified as a current liability if it satisfies **any** of the following criteria:

- a. The entity expects to settle the liability in its normal operating cycle.
- b. The liability is held primarily for the purpose of trading. This means that all trade payables are current liabilities, even if settlement is not due for over 12 months after the end of the reporting period.
- c. It is due to be settled within 12 months after the end of the reporting period.
- d. A portion of non-current liabilities that is due to be settled within 12 months after the end of the reporting period must be classified as current liability.

Illustration

For example, if an entity borrows ₦100,000,000 on January 1, 2022, repayable in ten equal annual instalments starting from December 2022, the classification of liabilities will be as follows:

- i) As at January 1, 2022:
 - Current liabilities: ₦10,000,000 (the amount due within the next 12 months)
 - Non-current liabilities: ₦90,000,000 (the remaining amount payable after 12 months)
- ii) As at December 31, 2022 (after the first instalment is due and presumably paid):
 - Current liabilities: ₦10,000,000 (next instalment due within 12 months)
 - Non-current liabilities: ₦80,000,000 (balance payable over the remaining 8 years)

All other liabilities should be classified as non-current liabilities.

13.3.5 Information to be presented on the face of the statement of financial position

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of financial position as a 'line item' (in other words, on a separate line in the statement):

Assets

- (a) Property, plant and equipment
- (b) Intangible assets
- (c) Inventories
- (d) Trade and other receivables
- (e) Cash and cash equivalents.

Liabilities

- (f) Trade and other payables
- (g) Financial liabilities (for example, bank loans)
- (h) Liabilities (but possibly assets) for current tax

Equity

- (i) Issued capital and reserves attributable to the **owners** of the entity. (The term 'owners', refers to the **equity holders**.)

Note that IAS 1 requires more detail than this but other areas mentioned are not covered in this syllabus.

Additional line items should be included in the statement of financial position when presenting them separately and is 'relevant to an understanding of the entity's financial position.

Information to be shown on the face of the statement of financial position or in notes

Some of the line items in the statement of financial position should be sub-classified into different categories, giving details of how the total figure is made up. This sub-classification may be presented either:

- a. as additional lines on the face of the statement of financial position (adding up to the total amount for the item as a whole) or
- b. in notes to the financial statements.

For example:

- a. Tangible non-current assets should be divided into sub-categories, as required by **IAS 16: Property, Plant and Equipment**.
- b. Receivables should be sub-classified into trade receivables, prepayments and other amounts.
- c. Inventories are sub-classified in accordance with **IAS 2: Inventories** into categories such as merchandise, materials, work-in-progress and finished goods.

Example: statement of financial position of an individual entity

IAS 1 does not specify what the exact format of the statement of financial position should be. However, it includes an illustrative statement of financial position in Guidance to implementing the Standard (which is an appendix to the Standard).

The example below is based on that example. Illustrative figures are included.
Statement of financial position of ABCD Entity as at December 31, 20XX

	Nm	Nm
Assets		
Non-current assets		
Property, plant and equipment	205.1	
Intangible assets	10.7	
Investments	6.8	
		222.6
Current assets		
Inventories	17.8	
Trade and other receivables	13.3	
Other current assets	2.0	
Cash and cash equivalents	0.7	
		33.8
Total assets		256.4
Equity and liabilities		
Share capital	50.0	
Retained earnings (accumulated profits)	60.6	
Other components of equity	31.9	
Total equity		142.5
Non-current liabilities		
Long-term borrowings	30.0	
Deferred tax	4.5	
Total non-current liabilities	34.5	
Current liabilities		
Trade and other payables	67.1	
Short-term borrowings (bank overdraft)	3.2	
Current portion of long-term borrowing	5.0	
Current tax payable	4.1	
Total current liabilities	79.4	
Total liabilities		113.9
Total equity and liabilities		256.4

13.4 Structure And Content Of The Statement Of Profit Or Loss And Other Comprehensive Income

13.4.1 A single statement or two statements

The statement of profit or loss and other comprehensive income provides information about the performance of an entity in a period. It consists of two parts:

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

IAS 1 allows an entity to present the two sections in a single statement or in two separate statements. If two separate statements are used they should include all the information that would otherwise be included in the single statement of profit or loss and other comprehensive income.

The statement of profit or loss shows the components of profit or loss, beginning with 'Revenue' and ending with 'Profit (or Loss)' for the period after tax.

Definition of total comprehensive income

Total comprehensive income during a period is the sum of:

- a. the profit or loss for the period and
- b. other comprehensive income.

Items which must be recognised as other comprehensive income are not in your syllabus. This means that statements of comprehensive income at this level include only the statement of profit or loss.

13.4.2 Information to be presented on the face of the statement of profit or loss

As a **minimum**, IAS 1 requires that the statement of profit or loss should include line items showing the following amounts for the financial period:

- (a) revenue
- (b) finance costs (for example, interest costs)
- (c) tax expense
- (d) profit or loss
- (e) each component of other comprehensive income
- (f) total comprehensive income.

Additional line items should be presented on the face of the statement of profit or loss when it is relevant to an understanding of the entity's financial performance.

Example: statement of profit or loss of an individual entity

IAS 1 does not specify formats.

The example below is based on a suggested presentation included in the implementation guidance to IAS 1.

XYZ Entity: Statement of profit or loss for the year ended December 31, 20XX

Revenue	678
Cost of sales	<u>250</u>
Gross profit	428
Other income	44
Distribution costs	(98)
Administrative expenses	(61)
Other expenses	(18)
Finance costs	<u>(24)</u>
Profit before tax	271
Taxation	<u>(50)</u>
PROFIT FOR THE YEAR	221
Other comprehensive income	
Gains on property revaluation	<u>46</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	267

Information to be shown on the face of the statement of profit or loss (or the statement of profit or loss, if separate) or in the notes

The following information may be shown either on the face of the statement of profit or loss or in a note to the financial statements:

- a. **material items** of income and expense
- b. an **analysis of expenses**, providing either:
 - expenses analysed by their nature, or
 - expenses analysed by the function that has incurred them.

IAS 1 encourages entities to show this analysis of expenses on the face of the statement of profit or loss, rather than in a note to the accounts.

Material items that might be disclosed separately include:

- a. a write-down of inventories from cost to net realisable value, or a write-down of items of property, plant and equipment to recoverable amount
- b. disposals of items of property, plant and equipment
- c. litigation settlements

13.4.3 Analysis of expenses by their functions

When expenses are analysed according to their function, the functions are commonly 'cost of sales', 'distribution costs', 'administrative expenses' and 'other expenses'. This method of analysis is also called the 'cost of sales method'.

In practice, most entities use this method.

An example of a statement of profit or loss, showing expenses by function (cost of sales, distribution costs, administrative expenses) is as follows.

Example: Analysis of expenses by function

The following is an extract from the accounts of Entity Red for the year to June 30, 20X5, after the year-end adjustments had been made

	Debit	Credit
	₦000	₦000
Cost of sales	6,214	
Distribution costs	3,693	
Revenue		14,823
Other expenses	248	
Administrative expenses	3,901	
Other income		22

Entity Red: Statement of profit or loss for the year ended June 30,

20X5

Revenue	14,823
Cost of sales	6,214
Gross profit	8,609
Other income	22
Distribution costs	(3,693)
Administrative expenses	(3,901)
Other expenses	(248)
Profit before tax	789

Required

Show the first part of Entity Red's statement of profit or loss using the 'cost of sales' analysis method.

The basis for separating these costs between the functions would be given in the question.

13.4.4 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.

In a manufacturing business, expenses would probably be classified as:

- a. raw materials and consumables used;
- b. staff costs ('employee benefits costs'); and
- c. depreciation.

Items of expense that on their own are immaterial are presented as 'other expenses'.

There will also be an adjustment for the increase or decrease in inventories of finished goods and work-in-progress during the period.

Other entities (non-manufacturing entities) may present other expenses that are material to their business.

An example of a statement of profit or loss, showing expenses by their nature, is shown below, with illustrative figures included.

Example: Analysis of expenses by nature

The following is an alternative method of presenting the accounts of Entity Red.

	N000
Increase in inventories of finished goods and work-in-progress	86
Revenue	14,823
Raw materials and consumables	5,565
Depreciation	1,533
Other income	22
Staff costs	4,926
Other operating expenses	2,118

Required

Show the first part of Entity Red's statement of profit or loss using the 'nature of expenditure' method, down to the operating profit level.

Entity Red: Statement of profit or loss for the year ended June 30, 20X5

	N000	N000
Revenue	14,823	
Other income		22
		<u>14,845</u>
Changes in inventories of finished goods and work-in-progress (reduction=expense, increase=negative expense)	(86)	
Raw materials and consumables used	5,565	
Staff costs (employee benefits costs)	4,926	
Depreciation and amortisation expense	1,533	
Other operating expenses	<u>2,118</u>	
	14,056	
Profit before tax		<u><u>789</u></u>

13.5 Accounting For Taxation

13.5.1 Taxation on profits

A company is a legal person, and is liable to pay tax on the profits that it makes. This tax is called income tax in international accounting standards.

The statement of profit or loss and statement of financial position of a sole trader or partnership are prepared without any concern for taxation on profits. The taxation of the income of sole traders and partners is not a concern of their businesses, and is not recorded in the financial accounts of the business.

Companies are different, because the company has a liability for taxation that is reported in its statement of profit or loss and statement of financial position.

- a. The statement of profit or loss reports the amount of taxation on the profit of the company for the year. This is deducted in reaching a figure for profit after taxation.
- b. The statement of financial position reports the amount of taxation that the company owes to the tax authorities as at the end of the reporting period.

13.5.2 Taxation in the statement of profit or loss

Taxation in the statement of profit or loss might relate to the profit or loss section or to other comprehensive income. Tax is recognised in each section as appropriate.

The tax charge that relates to profit or loss is a charge against profits after interest. The profit after tax is added to the retained earnings reserve.

Example:

	₤
Profits from operations	460,000
Interest	(60,000)
Profit before tax	<u>400,000</u>
Tax	(100,000)
Profit after tax	<u>300,000</u>

The profit after tax is added to the retained earnings (accumulated profits) brought forward at the start of the year to give a total which appears on the face of the statement of financial position at the year end (unless there are any other transfers into or out of this amount, for example, dividend payments).

Over-estimate or under-estimate of tax from the previous year

When the financial statements are prepared, the tax charge on the profits for the year is likely to be an estimate. The figure for tax on profits in the statement of profit or loss is therefore not the amount of tax that will eventually be payable, because it is only an estimate. The actual tax charge, agreed with the tax authorities some time later, is likely to be different.

In these circumstances, the tax charge for the year is adjusted for any under-estimate or over-estimate of tax in the previous year.

- a. An under-estimate of tax on the previous year's profits is added to the tax charge for the current year.
- b. An over-estimate of tax on the previous year's profits is deducted from the tax charge for the current year.

Example:

	₦	₦
Profit from operations		460,000
Interest		(60,000)
Profit before tax		<u>400,000</u>
Tax:		
Adjustment for under-estimate of tax in the previous year	3,000	
Tax on current year profits	<u>100,000</u>	
Tax charge for the year		<u>(103,000)</u>
Profit after tax		<u>297,000</u>

13.5.3 Taxation in the statement of financial position

The taxation charge for the year is the liability that the company expects to pay. The timing of tax payments on profits varies from one country to another, depending on the tax rules in each country. The actual amount of tax payable, and reported in the statement of financial position as a current liability (taxation payable), is calculated as follows:

Illustration:

	₦
Tax payable at the beginning of the year	<u>X</u>
Tax charge for the year	X
	X
Tax payments made during the year	<u>(X)</u>
Tax payable at the end of the year	X

Example:

Fresh Company has a financial year ending on December 31. At December 31, Year 5 it had a liability for income tax (tax on its profits) of ₦77,000. The tax on profits for the year to December 31, Year 6 was ₦114,000.

The tax charge for the year to December 31, Year 5 was over-estimated by ₦6,000.

During the year to December 31, Year 6, the company made payments of ₦123,000 in income tax.

Required

Calculate:

- a. The tax charge for the year to December 31, Year 6, to include in the statement of profit or loss
- b. The liability for income tax as at December 31, Year 6, to include in the balance sheet.

Tax:	₦
Adjustment for over-estimate of tax in the previous year	(6,000)
Tax on current year profits	114,000
Taxation charge for the year	<u>108,000</u>
(b)	
	₦
Tax payable at the beginning of the year	77,000
Tax charge for the year	108,000
	<u>185,000</u>
Tax payments made during the year	(123,000)
Tax payable at the end of the year	<u>62,000</u>

Practice Question on Taxation

The estimated income tax of Ameh Ltd for the year ended June 30, 2024 was ₦15,000,000. This was later agreed with the tax authority at ₦16,500,000 in August 2024, and the amount was paid in September 2024.

The company's profit before tax for the year ended June 30, 2025 was ₦82,400,000.

The applicable income tax rate is 30%.

Required:

- Calculate the income tax expense for the year ended June 30, 2025
- Show the amount of tax payable as at June 30, 2025

Suggested solution

- a. Income Tax Expense for the Year Ended June 30, 2025

Description	₦'000
Under-provision for prior year (~~₦16.5m~~ - ~~₦15m~~)	1,500
Current year tax: ₦82,400,000 × 30%	24,720
Total income tax expense	26,220

- b. Tax Payable as at June 30, 2025

Since the prior year's tax liability (~~₦16,500,000~~) has already been settled in September 2024, the tax payable at June 30, 2025 relates only to the current year:

Description	₦'000
Income tax for 2025	24,720
Tax payable	24,720

13.6 Accounting For Share Issue

13.6.1 Introduction

Companies raise capital through various financial instruments, including ordinary shares, preference shares, and loan notes. These instruments collectively form the capital structure of a company. This chapter explores the accounting treatment and key concepts related to the issue of these instruments.

13.6.2 Types of Financial Instruments

1 Ordinary Shares

Ordinary shares (also known as equity shares) represent ownership in a company. Holders of ordinary shares have:

- Voting rights
- A right to receive dividends (if declared)
- No fixed dividend rate
- No maturity date

Ordinary shareholders bear the highest level of risk but also stand to gain the most if the company performs well.

2 Preference Shares

Preference shares have a higher claim on assets and dividends than ordinary shares. Typically, they:

- a. Have a fixed dividend rate
- b. May or may not have a maturity date
- c. Generally do not carry voting rights (unless specified)

a) Categories of Preference Shares:

i) Redeemable Preference Shares:

These are repayable at a future date, either at the company's discretion or the shareholder's option. For accounting purposes, they are classified as liabilities and reported as such on the statement of financial position.

ii) Non-Redeemable Preference Shares:

These do not have a maturity date and are not repayable. They are treated similarly to equity. However, their dividend is fixed.

Note:

Section 147 of the *Companies and Allied Matters Act (CAMA), 2020* prohibits Nigerian companies from issuing non-redeemable preference shares. All preference shares must be redeemable.

ii) Other Variants of Preference Shares:

a. Participating Preference Shares:

Entitle holders to both a fixed dividend and an additional share in company profits, as specified.

b. Cumulative Preference Shares:

If dividends are not paid in any year, the unpaid amounts accumulate and must be paid in full before any dividends are paid to ordinary shareholders. In liquidation, cumulative preference shares and their arrears are settled before ordinary shares.

c. Convertible Preference Shares:

These may be converted into ordinary shares under specified conditions, enabling holders to benefit from potential share price appreciation.

13.6.3 Loan Notes

Loan notes are debt instruments through which a company borrows funds from investors. Features include:

- a. Fixed interest payments
- b. Repayment of principal at maturity
- c. Classification as non-current liabilities in the statement of financial position

Interest payable is classified as a finance cost in the profit or loss statement and shown under current liabilities in the statement of financial position.

a) Types of Loan Notes:

i. Convertible Loan Notes:

May be converted into equity shares.

ii. Non-Convertible Loan Notes:

Repaid fully in cash at maturity without conversion rights.

13.6.4 Key Terms:

a. Nominal Value (Face/Par Value):

The minimum legal issue price of a share.

E.g., If 1,000,000 shares are issued at a nominal value of ₦1 each, the nominal share capital is ₦1,000,000.

b. Share Premium:

The excess amount received over the nominal value.

E.g., If shares with a ₦1 nominal value are issued at ₦3 each, the share premium is ₦2 per share, totalling ₦2,000,000 for 1,000,000 shares.

c. Minimum Share Capital:

The minimum amount of share capital required to begin operations. This varies by jurisdiction and company type.

d. Authorised Share Capital:

The maximum share capital a company is allowed to issue.

Note: In Nigeria, **CAMA 2020** has **abolished** the concept of authorised share capital.

Companies are no longer required to specify a maximum capital limit.

e. Issued Share Capital:

The portion of authorised capital that has been offered and allotted to shareholders.

f. Called-Up Share Capital:

The portion of issued capital for which the company has requested payment from shareholders.

g. **Paid-Up Share Capital:**

The portion of called-up capital that shareholders have actually paid to the company.

13.6.5 Issue of shares

When an entity issues new ordinary shares:

- a. the issued shares become a part of equity, and
- b. the entity receives cash from the issue, or possibly assets other than cash (for which a carrying value is determined).

The issue price of new equity shares is usually higher than their face value or nominal value. The difference between the nominal value of the shares and their issue price is accounted for as share premium, and credited to a share premium reserve. (This reserve is a part of equity).

Transaction costs of issuing new equity shares for cash should be debited directly to equity.

	Dr (N000)	Cr (N000)
Cash (200,000 × 250)	50,000	
Share capital (200,000 × 25)		5,000
Share premium (200,000 × 250 – 25)		45,000
Share premium Cash	3,000	

The costs of the issue, net of related tax benefit, are set against the share premium account. (If there is no share premium on the issue of the new shares, issue costs should be deducted from retained earnings).

Example: Share issue

A company issues 200,000 shares of N25 each at a price of N250 per share. Issue costs are N3,000,000.

The share issue would be accounted for as follows:

Illustration: Share issue double entry

	Debit	Credit
Bank (cash received)	X	
Share capital (nominal value of shares issued)	X	
Share premium (with the excess of the issue price of the shares over their nominal value)		X

- a) **Over-subscription for Shares**
 - i) **Definition**

Over-subscription occurs when the number of shares applied for exceeds the number of shares offered by the company. This usually indicates high demand for the company's shares.

ii) **Accounting Treatment for Over-subscription**

When shares are over-subscribed and fully paid for during the application stage, the accounting process involves the following steps:

1. **Receipt of Application Money:**
The company receives money from applicants and records it as a liability (application money or deposit for shares).
2. **Allotment of Shares:**
Shares are allotted to successful applicants. If the shares are fully paid, the application money is transferred to the share capital and share premium accounts as appropriate.
3. **Refund of Excess Application Money:**
The company refunds excess application money to the unsuccessful applicants.

Accounting Entries

- a. **Debit:** Bank (with the total application money received)
- b. **Credit:** Share Application (liability account)

Upon allotment:

- a. **Debit:** Share Application
- b. **Credit:** Share Capital (nominal value of shares allotted)
- c. **Credit:** Share Premium (excess over nominal value)

For refunds:

- a. **Debit:** Share Application
- b. **Credit:** Bank

13.6.6 Accounting for Share Premium

The **share premium** is the excess of the issue price over the nominal value of shares. It is recorded in the *Share Premium Account*, which is **not distributable** as dividends.

Permissible Uses of Share Premium:

- a. issuing fully paid bonus shares to existing shareholders;
- b. writing off the expenses of issuing shares;
- c. providing for premium payable on redemption of redeemable preference shares; and
- d. purchasing the company's own shares and other securities.

13.6.7 Accounting for Rights Issue

i) Definition

A **rights issue** is an offer made by a company to its existing shareholders to purchase additional shares, typically at a price below the market value and in proportion to their current holdings.

Key Features:

- a. Offered on a *pro-rata* basis (For example, 1 for 2 means 1 new share for every 2 shares held)
- b. Issue price may exceed the nominal value but is usually below the market price

iii) Accounting Treatments

Rights issues are accounted for in the same way as public issues of shares. The proceeds are recorded in the share capital and share premium accounts as applicable.

iv) Disclosure Requirements

The financial statements must disclose:

- a. number of shares issued;
- b. issue price; and
- c. terms and conditions.

v) Impact on Financial Statements

- a. A rights issue increases:
 - share capital
 - possibly share premium
- b. It can also affect financial ratios and capital structure.

13.6.8 Bonus Shares

i) Nature of Bonus Shares

Bonus shares are free additional shares given to existing shareholders, drawn from retained earnings or reserves. Also called *scrip issues* or *capitalisation issues*, they increase share capital without affecting total equity.

- a. No cash outflow is involved
- b. The shareholder's proportionate ownership remains unchanged

ii) Legal Provision (CAMA 2020)

Under Section 145 of CAMA 2020 (as amended), a company may apply the share premium account to pay up unissued shares to be issued as fully-paid bonus shares. If share premium is insufficient, the balance is taken from retained earnings.

Example:

A company with 20,000,000 ordinary shares of ₦10 each declares a 1-for-5 bonus issue. Balances before issue:

- Share Premium = ₦24,000,000
- Retained Earnings = ₦42,000,000

Bonus Shares to be Issued:

$20,000,000 \div 5 = 4,000,000$ shares

Nominal value = $4,000,000 \times ₦10 = ₦40,000,000$

Accounting:

- Use ₦24,000,000 from share premium
- Use ₦16,000,000 from retained earnings

Journal Entry:

Dr Share Premium	₦24,000,000
Dr Retained Earnings	₦16,000,000
Cr Share Capital	₦40,000,000

New balances in equity:

- Share Capital = ₦200,000,000 + ₦40,000,000 = ₦240,000,000
- Share Premium = ₦0 (fully utilised)
- Retained Earnings = ₦42,000,000 - ₦16,000,000 = ₦26,000,000

13.6.9 Issue of Loan Notes

i) Introduction

Loan notes are debt instruments issued by companies to raise long-term funds. A loan note specifies:

- a. the loan amount (principal);
- b. the interest rate; and
- c. the repayment terms.

ii) Accounting Treatment:

- a. Principal is shown as a non-current liability
- b. Unpaid interest is a current liability
- c. Interest expense is recognised as a finance cost in the statement of profit or loss.

13.6.10 Accounting for Dividends

i) Dividends on Ordinary Shares

- Declared at the company's Annual General Meeting (AGM) based on directors' recommendation
- Formula:
$$\text{Dividend} = \text{Number of Shares Held} \times \text{Dividend per Share}$$

ii) Accounting

Treatment:

- a. Proposed dividends are not recognised as liabilities until declared; they are disclosed in the notes
- b. When paid, dividends:
 - reduce retained earnings;
 - are recorded in the statement of changes in equity; and
 - appear as a cash outflow under Financing Activities in the statement of cash flows.

iii) Dividends on Preference Shares

- a. Usually fixed in nature
- b. Formula:
$$\text{Dividend} = \text{Preference Share Capital} \times \text{Dividend Rate}$$

Accounting Treatment:

- a. Recorded as a finance cost in the statement of profit or loss and other comprehensive income
- b. Shown as a current liability, if unpaid

13.7 Financial Statement–Specimen Formats

IAS 1 does not specify formats for financial statements. However, it includes illustrative statements in an appendix to the Standard).

The illustrations below are based on the illustrative examples but have been modified to exclude some items not in this syllabus.

13.7.1

Statement of profit or loss (analysis of expenses by function)**Illustration: Statement of profit or loss (analysis of expenses by function)**

Revenue	X
Cost of sales	(X)
Gross profit	X
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Finance costs	(X)
Profit before tax	X
Taxation	(X)
PROFIT FOR THE YEAR	X
Other comprehensive income	
Gains on property revaluation	X
Other gains and losses	X
Other comprehensive income for the year	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X

Statement of profit or loss for the year ended 31 December 2019 ~~Am~~

Illustration: Statement of financial position format Statement of financial position as at 31 December 2019

	Nm	Nm
Assets		
Non-current assets		
Property, plant and equipment		X
Intangible assets		XX
Investments		
<i>Total non-current assets</i>		X
Current assets		
Inventories		X
Trade and other receivables		X
Other current assets		X
Cash and cash equivalents		X
<i>Total current assets</i>		X
Total assets		X
Equity and liabilities		
Share capital		X
Retained earnings (accumulated profits)		X
Other components of equity		X
<i>Total equity</i>		X
Non-current liabilities		
Long-term borrowings	X	
Deferred tax	X	
<i>Total non-current liabilities</i>	X	
Current liabilities		
Trade and other payables	X	
Short-term borrowings (bank overdraft)	X	
Current portion of long-term borrowing	X	
Current tax payable	X	
<i>Total current liabilities</i>	X	
<i>Total liabilities</i>		X
Total equity and liabilities		X

13.8 IAS: Accounting Policies, Changes In Accounting Estimates And Errors

13.8.1 Introduction to IAS8

IAS 8 Accounting policies, changes in accounting estimates and errors deals with several different issues in financial reporting:

- a. selecting and applying accounting policies (dealt with in an earlier chapter)
- b. accounting for changes in accounting policies
- c. changes in accounting estimates
- d. corrections of errors in a prior accounting period.

Much of IAS 8 is therefore concerned with how changes or corrections should be reported in the financial statements.

13.8.2 Changes in accounting policies

Users of financial statements need to be able to compare financial statements of an entity over time, so that they can identify trends in its financial performance or financial position. Frequent changes in accounting policies are therefore undesirable because they make comparisons with previous periods more difficult. IAS 8 therefore states that a change in accounting policy is permitted only in the following circumstances:

- e. When a change in accounting policy is required by an IFRS or revised IAS (or an Interpretation of an IFRS), or
- f. If a change in accounting policy results in the financial statements providing reliable and more relevant financial information.

When a change in accounting policy is required by a new Standard, the Standard will often include specific '**transitional provisions**'. These explain how the change should be introduced.

In the absence of specific transitional provisions, a change in policy should be applied retrospectively.

Determining when there is a change in accounting policy

How should an entity decide whether it would be introducing a change in accounting policy, if it decided to account for a particular type of transaction in a particular way?

IAS 8 specifies that when a new accounting policy is applied for transactions or events that did not occur previously, in earlier financial periods, this is **not** a change of accounting policy; it would simply be the application of a suitable accounting policy to a new type of transaction.

A change in accounting policy can be established as follows. The accounting policies chosen by an entity should reflect transactions and events through:

- g. recognition (e.g. capitalising or writing off certain types of expenditure)
- h. measurement (e.g. measuring non-current assets at cost or valuation)
- i. presentation (e.g. classification of costs as cost of sales or administrative expenses)

If at least one of these criteria is changed, then there is a change in accounting policy.

Example: Accounting policy

A company has previously written off borrowing costs as incurred in the statement of profit or loss. It is now proposed that any relevant finance costs should be capitalised as required IAS 23 Borrowing Costs.

This affects:

- ☐ recognition—the interest cost is now recognised as an asset rather than an expense
- ☐ presentation—the interest cost is now presented in the statement of financial position rather than the statement of profit or loss.

In this example, there has been no change to the measurement of the finance costs but this is still a change in accounting policy due to a change in recognition and presentation.

13.8.3 Retrospective application of a change in accounting policy

When a change in accounting policy is required by a new accounting standard and there are no transitional provisions relating to the introduction of that new standard, the change in policy should be applied retrospectively.

The entity should adjust the opening balance for each item of equity affected by the change, for the earliest prior period presented, and the other comparative amounts for each prior period, as if the new accounting policy had always been applied. For example, suppose that a change in accounting policy is required from Year 3 onwards, and the earliest prior period presented in the Year 3 financial statements is Year 2, for which comparative prior year figures are presented. In that case, the change in accounting policy should be applied retrospectively. This means that the change should be applied to the opening balances at the start of Year 2 (in the comparative prior period information), as if the new policy had always been applied.

Similarly, any other comparative amounts in previous periods should be adjusted as if the new accounting policy had always been applied.

If this is impracticable, retrospective application should be applied from the earliest date that is practicable.

13.8.4 Disclosure of a change in accounting policy

When an entity makes a change in an accounting policy, a note to the financial statements should disclose the following information about the change:

Disclosures required	Change due to a new Standard or Interpretation	Voluntary change
The nature of the change in accounting policy	Yes	Yes
For the current and previous period(s), to the extent practicable, the amount of the adjustment to each item in the financial statements and the adjustment to the basic and fully diluted earnings per share	Yes	Yes
To the extent practicable, the adjustment relating to accounting periods before those presented in the financial statements	Yes	Yes
If retrospective application is impracticable, an explanation of how the accounting policy change has been applied	Yes	Yes
The title of the Standard or Interpretation	Yes	na
A description of any transitional provisions	Yes	na
The reason why the new accounting policy provides reliable and more relevant information	na	Yes

13.8.9 Accounting estimates

An accounting estimate is made for an item in the financial statements when the item cannot be measured with precision, and there is some uncertainty about it. An estimate is therefore based, to some extent, on management's judgement. Management estimates might be required, for example, for the following items:

- j. Bad debts
- k. Inventory obsolescence
- l. the fair value of financial assets or liabilities
- m. the useful lives of non-current assets
- n. the most appropriate depreciation pattern (depreciation method) for a category of non-current assets
- o. warranty obligations.

It is important to distinguish between an accounting policy and an accounting

estimate.

As an example a company may have an accounting policy to depreciate plant and equipment over its useful life. However whether the company uses the

straight line method of depreciation or the reducing balance method will be a choice of accounting estimate.

IAS 8 requires a change in an accounting policy to be accounted for retrospectively whereas **a change in an accounting estimate is normally recognised in the current period** (and there is no requirement for retrospective application).

13.8.10 Changes in accounting estimates

A change in accounting estimate may be needed if changes occur in the circumstances on which the estimate was based, or if new information becomes available. A change in estimate is **not** the result of discovering an error in the way an item has been accounted for in the past and it is **not** a correction of an error.

The effect of a change in accounting estimate should be recognised prospectively, by including it:

- p. in profit or loss for the period in which the change is made, if the change affects that period only, or
- q. in profit or loss for the period of change and future periods, if the change affects both.

Prospective application of a change in estimate

A **change in accounting estimate is not applied retrospectively**. There is prospective application of the change. This means that the effect of the change is recognised in the current period and the future periods affected by the change.

To the extent that a change in estimate results in a change in assets and liabilities, it should be recognised by adjusting the carrying amount of the affected assets or liabilities in the period of change.

Example: Change in accounting estimate

A non-current asset was purchased for ₦200,000 two years ago, when its expected economic life was ten years and its expected residual value was nil. The asset is being depreciated by the straight-line method.

A review of the non-current assets at the end of year 2 revealed that due to technological change, the useful life of the asset is only six years in total, and the asset therefore has a remaining useful life of four years.

The original depreciation charge was ₦20,000 per year ($\frac{₦200,000}{10 \text{ years}}$) and at the beginning of Year 2, its carrying value was ₦180,000 ($₦200,000 - ₦20,000$).

The change in the estimate occurs in Year 2. The change in estimate should be applied prospectively, for years 2 onwards (years 2–6). From the beginning of year 2, the asset has a revised useful remaining life of five years.

The annual charge for depreciation for year 2 (the current year) and for the future years 3–6 will be changed from ₦20,000 to ₦36,000 ($\frac{₦180,000}{5 \text{ years}}$).

Example: Change in accounting estimate

The carrying value of an item of inventory is ₦7,000. The inventory is no longer used due to a change in materials specifications for the products that used to contain the inventory item. The inventory has no scrap value and is now considered worthless.

A change in accounting estimate should reduce the value of the inventory to zero. The change affects the current year only, and the write-off of ₦7,000 should be treated as an expense for the year.

13.8.11 Errors

Errors might happen in preparing financial statements. If they are discovered quickly, they are corrected before the finalised financial statements are published. When this happens, the correction of the error is of no significance for the purpose of financial reporting.

A problem arises, however, when an error is discovered that relates to a prior accounting period. For example, in preparing the financial statements for Year 3, an error may be discovered affecting the financial statements for Year 2, or even Year 1.

Errors might be:

- r. the effect of a mathematical mistake;
- s. a mistake in applying an accounting policy;
- t. an oversight;
- u. a misinterpretation of facts; and
- v. caused by fraud.

Prior period errors are defined in IAS 8 as: 'omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- w. was available when financial statements for those periods were authorised for issue; and
- x. could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.'

13.8.12 The correction of prior period errors

IAS 8 states that all material prior period errors should be **corrected retrospectively** in the first set of financial statements following the discovery of the error.

Comparative amounts for the previous period should be restated at their corrected amount.

If the error occurred before the previous year, the opening balances of assets, liabilities and equity for the previous period should be restated at their corrected amount.

The correction of a prior period error is excluded from profit or loss in the period when the error was discovered.

For example, suppose that an entity preparing its financial statements for Year 3 discovers an error affecting the Year 2 financial statements. The error should be corrected in the Year 3 financial statements by restating the comparative figures for Year 2 at their correct amount. If the error had occurred in Year 1, the comparative opening balances for the beginning of Year 2 should be restated at their correct amount. The reported profit for Year 3 is not affected.

Example: Correction of prior period errors

Kano Transport Company (KTC) is preparing its financial statements for 20X4. The draft statement of changes in equity is as follows:

	Share capital ₦000	Share premium ₦000	Retained earnings ₦000	Total ₦000
Balance at 31/12/X2	500	50	90	640
Profit for the year	-	-	150	150
Balance at 31/12/X3 20X4	500	50	240	790
Profit for the year			385	385
Balance at 31/12/X4	500	50	625	1,175

KTC has now discovered an error in its inventory valuation. Inventory was overstated by ₦70,000 at 31 December 20X4 and by ₦60,000 at 31 December 20X3.

The error in 20X4 is corrected against the current year profit.

The error in 20X3 is corrected against the prior year profit. (Note that the 20X3 closing inventory is the opening inventory in 20X4 so the 20X3 adjustment will impact both periods statements comprehensive income (reducing 20X3 profit but increasing 20X4 profit).

Example (continued): Correction of prior period errors

The necessary profit adjustments are as follows:

Profit adjustments:	20X4	20X3
	₦000	₦000
Profit (20X4 draft and 20X3 actual)	385	150
Deduct error in closing inventory	(70)	(60)
Add error in opening inventory	60	
	(10)	(60)
Adjusted profit	375	90

The statement of changes in equity as published in 20X4 becomes:

	Share capital	Share premium	Retained earnings	Total
	₦000	₦000	₦000	₦000
Balance at 31/12/X2	500	50	90	640
Profit for the year (restated)	-	-	90	90
Balance at 31/12/X3 20X4	500	50	180	730
Profit for the year			375	375
Balance at 31/12/X4	500	50	555	1,105

13.9: IFRS 18: Presentation and Disclosure in Financial Statements

13.9.1 Introduction

IFRS 18 was issued in 2024 to replace IAS 1: **Presentation of Financial Statements** and will become effective from January 1, 2027, although early adoption is permitted.

13.9.2 Objective of the Standard

The objective of IFRS 18 is to provide relevant and comparable information about an entity's assets, liabilities, equity, income, and expenses. It sets out general presentation and disclosure requirements for financial statements.

The standard is designed to:

- a. standardise the structure of the income statement;
- b. enhance comparability of financial information across entities;
- c. improve the communication of financial performance to investors; and
- d. strengthen disclosure requirements for subtotals and management-defined metrics.

To achieve these goals, IFRS 18 introduces three major sets of requirements:

- a) Defined subtotals in the statement of profit or loss
IFRS 18 requires companies to present the following defined subtotals in the income statement:
 - i. Operating profit
 - ii. Profit before financing and income taxesThese defined subtotals improve comparability across entities by providing a consistent structure. However, they do not change how companies measure their total profit or assess overall financial performance.

- b) Disclosure of management-defined performance measures (MPMs)
IFRS 18 mandates companies to disclose management-defined performance measures (MPMs), which are:
subtotals of income and expenses used in official public communications to convey management's view of the financial performance of the entity as a whole.

i) Public Communications

These include:

- management commentary;
- press releases; and
- investor presentations.

They exclude oral communication, social media posts, and transcripts of such communications.

ii) Examples of MPMs

- Adjusted profit or loss (For example, excluding restructuring costs)
- Adjusted EBITDA (Earnings before interest, tax, depreciation, and amortisation)
- Adjusted operating profit
- Adjusted profit from continuing operations

iii) **Common Adjustments Include:**

- impairment losses or reversals on property, plant and equipment (PPE) and intangible assets; and
- gains or losses on the disposal of PPE or intangible assets.

iv) **What Are Not MPMs?**

The following do not qualify as MPMs under IFRS 18:

- subtotals of only income or expenses;
- financial position metrics (assets, liabilities, equity);
- ratios (For example, return on equity);
- liquidity or cash flow measures (For example, free cash flow); and
- non-financial performance indicators.

These may still be communicated to the public but are outside the scope of IFRS 18 MPM requirements.

v) **Disclosure Requirements for MPMs**

The following must be disclosed in a single note to the financial statements:

- a statement that the MPM reflects management's view of financial performance;
- a warning that MPMs may not be comparable across entities;
- a clear label (e.g., "Adjusted Operating Profit");
- the specific items added to or subtracted from IFRS-defined figures;
- the method used to determine the income tax effect of adjustments;
- a reconciliation between the MPM and the most directly comparable IFRS subtotal; and
- comparative reconciliation for the previous reporting period.

c) **Aggregation and Disaggregation Requirements**

IFRS 18 provides principles for determining the appropriate level of detail in financial statements.

Key Provisions

- Items must be aggregated or disaggregated to ensure that financial statements provide useful, structured summaries.
- Line items should be clearly presented in the primary financial statements when material.
- In the notes, information should be grouped or broken down to enhance clarity but must not obscure material details.
- The presentation of operating expenses must follow enhanced guidance, including disclosing specified expenses by nature and providing further detail on grouped items.

Components of Financial Statements

i) Primary financial statements

The primary financial statements required under IFRS 18 are:

- the statement of financial position;
- the statement of profit or loss;
- the statement of comprehensive income;
- the statement of changes in equity; and
- the statement of cash flows.

ii) Secondary Financial Statement

The notes to the financial statements are considered secondary. They provide essential explanatory information and support the figures presented in the primary statements.

Classification of Income and Expenses and Subtotals in the Statement of Profit or Loss

IFRS 18 requires companies to:

- classify income and expenses into five categories: operating, investing, financing, income taxes, and discontinued operations.
- present two new defined subtotals in the statement of profit or loss:
 - operating profit
 - profit before financing and income taxes

These subtotals enhance consistency and comparability but do not require subtotals for the investing or financing categories as found in the statement of cash flows.

a) **Presentation of Expenses: Nature vs. Function**

IFRS 18 permits companies to present expenses by nature or function:

- Nature of expenses refers to classification based on the type of resource consumed, such as raw materials, labour, depreciation, electricity, and advertising.
- Function of expenses groups expenses by business activities, such as cost of sales, distribution costs, and administrative expenses.

A company may use one approach consistently or apply a mixed approach, using the nature of expenses in some areas and the function of expenses in others, if this better reflects the entity's operations. For example, a manufacturing company might choose to present expenses, such as raw materials, labour, and production overheads by nature.

b) **Flexibility for Industry-Specific Presentations**

IFRS 18 allows entities, such as banks, insurance companies, and property investment firms to adapt their profit or loss presentation according to the nature of their main business activities. This ensures that their financial statements more accurately reflect the nature of their operations.

c) IFRS 18 Categories in the statement of profit or loss

IFRS 18 classifies income and expenses into five categories:

1. operating category;
2. investing category;
3. financing category;
4. income taxes category; and
5. discontinued operations category.

i) Operating category

This is the default category for income and expenses not classified under the other four. It includes:

- income from the main business activities; and
- other income and expenses that do not meet the criteria for investing, financing, income taxes, or discontinued operations.

Note: The operating category is not limited to recurring activities. It reflects all results of operations that are not investing or financing in nature.

ii) Investing category

This category helps users evaluate returns from standalone investments, separate from core business operations. It includes:

- income from investment properties, dividends, and interest on bonds;
- gains or losses from investments in associates, joint ventures, or unconsolidated subsidiaries; and
- income from cash and cash equivalents.

iii) Financing category

This includes income and expenses from liabilities arising from pure financing activities, such as:

- interest on bank loans, bonds, and other borrowings; and
- interest expenses on leases and pension liabilities.

The financing category supports the presentation of the subtotal:

"Profit before financing and income taxes", which allows investors to assess performance excluding the impact of financing decisions.

iv) Income taxes category

This includes:

- current and deferred tax expenses (or income) as determined under IAS 12; and
- any foreign exchange differences related to income tax.

v) Discontinued operations category

This includes income and expenses from operations classified as discontinued under IFRS 5. It represents results of business segments that have been disposed of or are held for sale.

Special Classification Rules for Companies with Specific Main Activities

IFRS 18 recognises that certain entities, banks, insurance companies, and property companies, engage in investing or financing activities as part of their core

operations. As such, they are required to classify those activities under the operating category.

This approach improves financial reporting by allowing the statements to reflect the true nature of the business, improving investor decision-making and supporting resilient capital markets.

Banks

Banks generate operating income from:

- interest on loans and deposits;
- fees and commissions from financial services; and
- gains on trading securities.

Their operating expenses may include:

- interest on deposits and borrowings;
- provisions for loan losses; and
- day-to-day operating costs.

For banks, income and expenses typically classified as financing in other entities fall under operating. Therefore, banks often do not present the "profit before financing and income taxes" subtotal.

Insurance companies

Operating income includes:

- premiums from insurance contracts;
- investment income on assets backing liabilities; and
- gains on asset disposals.

Operating expenses include:

- claims paid;
- commission and brokerage fees;
- operating costs; and
- changes in insurance liabilities.

These companies often reclassify items normally under investing or financing to the operating category.

Property companies

Operating income includes:

- rental income;
- property management fees; and
- gains on property disposals.

Operating expenses include:

- property maintenance costs;
- property taxes; and
- other ownership-related expenses.

These income and expenses would typically be investing, but are classified as operating for property companies.

13.9.3 Structure and line items in the statement of profit or loss and other comprehensive income

(For entities without specified main business activities)

a) Operating Category

- Revenue
- Cost of sales
- Gross profit
- Other operating income
- Selling expenses
- Research and development expenses
- General and administrative expenses
- Goodwill impairment loss
- Other operating expenses

Subtotal: operating profit

(= Total of operating category items)

b) Investing Category

- Share of profit and gains on disposal of associates and joint ventures
- Rental income from investment property
- Dividends from investments in other companies
- Income from bonds

Subtotal: profit before financing and income taxes

(= operating profit + investing income)

c) Financing category

- Interest expense on borrowings
- Interest expense on lease liabilities
- Interest expense on pension liabilities and provisions

Subtotal: profit before income taxes

(= operating + investing – financing expenses)

- Income tax expense

d) Profit from continuing operations

(= profit before income taxes – income tax expense)

- Loss from discontinued operations (*if applicable*)

e) Profit for the period

f) Other comprehensive income

- Items such as revaluation of non-current assets

Note: At this level of examination, candidates are typically not tested on discontinued operations or items of other comprehensive income except revaluation of non current assets.

13.9.4 Statement of financial position: line items

Note: The format remains unchanged from IAS 1.

a) Assets

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

b) Equity and Liabilities

- Issued capital and reserves
- Non-controlling interests (within equity)
- Financial liabilities
- Provisions
- Trade and other payables

Statement of Changes in Equity

The structure of the Statement of Changes in Equity follows IAS 1 and includes:

- a) Total comprehensive income, showing separately:
 - Amount attributable to owners of the parent
 - Amount attributable to non-controlling interests
- b) Effects of retrospective adjustments:
 - Changes in accounting policies
 - Correction of prior period errors
- c) Separate disclosure of changes arising from:
 - Profit or Loss
 - Other Comprehensive Income
 - Distributions to owners (For example, dividends)
 - Contributions from owners (For example, issuance of new shares)
- d) Reconciliation of the opening and closing balances of each component of equity

13.9.5 Effect of IFRS 18 on IAS 7 – Statement of Cash Flows

Due to changes introduced by IFRS 18 in the structure of the statement of profit or loss, the classification of dividends and interest in the statement of cash flows is amended as follows:

- Dividends paid and interest paid are now generally required to be classified as cash flows from financing activities
- Dividends received and interest received are now generally required to be classified as cash flows from investing activities

Note: The previous treatment under IAS 7, which permitted these items to be classified under operating activities, is no longer allowed.

13.10 Chapter review

Chapter review

Before moving to the next chapter, check that you are now able to:

- a. prepare a simple statement of financial position in accordance with the guidance in IAS 1 from data and information provided;
- b. prepare a simple statement of profit or loss in accordance with the guidance in IAS 1 from data and information provided;
- c. account for taxation expense;
- d. account for share issues;
- e. accounting for changes in policies and estimates - IAS 8; and
- f. understand the presentation and disclosure requirements of IFRS 18.

13.11 End of chapter questions and suggested solutions

Question 1

IFAC recommends a standard that provides guidance on how companies should select and apply accounting policies, account for changes in those policies or in accounting estimates, and correct prior period errors.

Required:

- a. In accordance with IAS 8, explain what is meant by material prior period error.
- b. Explain the causes of material prior period error and how such an error should be corrected.
- c. List the disclosure which must be made when a material prior period error is corrected

Suggested solution

a. **Material Prior Period Error (IAS 8)**

Explanation of what is material prior error.

According to IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors, a prior period error is an omission from or a misstatement in an entity's financial statements for one or more prior periods that is discovered in the current period. A material prior period error is one that is significant enough to impact the accuracy and reliability of financial statements.

b. **Causes of Material Prior Period Errors**

i. Material prior period errors can arise from various sources, including:

- Mathematical mistakes: Errors in calculations or arithmetic.
- Misinterpretation of accounting standards: Incorrect application or understanding of accounting principles.

- Omissions: Failure to record or disclose transactions or events.
- Fraud: Intentional misrepresentation or manipulation of financial information.

ii. Correction of Material Prior Period Errors

To correct a material prior period error, an entity should:

- Retrospectively restate the financial statements for the prior period(s) in which the error occurred.
- Adjust the opening balance of retained earnings for the earliest period presented.
- Disclose the nature of the error and the amount of the correction.

c. Disclosure Requirements

When correcting a material prior period error, an entity must disclose the following:

- Nature of the prior period error: A description of the error and how it was corrected.
- Amount of the correction: The amount of the correction for each financial statement line item affected.
- Impact on earnings per share: The effect of the correction on earnings per share (if applicable).
- Opening balance adjustment: The adjustment to the opening balance of retained earnings.
- Reason for the correction: An explanation of why the error was not detected earlier.

Question 2

The following information relates to XYZ Ltd for the year ended 31 December 20X5:

Item	£000
Revenue	25,000
Cost of sales	15,000
Distribution costs	3,000
Administrative expenses	2,500
Other income	200
Finance costs	500
Taxation expense	1,200
Share capital	5,000
Retained earnings (opening)	4,500
Property, plant & equipment (net)	10,000
Inventories	2,000
Trade receivables	3,300
Trade payables	2,300
Bank overdraft	500

Required:

- Prepare a statement of profit or loss for the year ended 31 December 20X5.
- Prepare a statement of financial position as at 31 December 20X5.

Suggested solution

a) XYZ Ltd Statement of Profit or Loss for the year ended 31 December 20X5

XYZ Ltd	₦000
Revenue	25,000
Cost of sales	(15,000)
Gross profit	10,000
Other income	200
Distribution costs	(3,000)
Administrative expenses	(2,500)
Finance costs	(500)
Profit before tax	4,200
Taxation expense	(1,200)
Profit for the year	3,000

b) XYZ Ltd Statement of Financial Position as at 31 December 20X5

XYZ Ltd	₦000	₦000
Assets		
Non-current assets		
Property, plant & equipment (net)		10,000
Total non-current assets		10,000
Current assets		
Inventories		2,000
Trade receivables		3,300
Cash and cash equivalents		(500)
Total current assets		4,800
Total assets		14,800
Equity and liabilities		
Share capital		5,000
Retained earnings		7,500
Total equity		12,500
Non-current liabilities		-
Current liabilities		
Trade payables		2,300
Total current liabilities		2,300
Total liabilities		2,300
Total equity and liabilities		14,800

Note:**Workings**

1. Retained earnings	
Brought forward	4,500
For year	<u>3,000</u>
Total	<u>7,500</u>

Question 3

Excel Ltd has an issued share capital of ~~N~~4,000,000, made up of 2,000,000 ordinary shares of ~~N~~2 each, fully paid.

On 1 July 2024, the company made a 1-for-4 rights issue at ~~N~~2.50 per share. The issue was fully subscribed and paid for by existing shareholders.

Required:

(a) Calculate:

- The number of new shares issued under the rights issue.
- The total proceeds from the rights issue.
- The increase in share capital and share premium arising from the rights issue.

(b) Prepare journal entries to record the rights issue.

(c) Show the extract of the equity section of the Statement of Financial Position of Excel Ltd immediately after the rights issue.

Suggested solutions

(a) Calculations

i. Number of new shares issued:

- Rights issue is 1-for-4, so for every 4 existing shares, 1 new share is offered.
- Existing shares = 2,000,000
- New shares = $2,000,000 \div 4 = 500,000$ shares

ii. Total proceeds from the rights issue:

- Issue price per share = ~~N~~2.50
- Number of shares = 500,000
- Total proceeds = $500,000 \times \text{N}2.50 = \text{N}1,250,000$

ii. Increase in share capital and share premium:

- Nominal value of shares = ~~N~~2
- Issue price = ~~N~~2.50
- Premium per share = $\text{N}2.50 - \text{N}2 = \text{N}0.50$

Share Capital Increase = $500,000 \times \text{N}2 = \text{N}1,000,000$

Share Premium Increase = $500,000 \times \text{N}0.50 = \text{N}250,000$

(b) Journal Entries to Record the Rights Issue

	Dr (N)	Cr (N)
1. Bank	1,250,000	
Application		1,250,000
To record money received from rights issue		
2. Application	1,250,000	
Ordinary share capital		1,000,000
Share premium		250,000
To record the transfer of application money to ordinary share capital and share premium		

(c) Extract from the Statement of Financial Position (Equity Section)

Excel Ltd – Equity Section after Rights Issue

As at 1 July 2024

Equity

Share Capital (2,500,000 shares @ N2) ~~N5,000,000~~

Share Premium ~~N250,000~~

Total Equity **N5,250,000**

PREPARATION OF PARTNERSHIP ACCOUNTS

Contents

- 14.0 Learning objective
- 14.1 Learning outcomes
- 14.2 Features of partnerships
- 14.3 Sharing the profits between the partners
- 14.4 Changes in partnerships
- 14.5 Chapter review
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14. Preparation of Partnership Accounts

14.0 Learning objectives

This chapter explains aspects of partnership accounts.

14.1 Learning outcomes

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

- a. describe the main features of a partnership;
prepare partners' current and capital accounts;
- b. account for partners' shares of profit at the end of a period; and
- c. account for changes in a partnership.

14.2 Features Of Partnerships

14.2.1 Partnerships

A partnership is a type of business structure.

Definition: Partnership

The relation which subsists between persons carrying on a business in common with a view of profit.

The partners are carrying on a business in common with a view to making a profit.

Partnerships in Nigeria are subject to rules set out in UK Partnership Act 1890.

The partnership deed

The Partnership Act 1890 provides certain rules to be observed in the absence of any agreement among partners. However, the circumstances must determine whether these rules are applicable in the particular case.

The Partnership Act 1890 provides, among other things, that:

- (a) All profits and losses are to be shared equally between the partners;
- (b) No interest is allowed on capital and current accounts;
- (c) No remuneration will be paid to a partner; and
- (d) Any advance or loan made by a partner in excess of his agreed share of capital will attract interest at 5% per annum.

Note that in 2011 the Lagos state government amended the Act for use in Lagos.

Persons who have entered into partnership with one another are called individually **partners** and collectively a **firm** and the name under which their business is carried on is called the **firm name**.

Features of a partnership

There must be an association of two or more persons to carry on a business.

There must be an agreement entered into by all the persons concerned.

The agreement must be to share the profits of a business.

The business must be carried on by all or any of the persons concerned acting for all.

Change in partners

The composition of a partnership might change on occasion with new partners being admitted or an existing partner leaving or through two separate partnerships amalgamating into a single new partnership.

Sometimes a partnership might dissolve (known as dissolution of the partnership) Later sections explain the accounting treatment to reflect these events.

14.2.2 Partnership accounts

Partnership accounts are the financial accounts of a partnership business.

The financial statements of partnerships are the same as those of a sole proprietor with the exception of capital. The major difference between a partnership and a sole proprietor business is that a partnership has several joint owners.

Ownership is reflected in the capital of a business so whereas there is a single capital account in the statement of financial position of a sole proprietor the capital section of the statement of financial position of a partnership must reflect the fact that there is more than one owner.

The accounts of the partnership must record the capital and profits that are attributable to each individual partner.

The profit of a sole proprietor is simply added to the capital balance brought forward. In the case of a partnership the profit belongs to the partners so there must be a mechanism by which this is shared. Partners' shares are then added to their personal capital accounts.

14.2.3 Partners' capital

Each partner contributes capital to the business and shares in the profit (or loss) of the business. The capital of each partner must be identified separately.

The capital of each partner is usually contained in two accounts.

- Capital account
- Current account

Capital account

The partnership agreement usually specifies that each partner must contribute a minimum amount of 'fixed' capital and that partners cannot draw out any of their fixed capital.

In addition, each partner might retain some of his or her share of accumulated profits in the business. The partnership agreement should allow partners to draw out their share of accumulated profits, if they wish to do so.

The capital account records the fixed capital or long-term capital of the partner that the partner must retain in the business and cannot take out in drawings.

The balance on this account does not change very often.

Current account

A current account is used to record the accumulated profits of the partner and the partner's drawings.

- The profits of the business are shared between the partners. The share of each partner is credited to (added to) his or her current account.
- Each partner may take drawings out of the business. Drawings are a withdrawal of profit. These are recorded by debiting the current account of the partner (and crediting the Bank account).

Illustration: Partner X: current account

Partner X: current account	₦
Opening balance	X
Partner's share of profit for the year	X
Drawings by the partner during the year	(X)
Closing balance	X

14.3 Sharing The Profits Between The Partners

14.3.1 Profit-sharing ratio

The profit or loss for the financial period is calculated according to the normal rules (as described already for a sole trader). This total profit or loss figure is then divided between the partners and credited to their current account.

The partners are free to decide on how the profit (or loss) of the partnership is shared between the partners. The profit sharing arrangements are set out in the partnership agreement.

- The profit for the period might be shared in agreed profit sharing ratio. This is sometimes abbreviated as PSR. (The term profit sharing ratio covers the sharing of both profit and loss).
- Alternatively, there might be other means of allocating a first share of profit with the residual profit being shared in the agreed profit sharing ratio. Methods of allocating a first share of profit include:
- Notional salaries;
- Notional interest on long term capital.

The first example shows the use of a profit sharing ratio without any other method of allocating a first share of profit.

Example:

The WXY Partnership has three partners, W, X and Y, who share profits and losses in an agreed ratio of 3:5:8. (Profit is divided into 16 parts {3+5+8} and W, X and Y receives 3 parts, 5 parts and 8 parts respectively).

Profits for the year were ₦1,920,000.

The total profits are divided between the partners as follows:

Partner		₦
W	₦1,920,000 × 3/16	360,000
X	₦1,920,000 × 5/16	600,000
Y	₦1,920,000 × 8/16	960,000
		1,920,000

This might be recorded using an appropriation account.

The profit would first be transferred into the appropriation account:

Illustration:		
	Debit	Credit
Statement of comprehensive income account	1,920,000	
Appropriation account		1,920,000

The profit would then be transferred from the appropriation account to the partners' current accounts:

Illustration:		
	Debit	Credit
Appropriation account	1,920,000	
Partner W's current account		360,000
Partner X's current account		600,000
Partner Y's current account		960,000

14.3.2 Notional salaries for partners

A partnership agreement might recognise the different amount of work done by partners by awarding one or more of the partners with a notional salary.

A notional salary is an agreed amount awarded to the individual partner from the partnership profits.

Note that a notional salary is not a business expense in the same way that salary to employees is. It is a share of the partnership profits.

Also note that notional salary may not be paid to a partner in the same way that salary is paid to employees. A partner takes cash out of the business through drawings.

The salary is awarded to each partner from the profits, and the residual profit after deduction of notional salaries is then divided between the partners in the agreed profit-sharing ratio.

Example:

The PQR Partnership has three partners, P, Q and R.

The partnership agreement provides for the residual profit (or loss) to be shared between them in the ratio 4:3:2, after allowing a notional salary of ₦30,000 to R.

The profit for the year is ₦345,000.

Residual profits = ₦345,000 – ₦30,000 = ₦315,000.

Profits are shared as follows:

	Total ₦	P ₦	Q ₦	R ₦
Notional salary	30,000			30,000
Residual profit:				
P share $\text{₦}315,000 \times \frac{4}{9}$	140,000	140,000		
Q share $\text{₦}315,000 \times \frac{3}{9}$	105,000		105,000	
R share $\text{₦}315,000 \times \frac{2}{9}$	70,000			70,000
	<u>315,000</u>			
Profit share	345,000	140,000	105,000	100,000

The profit share of each partner is added to the balance on their individual current accounts.

Practice question**1**

A, B and C are in partnership sharing profits and losses in the ratio of 2:2:1.

B is allowed a salary of ₦100,000 per annum and C is allowed a salary of ₦150,000 per annum.

The net profit for year was ₦1,000,000.

Show how profit should be shared between the partners.

14.3.3 Notional interest on long-term capital

The partnership agreement might provide for the partners to obtain notional interest on the long-term capital they have invested in the business. This is interest on the balance in their capital account.

Notional interest on long-term capital is not interest expense, because the capital in the partners' capital account is equity, not a liability of the business.

The notional interest is a share of the partnership profits. Like notional salaries, the notional interest is awarded to each partner in accordance with the partnership agreement.

The residual profit shared between the partners in the profit-sharing ratio is the profit after notional salaries and notional interest on capital are deducted.

Example:

Partnership DEF has three partners, D, E and F.

Partner D has contributed ₦100,000 of fixed capital, Partner E ₦120,000 and Partner F ₦60,000.

They have agreed to share profits in the following way.

1. Partner D to receive a salary of ₦4,000 and Partner F a salary of ₦7,000.
2. All three partners receive interest at 5% on the fixed capital contributed.
3. Residual profit or loss to be shared between D, E and F in the ratio 3:5:2. The profit of the partnership for the year is ₦95,000.

The partnership profits would be shared between the partners as follows:

		Profit share			
		Total	D	E	F
		₦	₦	₦	₦
Notional salary		11,000	4,000		7,000
Notional interest at 5%		14,000	5,000	6,000	3,000
Residual profit (balance):					
Dshare	₦70,000 $\frac{3}{10}$	21,000	21,000		
Eshare	₦70,000 $\frac{5}{10}$	35,000		35,000	
Fshare	₦70,000 $\frac{2}{10}$	14,000			14,000
		70,000			
Profit share		95,000	30,000	41,000	24,000

Practice question**2**

G, H and I are in partnership.

The profit of the partnership for the year is ₦1,146,000.

Partner G has contributed ₦500,000 of fixed capital, Partner H ₦400,000 and Partner I ₦300,000.

The partners have agreed to share profits in the following way.

- 1 Partner H should receive a salary of ₦50,000 and Partner I a salary of ₦100,000.
- 2 All three partners should receive interest at 8% on the fixed capital contributed.
- 3 Residual profit (or losses) should be shared between G, H and I in the ratio 3: 2:1.

Show how the partnership profits should be shared between the partners

14.3.4 Guaranteed minimum profit share

A partnership agreement might guarantee a minimum profit share for one (or more) of the partners.

In these cases:

- The partnership profits are shared according to the partnership agreement, ignoring the minimum profit agreement.
- If the normal sharing mechanism does not result in a partner receiving the minimum guaranteed profit the other partners must make up the shortfall out of their profit share, in their profit-sharing ratio.

Example:

The XYZ Partnership has three partners, X, Y and Z.

The partnership agreement provides for Partner X to receive a notional salary of ₦20,000 and residual profits or losses are shared between X, Y and Z in the ratio 2:4:6.

In addition, the agreement guarantees a minimum profit share of ₦32,000 to Partner Y.

The partnership profit for the current year is ₦80,000.

The partnership profits would be shared between the partners as follows:

	Total	X	Y	Z
	₦	₦	₦	₦
Notional salary	20,000	20,000		
Residual profit (balance)				
Xshare ~~₦60,000~~ $\frac{2}{12}$	10,000	10,000		
Yshare ~~₦60,000~~ $\frac{4}{12}$	20,000		20,000	
Zshare ~~₦60,000~~ $\frac{6}{12}$	30,000			30,000
	60,000			
	80,000	30,000	20,000	30,000
Transfer to meet shortfall:				
Xshare ~~₦12,000~~ $\frac{2}{8}$		(3,000)	3,000	
Zshare ~~₦12,000~~ $\frac{6}{8}$			9,000	(9,000)
			12,000	
Profit share	~~80,000~~	~~27,000~~	~~32,000~~	~~21,000~~

14.3.5 Changes in the partnership agreement on profit – sharing

The agreement on how the partners should share the profits of the business may be changed during a financial year. When this happens, the total profits for the year should be apportioned, on a time basis, between:

- profits of the business during the time of the 'old' profit-sharing arrangements, and
- profits of the business during the time of the 'new' profit-sharing arrangements.

The profits for each time period are then shared between the partners in accordance with the agreement for that period.

Example:

The DEF Partnership has three partners, D, E and F.

In the first half of year 1, to 30 June Year 1, Partner D and Partner F each received an annual salary of ₦30,000.

Residual profits or losses are shared between D, E and F in the ratio 3:5:2. (There is no interest on capital).

In the second half of the year, from July 1, to December 31, Partner D's salary was increased to ₦40,000, and the partners altered the profit-sharing ratio to 1:3:1 for D:E:F). The salary of Partner F was unchanged at ₦30,000 per year.

The profit for the year was ₦220,000 (arising evenly throughout the year).

The annual profit would be shared as follows:

		Total	D	E	F
First six months		₦	₦	₦	₦
Notional salary (6 months)		30,000	15,000		15,000
Residual profit (balance)					
Dshare	~~₦80,000~~ 3/10	24,000	24,000		
Eshare	~~₦80,000~~ 5/10	40,000		40,000	
Fshare	~~₦80,000~~ 2/10	16,000			16,000
		80,000			
		110,000	39,000	40,000	31,000
Second six months					
Notional salary (6 months)		35,000	20,000		15,000
Residual profit (balance)					
Dshare	~~₦75,000~~ 1/5	15,000	15,000		
Eshare	~~₦75,000~~ 3/5	45,000		45,000	
Fshare	~~₦75,000~~ 1/5	15,000			15,000
		75,000			
		110,000	35,000	45,000	30,000
Total for the year		220,000	74,000	85,000	61,000

14.3.6 Profits, drawings and the partners' current accounts

For each partner, the share of the annual profit is added to the partner's current account. Any drawings during the year are deducted.

Example:

There are three partners in the ABC Partnership, A, B and C. The capital and current accounts of the partners at the beginning of the year were as follows:

Partner	Capital account (N)	Current account (N)
A	100,000	6,000
B	200,000	3,000
C	160,000	8,000

The profit for the year was N103,000.

Profit sharing agreement:

Partner A is given a salary of N17,000 and Partner C has a salary of N15,000

The partners pay themselves interest on capital at 5% per year

The residual profit or loss is shared between A, B and C in the ratio 1:3:2.

During the year, drawings by each partner were:

A	~~N~~ 20,000
B	~~N~~ 25,000
C	~~N~~ 40,000

The profit share is as follows:

	Total N	A N	B N	C N
Notional salary	32,000	17,000		15,000
Notional interest at 5%	23,000	5,000	10,000	8,000
Residual profit (balance)				
A share ~~N~~ 48,000 x 1/6	8,000	8,000		
B share ~~N~~ 48,000 x 3/6	24,000		24,000	
C share ~~N~~ 48,000 x 2/6	16,000			16,000
	48,000			
Profit share	103,000	30,000	34,000	39,000

Example (continued):

The partners' capital accounts are the same at the end of the year as at the beginning of the year.

The current accounts are as follows (all amounts in ₦000):

	A	B	C		A	B	C
				Current accounts			
				Balance b/d	6	3	8
Drawings	20	25	40	Profit share	30	34	39
Balance c/d	16	12	7				
	36	37	47		36	37	47
				Balance b/d	16	12	7

The current accounts can also be set out in columnar form as follows:

Current accounts	Partner A	Partner B	Partner C
	₦	₦	₦
Beginning of the year	6,000	3,000	8,000
Add share of profit	30,000	34,000	39,000
	36,000	37,000	47,000
Deduct drawings	(20,000)	(25,000)	(40,000)
End of the year	16,000	12,000	7,000

Practice question**3**

X, Y and Z are in partnership.

Partner	Capital account at The start of the year	Current account at the start of the year	Drawings during the year
	₦	₦	₦
X	1,000,000	20,000	780,000
Y	800,000	50,000	580,000
Z	600,000	10,000	350,000

The profit for the year was ₦1,944,000.

Profits are shared as follows:

- The partners pay themselves interest on capital at 6% per year.
- The residual profit or loss is shared between X, Y and Z in the ratio 4:3:2.

Required:

- Show how the profits should be shared between the partners.
- Show their capital and current accounts as at the end of the year.

14.4 Changes In Partnerships

14.4.1 Introduction

A partnership may change due to one of the following:

- Admission of a new partner to the firm.
- Death or retirement of a partner
- Amalgamation of a partnership with another business (maybe a sole proprietor or another partnership).

The accounting problems are similar in each case (though amalgamation does have an extra dimension which will be discussed later).

In each case the old partnership comes to an end and a new partnership is formed. Usually the records of the old partnership continue as those of the new partnership with adjustments to reflect the change of ownership.

The main objective of these adjustments is to establish the capital of each partner in the old partnership. This is important in each of the above cases.

Case

Admission of a new partner

The existing partners will want the new partner to introduce a share of capital.

The size of the amount of capital the new partner must introduce depends on the existing capital of the business.

Retirement (or death) of an existing partner

The retiring partner will want to withdraw his capital so this must be measured at the date of retirement.

A deceased partner's capital must be paid to his estate so that his family or other beneficiaries may benefit.

Amalgamation

It is important to establish the capital worth of each partner in the new business; to show what each partner is bringing to

the new business.

This may sound straight forward as capital and current accounts already exist.

However, the balance on the accounts is the partners' share of the net assets of the firm as recorded in the statement of financial position. The statement of financial position is a list of assets and liabilities, not a statement of value.

The assets of the business will be stated at cost. This may be very different to their value at the date of the change in partnership.

Illustration:

A, B and C were in partnership sharing profits or losses equally.

The firm bought a plot of land in 2001 for ₦2,500,000.

A left the partnership on 30 June 2019.

The land was worth ₦4,000,000 at that date. (This is known as its fair value).

The land has risen in value by ₦1,500,000 but this is not reflected in the financial statements. This means that A's capital does not include his share of the gain but clearly ₦500,000 of the gain belongs to him.

Some how the extra amount must be accounted for so that A can benefit from this.

The firm's net assets are not the same as the value of the firm and each partner will be more concerned with this latter figure.

Illustration:

A, B and C were in partnership sharing profits or losses equally.

A left the partnership on June 30, 2019.

At this date the net assets of the firm were ₦6,000,000. The value of the firm was estimated at ₦9,000,000. (The difference of ₦3,000,000 is called goodwill and this will be explained shortly).

A's share of the net assets might be 2,000,000 but his share of the value of the firm is ₦3,000,000.

Somehow the extra amount must be accounted for so that A can benefit from this.

The solution to the above problems is as follows:

- The net assets must be revalued so that the partners share in any adjustment; and
- The difference between the value of the firm and the net assets of the firm (goodwill) must be recognised.

14.4.2 Goodwill

Goodwill is the amount by which the value of a business exceeds the value of all its net assets (its assets less liabilities).

Goodwill is an intangible asset of a business, but normally it is not recognised as an asset in the financial statements.

The value of a business is usually more than the net assets of the business because it reflects the trading potential that the business possesses, i.e. its ability to generate profits in the future. All successful businesses have goodwill, which means that buyers will be prepared to pay more to acquire the business than the value of its net assets.

Illustration: Goodwill

Value of the firm (what another party would pay for it)	X
Assets less liabilities of the firm (net assets)	(X)
Goodwill	<u>X</u>

Strictly speaking the assets and liabilities of the firm should be restated to their fair value in order to measure goodwill. Fair value is a very important concept in financial reporting but that is beyond the scope of this syllabus. For the purposes of this chapter it is sufficient to think of it as the market value of an asset, that is, how much it is worth.

Example:

A firm has net assets of ₦1,000,000.

One of the assets held by the firm is a property at cost less accumulated depreciation of ₦400,000. This property has a market value of ₦600,000 (₦200,000 above its book value).

The firm is valued at ₦1,800,000.

Goodwill calculation:

	Without revaluing the asset	With revaluation of the asset
Value of the firm		
Assets less liabilities as per the accounts	1,800,000	1,800,000
Assets less liabilities (at fair value) 1,000,000 + 200)	(1,000,000)	(1,200,000)

Goodwill	<u>800.000</u>	<u>600.000</u>

Amount shared by the partners:

Goodwill	800.000	600.000
Revaluation gain		200,000
Amount shared by the partners in the profit sharing ratio:	<u>800.000</u>	<u>800.000</u>

In the above example the figure of ~~N~~600,000 for goodwill is the value that most closely fits the guidance given in IFRS. However, for the purpose of measuring adjustments to partners' capital at a time of change the example demonstrates that whether the net assets are revalued or not might be irrelevant as the overall gain to each partner is not affected.

The above example implies that there may be no point in revaluing assets in questions involving change. This is not true because questions on this topic usually provide the goodwill figure and revaluation rather than the value of the firm.

Valuing goodwill

The method of arriving at total value of the firm might be based on a formula set out in the partnership agreement.

Example:

The XYZ Partnership has an agreed method to value the firm for purposes of change in partnership as 10 times the average annual profit for the last three years for which financial statements are available.

Profit for the last three years has been as follows:

Year 3	~~N~~ 100,000
Year 2	~~N~~ 90,000
Year 1	~~N~~ 80,000

The average annual profit is: $100,000 + 90,000 + 80,000 / 3 = \text{N}90,000$

The valuation of the firm is: $10 \times \text{N}90,000 = \text{N}900,000$

Alternatively, a partnership agreement might specify a method for valuing goodwill directly. One such method is measuring goodwill as a multiple of average annual profits or a multiple of its average annual 'excess' profits.

Example:

The XYZ Partnership values its goodwill as two times the average of the annual profits in excess of ~~N~~60,000 each year for the last three years.

Profit for the last three years has been as follows:

Year 3	~~N~~ 100,000
Year 2	~~N~~ 90,000
Year 1	~~N~~ 80,000

The profits in excess of ~~N~~60,000 have been:

$$\text{N}40,000 + \text{N}30,000 + \text{N}20,000 = \text{N}90,000$$

The average annual excess profit is: $\text{N}90,000 / 3 = \text{N}30,000$ The

valuation of goodwill is: $2 \times \text{N}30,000 = \text{N}60,000$

It is very unlikely that you will have to calculate goodwill in this exam but you will have to account for it.

14.4.3 Accounting for a change in partnership

As previously stated, the old partnership comes to an end and a new partnership begins but the records of the old partnership continue as those of the new partnership with adjustments to reflect the change of ownership.

The adjustments aim to establish each partner's share of the worth of the firm in the old partnership. This is done by recognising goodwill and any revaluation gains (or losses).

Illustration: Journal to recognise goodwill of old partnership

	Debit	Credit
Goodwill	X	
Partners' capital (in old partnership profit sharing ratio)		X
Being: Recognition of goodwill prior to a change in partnership		

The goodwill figure is not usually retained in the accounts after the change in the partnership. It is removed as follows:

Illustration: Journal store move goodwill from books of the new partnership

	Debit	Credit
Partners' capital (in new partnership profit sharing ratio)	X	
Goodwill		X
Being: Removal of goodwill after a change in partnership		

Similar entries to those necessary to record goodwill might also be required to recognise revaluation of a specific asset.

Other entries will involve the recognition of capital introduced by a new partner or the removal of capital by a retiring partner or taken on behalf of a deceased partner.

14.4.4 Admitting a new partner

When a new partner is admitted to a partnership the following steps are required when accounting for this admission:

Steps	Detail
1	Measure goodwill of the old partnership (this figure will usually be given to you).
2	Recognise goodwill sharing the credit entry to the partners of the old partnership in the old profit sharing ratio.
3	Remove the goodwill in the books of the new partnership sharing the debit entry to the partners of the new partnership in the new profit sharing ratio.
4	Account for capital introduced by the new partner.

Example:

R and S are in partnership sharing profits or losses equally.

R has ~~N~~80,000 of capital and S has contributed ~~N~~60,000 of capital.

T is to be admitted to the partnership and will introduce capital of ~~N~~50,000. Profits or losses are to be shared in the new partnership in the ratio of 2:2:1.

Step 1: The goodwill of the partnership at the date of admission is agreed to be ~~N~~30,000.

Step 2: Recognise goodwill

	Debit	Credit
Goodwill	30,000	
Capital – Partner R ($\frac{1}{2}$ of 30,000)		15,000
Capital – Partner S ($\frac{1}{2}$ of 30,000)		15,000

Goodwill account (~~N~~ 000)	
Capital accounts	30

Capital accounts (N000)							
	R	S	T		R	S	T
				Balanceb/d	80	60	
				Goodwill	15	15	

Step 3: Remove the goodwill

	Debit	Credit
Capital – Partner R ($\frac{2}{5}$ of 30,000)	12,000	
Capital – Partner S ($\frac{2}{5}$ of 30,000)	12,000	
Capital – Partner T ($\frac{1}{5}$ of 30,000)	6,000	
Goodwill		30,000

Goodwill account (~~N~~ 000)	
Capital accounts	30

Capital accounts	
	30

Capital accounts(~~N~~ 000)							
	R	S	T		R	S	T
Balance b/d					80	60	
Goodwill	12	12	6		15	15	

Step 4: Recognise new partner's capital introduced

	Debit	Credit
Cash	50,000	
Capital – Partner T		50,000

Example (continued)

The capital accounts now look like this:

Capital accounts (N000)

	R	S	T		R	S	T
				Balance b/d	80	60	
Goodwill	12	12	6	Goodwill	15	15	
				Cash			50
Balance c/d	83	63	44				
	95	75	50		95	75	50
				Balance b/d	83	63	44

Note that the balance on partner T's capital account is only ~~N44,000~~ even though he has introduced ~~N50,000~~. This is because he has paid for his share of the goodwill of the business.

Practice question**4**

P and Q are in partnership sharing profits or losses in the ratio of 2:1. P has contributed ~~N600,000~~ of capital and Q has contributed ~~N500,000~~ of capital.

They are about to admit a new partner, M, to the partnership and M has agreed to pay the partnership ~~N400,000~~ of capital.

After the admission of M profits or losses will be shared between P, Q and M in the ratio of 2:2:1.

The goodwill of the partnership at the date of admission is estimated to be ~~N150,000~~.

Writeup the capital accounts of the partners to show the admission of M to the partnership.

14.4.5 Retirement or death of a partner

When a partner leaves a partnership the following steps are required when accounting for his leaving:

Steps	Detail
1	Measure goodwill of the old partnership (this figure will usually be given to you)
2	Recognise goodwill sharing the credit entry to the partners of the old
3	partnership in the old profit sharing ratio. Remove the goodwill in the books of the new partnership sharing the debit entry to the partners of the new partnership in the new profit sharing ratio.
4	Account for capital taken

Example:

P, Q and R are in partnership sharing profits or losses equally.

P has ~~N~~80,000 of capital and Q has ~~N~~60,000 of capital and R has ~~N~~75,000 of capital.

Risto retire. He will be paid cash in the amount of ~~N~~50,000 and he will leave the rest as a loan to the company.

Profits or losses are to be shared equally in the new partnership.

Step 1: The goodwill of the partnership at the date of retirement is agreed to be ~~N~~60,000.

Step 2: Recognise goodwill

	Debit	Credit
Goodwill	60,000	
Capital – Partner P (1/3 of 60,000)		20,000
Capital – Partner Q (1/3 of 60,000)		20,000
Capital – Partner R (1/3 of 60,000)		20,000

Goodwill account (~~N~~000)

Capital accounts	60

Capital accounts (~~N~~000)

P	Q	R	P	Q	R	
			Balance b/d	80	60	75
			Goodwill	20	20	20

Example (continued)**Step 3:** Remove the goodwill

	Debit	Credit
Capital – Partner P ($\frac{1}{2}$ of 60,000)	30,000	
Capital – Partner Q ($\frac{1}{2}$ of 60,000)	30,000	
Goodwill		60,000

Goodwill account (R000)

Capital accounts	60	Capital accounts	60

Capital accounts (R000)

	P	Q	R		P	Q	R
				Balance b/d	80	60	75
Goodwill	30	30		Goodwill	20	20	20

Step 4: Recognise amount paid to retiring partner and any other arrangement

	Debit	Credit
Cash	50,000	
Capital – Partner T		50,000

The capital accounts now look like this:

Capital accounts (R000)

	P	Q	R		P	Q	R
				Balance b/d	80	60	75
Goodwill	30	30		Goodwill	20	20	20
Cash			50				
Loan			45				

Balance c/d	70	50	0				
	100	80	95		100	80	95
				Balance b/d	70	50	0

Practice question**5**

J, K and L are partners sharing profits or losses and losses equally.

Capital account balances at 31 December 2019 are ₦320,000, ₦210,000 and ₦120,000.

K is to retire, leaving the amounts due to her as a loan to the partnership.

The land and buildings were revalued by ₦1,800,000 and goodwill was valued at ₦900,000.

After the change the profit share is revised to 3:1 and goodwill is not to be recorded in the books.

Show how the retirement of K should be shown in the capital accounts.

14.5 Chapter review**Chapter review**

Before moving to the next chapter, check that you are now able to:

- describe the main features of a partnership;
- prepare partners' current and capital accounts;
- account for partners' shares of profit at the end of a period; and
- account for changes in a partnership.

14.6 End of chapter questions and suggested solution**Question 1**

Elegbe and Amuda have been friends for some time and they both had different businesses as sole-traders and decided to form a partnership with effect from May 1, 2025.

Their respective financial position on April 30, 2025 is as follows:

	Elegbe ₦'000	Amuda ₦'000		Elegbe ₦'000	Amuda ₦'000
Capital	171,800	276,232	Premises	68,000	137,600
Payables	1,920	4,928	Office equipment	35,200	68,000
Loan		68,000	Inventory	1,720	7,680
			Receivables	34,600	68,880
			Cash	<u>34,200</u>	<u>67,000</u>
	<u>173,720</u>	<u>349,160</u>		<u>173,720</u>	<u>349,160</u>

For the purpose of the partnership formation, the following agreements were reached:

- Elegbe: Premises were re-valued at ₦103,200,000 and was to be used as an office annex and the equipment valued at ₦10,300,000 was counted as obsolete; some of the

customers were found unable to pay their outstanding debts therefore, ₦6,880,000 should be written-off. The payables were settled out of the bank balance; other assets were brought in at book values.

- (ii) Amuda: He agreed to acquire, out of his private resources, additional equipment costing ₦10,800,000, to pay his payables from his bank balance, repay his loan by himself and bring in his other assets at book values.

Required:

- Prepare the necessary ledger accounts to effect the amalgamation of Elegbe and Adamu businesses.
- Prepare the statement of financial position for the partnership of Elegbe and Amuda on May 1, 2025.

Suggested solution

a. Ledger accounts:

Revaluation account -Elegbe

	₦'000		₦'000
Office equipment	10,300	Premises	35,000
Bad debt written off	6,880		
Gain- capital account	<u>27,820</u>		
	<u>35,000</u>		<u>35,000</u>

Capital accounts

	₦'000	₦'000		₦'000	₦'000
Balance c/f	189,820	355,032	Balance b/f	172,000	276,232
			Loan		68,000
			Equipment- new		10,800
			Revaluation	<u>17,820</u>	
	<u>189,820</u>	<u>355,032</u>		<u>189,820</u>	<u>355,032</u>

Cash accounts

	₦'000	₦'000		₦'000	₦'000
Balance b/f	34,200	67,000	Payables	1,920	4,928
			Balance c/f	<u>32,280</u>	<u>62,072</u>
	<u>34,200</u>	<u>34,400</u>		<u>34,200</u>	<u>67,000</u>
Balance b/f	32,280	62,072			

b. Elegbe and Amuda in Partnership

Statement of financial position as at May 1, 2025

	N'000	N'000
Non-current assets:		
Premises (103,200 + 137,600)	240,800	
(35,200-10300) + (68,000 +10800)	<u>103,700</u>	
Total non-current assets		344,500
Current assets:		
Inventory (1,720 +7,680)	9,400	
Receivables (34,600 +68,880 -6,880)	96,600	
Cash (32,280+62,072)	<u>94,352</u>	
Total current assets		<u>200,352</u>
Total Assets		<u>544,852</u>
Capital:		
Elegbe		189,820
Amuda		<u>355,032</u>
Total capital		<u>544,852</u>

Question 2

X, Y, and Z are in partnership, sharing profits and losses in the ratio 2:2:1. The trial balance at the end of the year shows the following:

- Net profit for the year: ~~N~~100,000
- Drawings:
 - X: ~~N~~15,000
 - Y: ~~N~~10,000
 - Z: ~~N~~8,000
- Interest on capital is 10% per annum. The capital balances are:
 - X: ~~N~~60,000
 - Y: ~~N~~50,000
 - Z: ~~N~~40,000
- Partner Z receives a notional salary of ~~N~~12,000 per annum.

Required:

- Calculate the profit to be shared among the partners.
- Prepare the Profit Appropriation Account for the year.
- Prepare the Partners' Current Accounts as at the end of the year.

Suggested solution

a) Profit to be shared among the partners

Step 1: Calculate Interest on Capital (10% of capital)

Partner Capital (N) Interest @10% (N)

X	60,000	6,000
Y	50,000	5,000
Z	40,000	4,000
Total		15,000

Step 2: Z's Notional Salary

Z is entitled to a notional salary of N12,000.

Step 3: Calculate Residual Profit

Residual Profit = ~~N100,000~~ - (~~N15,000~~ + ~~N12,000~~) = ~~N73,000~~

Step 4: Share Residual Profit in Ratio 2:2:1

Partner Share Ratio Share of N73,000

X	2/5	~~N29,200~~
Y	2/5	~~N29,200~~
Z	1/5	~~N14,600~~

a) XYZ
Profit Appropriation Account

	N	N	N	N
Partners' Interest			Net Profit	100,000
X	6,000			
Y	5,000			
Z	<u>4,000</u>	15,000		
Z's notional Salary		12,000		
Share of residual profits				
X	29,200			
Y	29,200			
Z	<u>14,600</u>	<u>73,000</u>		
		<u>100,000</u>		<u>100,000</u>

b) Partners' current account

	X	Y	Z
	N	N	N
Partners' interest	6,000	5,000	4,000
Notional salary			12,000
Share of profit	29,200	29,200	14,600
Total	35,200	34,200	30,600

Question 3

XYZ Enterprises is a partnership of three individuals: X, Y, and Z. They have been partners for 10 years, sharing profits in the ratio 3:2:1. Z intends to retire due to health reasons. The business has grown substantially, and the partners must:

- Value goodwill, which is estimated at N60,000.
- Settle Z's account through part payment in cash and the balance as a loan.
- Reallocate profit-sharing between X and Y equally.

Required:

As the external accountant, prepare a written advisory note to the firm:

- a) Outlining the accounting steps necessary to retire Z, including treatment of goodwill.
- b) Explaining how profit-sharing will be adjusted between X and Y.
- c) Discussing how capital balances and the loan account for Z should be updated and maintained in the books.

Suggested solution

XYZ Enterprises

Partners: X, Y, Z

Old profit-sharing ratio: 3 : 2 : 1

Goodwill valuation: ₦60,000

Z retiring — profit sharing to be reallocated equally between X and Y

- a) Accounting steps necessary to retire Z, including treatment of goodwill
 - i) Measure goodwill of the partnership (given as ₦60,000).
 - ii) Recognise goodwill in the books before retirement:
 - Credit goodwill to existing partners' capital accounts in their old profit-sharing ratio (3:2:1).
 - Debit goodwill account.
 - iii) Write off goodwill after adjustment:
 - Debit goodwill to eliminate it.
 - Credit partners' capital accounts in the new profit-sharing ratio (X and Y sharing 1:1, Z out).
 - iv) Revalue assets and liabilities if necessary (not specified here, but usually done before retirement).
 - v) Settle Z's capital account:
 - Pay Z the agreed cash settlement.
 - If the balance remains, record a loan payable to Z for the remaining amount.
 - vi) Close Z's capital account after full settlement (cash + loan).
- b) Explanation of profit-sharing adjustment between X and Y
 - i) Upon Z's retirement, Z's profit share (1 part out of 6) is relinquished.
 - ii) The remaining partners X and Y agree to share profits equally ($\frac{1}{2}$ each), instead of their original 3:2 ratio.
 - iii) This means future profits/losses will be split 50% to X and 50% to Y.
 - iv) All partnership agreements and accounting records must reflect this change immediately from the date of Z's retirement.
- c) Discussion on capital balances and loan account for Z
 - i) Capital balances:
 - Z's capital account balance (including goodwill adjustments) represents the amount due to Z.
 - This amount must be calculated and separated from the partnership's net assets.
 - ii) Loan account for Z:

- If Z cannot be paid the full capital balance in cash, the unpaid balance becomes a loan payable by the partnership to Z.
- The loan account should include terms such as interest rate and repayment schedule.
- The loan is a liability of the partnership and is shown separately in the books until fully repaid.
- Z remains entitled to interest on the loan (if agreed) until full repayment.
- iii) Maintenance of capital and loan accounts:
 - Z's capital account is closed after retirement.
 - The loan account remains open and must be monitored regularly.
 - Interest expenses on the loan (if applicable) are recognised in the partnership's profit and loss.

Summary:

To retire Z fairly and in compliance with accounting standards:

- Goodwill must be recognised and written off appropriately.
- Z's capital due must be paid partly in cash and partly as a loan.
- Profit-sharing ratios are adjusted for X and Y equally.
- Proper documentation and accounting entries should record these changes clearly.

SOLUTIONS TO PRACTICE QUESTIONS

Solutions		1			
	Total	A	Profit share		C
	₦	₦	B		₦
Notional salary	100,000		100,000		
	150,000				150,000
Residual profit:					
P share					
~~₦~~ 75,000 × $\frac{2}{5}$	300,000	300,000			
Q share					
~~₦~~ 75,000 × $\frac{2}{5}$	300,000		300,000		
R share					
~~₦~~ 75,000 × $\frac{1}{5}$	150,000				150,000
	750,000				
Profit share	1,000,000	300,000	400,000		300,000

Solutions		2			
	Total	G	Profit share		I
	₦	₦	H		₦
Notional salary	150,000		50,000		100,000
Notional interest					
Fixed capital		500,000	400,000		300,000
Interest @ (8%)	96,000	40,000	32,000		24,000
Residual profit:					
G share					
~~₦~~ 900,000 × $\frac{3}{6}$	450,000	450,000			
H share					
~~₦~~ 900,000 × $\frac{2}{6}$	300,000		300,000		
I share					
~~₦~~ 900,000 × $\frac{1}{6}$	150,000				150,000
	900,000				
Profit share	~~1,146,000~~	~~490,000~~	~~382,000~~		~~274,000~~

Solutions
3

a. The profit share is as follows:

	Total ₦(000)	X ₦	Y ₦	Z ₦
Notional interest				
Fixed capital		1,000,000	800,000	600,000
Interest @ (6%)	144,000	60,000	48,000	36,000
Residual profit(balance)				
X share ₦1.8m x $\frac{4}{9}$	800,000	800,000		
Y share ₦1.8m x $\frac{3}{9}$	600,000		600,000	
Z share ₦1.8m x $\frac{2}{9}$	400,000			400,000
	1,800,000			
Profit share	1,944,000	860,000	648,000	436,000

b.

Current accounts (₦000)

	X	Y	Z		X	Y	Z
				Balance b/d	20	50	10
Drawings	780	580	350	Profit share	860	648	436
Balance c/d	100	118	96				
	880	698	446		880	698	446
				Balance b/d	100	118	96

The current accounts can also be set out in columnar form as follows:

Current accounts	Partner X ₦	Partner Y ₦	Partner Z ₦
Beginning of the year	20,000	50,000	10,000
Add share of profit	860,000	648,000	436,000
	880,000	698,000	446,000
Deduct drawings	(780,000)	(580,000)	(350,000)
End of the year	100,000	118,000	96,000

Solutions
4

Capital accounts (N000)					
	P	Q	R		
				Balance b/d	600 500
				Recognise goodwill (2:1)	100 50
Remove goodwill (2:2:1)	60	60	30		
				Cash	400
Balance c/d	640	490	370		
	700	550	400		
				Balance b/d	640 490 370

The capital accounts can also be set out in columnar form as follows:

Capital accounts	Partner P	Partner Q	Partner R
	N	N	N
Beginning of the year	600,000	500,000	
Recognise goodwill (2:1)	100,000	50,000	
Removal of goodwill (2:2:1)	(60,000)	(60,000)	(30,000)
Capital introduced			400,000
End of the year	640,000	490,000	370,000

Solutions

5

Capital accounts (N000)

	J	K	L		J	K	L
				Balance b/d	320	210	120
				Revaluation (1:1:1)	600	600	600
Remove goodwill (3:1)	675	0	225	Recognise goodwill (1:1:1)	300	300	300
Transfer to loan	0	1,110	0				
Balance c/d	545	0	795				
	<u>1,220</u>	<u>1,110</u>	<u>1,020</u>		<u>1,220</u>	<u>1,110</u>	<u>1,020</u>
				Balance b/d	545	0	795

The capital accounts can also be set out in columnar form as follows:

Capital accounts	Partner J	Partner K	Partner L
	N	N	N
Beginning of the year	320,000	210,000	120,000
Revaluation (1:1:1)	600,000	600,000	600,000
Recognise goodwill (1:1:1)	300,000	300,000	300,000
Removal of goodwill (3:1)	(675,000)	0	(225,000)
Transfer to loan	0	(1,110,000)	0
End of the year	<u>545,000</u>	<u>0</u>	<u>795,000</u>

PREPARATION OF ACCOUNTS FROM INCOMPLETE RECORDS

Contents

- 15.0 Learning objective
- 15.1 Learning outcomes
- 15.2 The nature of incomplete records
- 15.3 Techniques for incomplete records
- 15.4 chapter review
- 15.6 End of chapter questions and suggested solutions

15. Preparation of Accounts from Incomplete Records

15.0 Learning objectives

This chapter explains how financial statements and financial information might be generated when the accounting records are incomplete

15.1 Learning outcomes

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

- a. understand situations that might necessitate the preparation of accounts from incomplete records (stock or assets destroyed, cash misappropriation or lost, accounting record destroyed, etc.);
- b. use the accounting equation as an approach to producing accounting information when accounting records are incomplete;
- c. use memorandum control accounts to identify missing information; and
- d. use cost structures to identify missing information.

15.2 The Nature Of Incomplete Records

15.2.1 The meaning of incomplete records

Incomplete records, as the term suggests, are accounting records where information is missing.

Problems of incomplete records may arise with small businesses where the owner of the business has not kept up-to-date accounting records or does not have a double entry book-keeping system. He might simply keep invoices or receipts for expenses and copies of invoices to customers. In addition, details of bank transactions can be obtained from a bank statement or other banking records.

The task of the accountant is to use these invoices, receipts and banking records, together with other information obtained from the business owner, to prepare financial statements for the year (and in particular a statement of profit or loss, which provides a basis for calculating the taxable income of the business owner from his or her business).

Other circumstances that cause problems include loss of records because of some kind of disaster, for example a fire in the office.

Another scenario is where records have not been maintained because a dishonest employee has stolen cash or inventory.

Whatever the cause of the problem the accountant's task involves piecing together information that is available in order to produce a set of financial statements or to calculate missing figures.

15.2.2 Dealing with incomplete records

Questions on incomplete records are a good test of knowledge and understanding of book-keeping and accounts. The task is often to identify the missing figures that the incomplete records do not provide.

Possible approaches to establishing missing numbers include:

- ### 15.3. Techniques For Incomplete Records

The accounting equation is:

$$\begin{array}{ccccccc} \text{Assets} & = & \text{Liabilities} & + & \text{Equity} & \text{or} & \text{Assets} - \text{Liabilities} = \text{Equity} \\ A & = & L & + & E & & A - L = E \end{array}$$

Profit or loss for a period can be calculated from the difference between the opening and closing net assets after adjusting for any drawings during the period.

Increase in net assets=Profit + capital introduced – drawings

Illustration: Using the accounting equation to calculate profit

	~~N~~
Closing assets – liabilities	X
Opening assets – liabilities	X
Increase/(decrease) in net assets in the period	X
Add drawings	X
Subtract new capital introduced by the owner(s)	(X)
Balance = profit /(loss) for the year	X

Example: Using the accounting equation to calculate profit

At 1 January 2019, Tom's business had assets of ~~£~~214,000 and liabilities of ~~£~~132,000.

At 31 December 2019, the business had assets of ~~£~~281,000 and liabilities of ~~£~~166,000.

Tom took ~~£~~25,000 in cash and ~~£~~3,000 in goods out of the business during the year for his personal use. He did not introduce any new capital.

The profit of the business in the year to December 31, 2019 is calculated as follows:

	~~£~~	~~£~~
Assets at 31 December 2019		281,000
Liabilities at 31 December 2019		(166,000)
Net assets at 31 December 2019		<u>115,000</u>
Assets at 1 January 2019	214,000	
Liabilities at 1 January 2019	(132,000)	
Net assets at 1 January 2019		<u>(82,000)</u>
Increase in net assets during the year		33,000
Add: Drawings (25,000 + 3,000)		28,000
Balance = Profit /(loss) for the year		<u>61,000</u>

Alternatively the profit figure could be calculated using the equation:

Increase in net assets = Profit + Capital introduced – Drawings

~~£~~33,000 = Profit + 0 – ~~£~~28,000

Profit = ~~£~~61,000

Practice question

1

The accountant for a sole trader has established that the total assets of the business at December 31, Year 4 were ~~£~~376,000 and total liabilities were ~~£~~108,000.

Checking the previous year's financial statements, he was able to establish that at December 31, Year 3 total assets were ~~£~~314,000 and total liabilities were ~~£~~87,000.

During Year 4 the owner has taken out drawings of ~~£~~55,000.

In December 31, Year 4 the owner had been obliged to input additional capital of ~~£~~25,000.

What was the profit of the business for the year to December 31, Year 4?

Identifying missing balances

The approach can also be used to identify a missing balance at the end of a period.

Example: Missing balance

At the start of the year a business had opening capital of ~~£~~350,000.

Profit for the year was ~~£~~200,000 and the owner had taken ~~£~~120,000 as drawings. No capital was introduced in the period.

At the end of the year the company cashier disappeared with an amount of cash.

The owner was able to identify the following balances at the year end:

Property, plant and equipment	95,000
Inventory	85,000
Receivables	65,000
Liabilities	(55,000)

The missing cash balance can be calculated as follows:

Step 1: Work out what closing net assets should be:	₦
Capital (net assets) at the start	350,000
Profit for the year	200,000
Less: Drawings	(120,000)
Capital (net assets) at the end should be:	<u>430,000</u>

Step 2: Work out what closing net assets are:	₦
Property, plant and equipment	95,000
Inventory	85,000
Receivables	65,000
Liabilities	(55,000)
	<u>190,000</u>
Step 3: Identify the missing amount:	<u>240,000</u>

The cashier has stolen cash in the amount of ~~₦~~240,000.

Calculation of opening capital

It might be necessary to establish the opening capital of a sole trader. This can be done simply by obtaining figures for the assets and liabilities of the business at the beginning of the financial period.

Opening capital is the difference between total assets and total liabilities. (Non-current assets for this purpose are measured at their carrying amount, i.e. net book value.)

Example: Calculation of opening capital

A sole trader does not keep any accounting records, and you have been asked to prepare a statement of profit or loss and statement of financial position for the financial year just ended. To do this, you need to establish the opening capital of the business at the beginning of the year.

The following information about assets and liabilities at the beginning of the year is available:

Motor van (balance sheet valuation)	£ 1,600
Bank overdraft	560
Cash in hand	50
Receivables	850
Trade payables	370
Payables for other expenses	90
Inventory	410

Required

The capital of the business as at the beginning of the year can be calculated as follows:.

	£	£
Assets		
Motor van (balance sheet valuation)		1,600
Inventory		410
Receivables		850
Cash in hand		50
Total assets		<u>2,910</u>
Liabilities		
Bank overdraft	560	
Trade payables	370	
Payables for other expenses	90	
Total liabilities		<u>1,020</u>
Net assets = Capital		<u>1,890</u>

15.3.2 Memorandum control accounts

A memorandum account is an account that is not a part of a proper ledger accounting system. When there are incomplete records, a memorandum account can be used to calculate a 'missing' figure, such as a figure for sales or purchases and expenses in the period.

Calculating a missing figure for sales

The records of a sole trader might be incomplete because the trader does not keep any record of sales in the period. However, it might be possible to obtain the following figures:

- a. receivables at the beginning of the year (from last year's balancesheet);
- b. receivables at the end of the year, from copies of unpaid salesinvoices;
- c. money banked during the year (assumed to be money from customers for sales);
- d. any bad debts writtenoff.

Where a business makes some sales for cash, there might also be a figure for cash sales where the money has not been banked. The amount of these cash sales might be calculated from the sum of:

- a. the increase in cash in hand at the end of the year;plus
- b. any expenses paid in cash, for which receipts areavailable.

Example: Using memorandum control account to calculate a missing sales figure

An accountant is looking through the records of a sole trader who does not have a bookkeeping system. He has established the following information.

	₦
Receivables at the beginning of the year	650
Receivables at the end of the year	720
Bad debt written off during the year	800
Money paid into the business bank account	58,600
Cash sales where the money was not banked	300

The sales for the year can be calculated as the balancing figure in a receivables memorandum account.

Receivables memorandum account			
	₦		₦
Opening balance	650	Money banked	58,600
Sales (balancing figure, 60,420 – 650)	59,770	Cash sales, money not banked	300
		Bad debt written off	800
		Closing balance	720
	60,420		60,420

The same calculation could be presented in a vertical format, as follows:

	₦
Receivables at the beginning of the year	650
Receivables at the end of the year	720
Increase/(decrease) in receivables	70
Money paid into the business bank account	58,600
Cash sales where the money was not banked	300
Bad debt written off during the year	800
Sales for the year	59,770

Calculating a missing figure for purchase

Practice question**2**

Calculate sales for the period from the following information.

	₦
Receivables at the start of the period	2,400
Receivables at the end of the period	1,800
Cash banked during the period	12,500
Bad debt written off	200

A similar approach can be taken using knowledge of the payables control account.

Example: Using memorandum control account to calculate a missing purchases figure

An accountant is looking through the records of a sole trader who does not have a book-keeping system. He has established the following information.

	N
Payables at the beginning of the year	1,200
Payables at the end of the year	1,800
Money paid out of the business bank account to suppliers	18,700

The purchases for the year can be calculated as the balancing figure in a payables memorandum account.

Payables memorandum account

	N		N
Cash paid	18,700	Opening balance	1,200
Closing balance	1,800	Purchases (balancing figure)	19,300
	20,500		20,500

The same calculation could be presented in a vertical format, as follows:

	N
Payables at the beginning of the year	1,200
Payables at the end of the year	1,800
Increase/(decrease) in payables	600
Money paid out of the business bank account	18,700
Purchases for the year	19,300

Practice question

3

Calculate purchases for the period from the following information.

	N
Payables at the start of the period	1,400
Payables at the end of the period	1,900
Cash paid to suppliers during the period	11,300

15.3.3 Memorandum cash and bank account

A memorandum account may also be used to record transactions in cash (notes and coins) and through the bank account, in order to establish a missing figure for a cash payment or possibly a cash receipt.

You might be given figures for:

- a. cash in hand and in the bank account at the beginning of the year;
- b. cash in hand and in the bank account at the end of the year;
- c. cash receipts (cash, cheques and other forms of receiving money);
- d. payments during the period for purchases, salaries and other cash expenses.

If there is a missing figure for a cash payment, this should emerge as a balancing figure.

Note: Cash in hand consists of banknotes and coins. Often, it is just petty cash. However, some businesses hold a large amount of cash in hand because they sell goods for cash; for example, retail stores may hold fairly large quantities of cash in hand.

Example: Memorandum cash and bank account

An accountant is trying to prepare the financial statements of a sole trader from incomplete records.

A problem is that the owner of the business admits to having taken cash from the business, but he has not kept a record of how much he has taken.

The accountant has established the following information:

Cash in hand at the beginning of the year	£200
Bank balance at the beginning of the year	2,300
Cash in hand at the end of the year	500
Bank balance at the end of the year	3,500
Receipts	42,800
Payments to employees	12,800
Payments to suppliers	17,100
Payments of interest/bank charges	400

The cash drawn by the owner during the year can be calculated as follows.

Example (continued): Memorandum cash and bank account

The drawings for the year can be calculated as the balancing figure in a cash and bank memorandum account.

Cash and bank memorandum account

	₦		₦
Opening balance, cash in hand	200	Payments to suppliers	17,100
Opening balance, bank	2,300	Payments to employees	12,800
Receipts	42,800	Payments of interest/bank charges	400
		Drawings (= balancing figure)	11,000
		Closing balance, cash in hand	500
		Closing balance, bank	3,500
	<u>45,300</u>		<u>45,300</u>

The same calculation could be presented in a vertical format, as follows:

	₦	₦
Cash in hand and bank at the beginning of the year		2,500
Receipts during the year		<u>42,800</u>
		45,300
Payments to suppliers	17,100	
Payments to employees	12,800	
Payments for interest/bank charges	<u>400</u>	
Total payments recorded		(30,300)
		15,000
Cash in hand and bank at the end of the year		<u>(4,000)</u>
Difference = missing figure = drawings		11,000

Practice question**4**

Calculate drawings for the period from the following information.

	₦
Cash in hand at the beginning of the year	100
Bank balance at the beginning of the year	2,400
Cash in hand at the end of the year	150
Bank balance at the end of the year	5,200
Receipts	51,700
Payments to employees	3,400
Payments to suppliers	38,200

15.3.4 Cost structures

Missing figures can sometimes be estimated by using cost structures which describe the relationship that exists between sales, cost of sales and gross profit.

The relationship between revenue and cost of sales can be expressed as a percentage.

There are two ways of doing this:

- Gross profit is expressed as a percentage of cost of sales – this is known as mark-up; or
- Gross profit is expressed as a percentage of sales – this is known as profit margin.

Example: Cost structures

A sole trader does not keep a record of sales. However, she does keep a record of purchases. The accountant has established that the gross profit margin is 20%, and that:

- a) Opening inventory was ₦700 at the beginning of the year
- b) Closing inventory is ₦1,200 at the end of the year
- c) Purchases during the year were ₦23,500.

Sales for the year can be calculated by first calculating the cost of sales figure and then adding the mark up to it.

20% (gross profit/sales), the mark-up on cost is 25% of cost ($20/(100 - 20)$).

	₦
Opening inventory	700
Purchases	23,500
	24,200
Closing inventory	(1,200)
Cost of sales	23,000
Gross profit (25% of cost)	5,750
Sales	28,750

Example: Cost structures

	₦	Mark-up	Profit margin
Revenue	100,000	125%	100%
Cost of sales	(80,000)	100%	80%
Gross profit	20,000	25%	20%

Practice question**5**

A business operates on the basis of a mark-up on cost of 40%.

Required:

Calculate the sales figure for the year from the following information:

	₦
Opening inventory	3,100
Closing inventory	4,000
Purchases	42,100

Practice question**6**

Complete the following table.

	₦	₦	₦	₦
Opening inventory	1,000	2,000	1,000	?
Closing inventory	(1,200)	(1,500)	(500)	(2,000)
Purchases	5,000	8,700	?	15,000
Sales	8,000	15,000	?	20,000
Cost of sales	?	?	8,000	?
Gross profit	?	?	?	5,000
GP as a % of sales	?	?	?	?
GP as a % of cost	?	?	25%	33.3%

More than one cost structure

A question might explain that a business has more than one cost structure.

You have to work carefully through the information to establish missing numbers.

Example: Multiple cost structures

A company has sales of ₦1,000.

The company sells three types of good.

60% of sales are of type A which is sold at a mark-up of 20%.

Type B goods are sold at a margin of 30%. The cost of type B sold in the year was ₦154.

Total gross profit for the year was ₦184.

Prepare sales, cost of sales and gross profit workings for each product and in total for the business and show the margin for type C goods.

Step 1: Set up a table and enter the known facts

	Type A	%	Type B	%	Type C	%	Total
Sales	600						1,000
Cost of sales		100	154	100			
Gross profit		20		30			184

Step 2: Fill in the easy figures

	Type A	%	Type B	%	Type C	%	Total
Sales	600	120		100			1,000
Cost of sales		100	154	70			816
Gross profit		20		30			184

Step 3: Apply the cost structures to calculate cost of sales and gross profits

	Type A	%	Type B	%	Type C	%	Total
Sales	600	120	220	100			1,000
Cost of sales	500	100	154	70			816
Gross profit	100	20	66	30			184

Step 4: Complete the table

	Type A	%	Type B	%	Type C	%	Total
Sales	600	120	220	100	180	100	1,000
Cost of sales	500	100	154	70	162	90	816
Gross profit	100	20	66	30	18	10	184

15.3.5 Missing inventory figure

The gross profit margin (or mark-up) can also be used to establish the value of inventory that is missing or lost, for example due to theft or a fire. In these situations, you might know the value of sales in the period, purchases during the period and opening and closing inventory.

By calculating the cost of sales from sales and the gross profit margin, it should be possible to establish the value of missing inventory that is unaccounted for, as a balancing figure.

Example: Calculating missing inventory

A sole trader operates his business from a warehouse, which has been damaged by a fire, which occurred at the end of the financial year. After the fire, the remaining inventory that is undamaged amounts to ₦2,000 (cost).

The accountant establishes the following information:

- a) Inventory at the beginning of the year was ₦16,000
- b) Purchases during the year were ₦115,000
- c) Sales during the year were ₦140,000
- d) The trader sells his goods at a mark-up of 25% of cost.

The cost of the inventory lost in the fire maybe calculated as follows:

Gross profit = 25% of cost.

As a proportion of sales, gross profit $= (25 / (25 + 100)) = 0.20$ or 20%. Sales = ₦140,000.

Therefore gross profit = 20% × ₦140,000 = ₦28,000

Cost of sales = 80% × ₦140,000 = ₦112,000.

	₦
Opening inventory	16,000
Purchases	115,000
	131,000
Cost of sales	(112,000)
Closing inventory should be	19,000
Actual closing inventory	(2,000)
Balancing figure = inventory lost in the fire	17,000

Practice question

A fire on March 31, destroyed some of the inventory of a company, and its inventory records were also lost. The following information is available.

The company makes a standard gross profit of 30% on its sales.

₦

Practice question	7
~~A business operates on the basis of a mark-up on cost of 40%.~~	8
Calculate the closing inventory from the following information:	
	₦
Opening inventory	5,000
Purchases	71,200
Sales	98,000

Inventory at March 1	127,000
Purchases for March	253,000
Sales for March	351,000
Inventory in good condition at March 31	76,000

Required:

Ascertain the cost of the inventory lost in the fire.

15.4 Chapter review

Chapter review

Before moving to the next chapter, check that you are now wable to:

- understand situations that might necessitate the preparation of accounts from incomplete records (inventory or assets destroyed, cash misappropriation or lost, accounting record destroyed etc.);
- use the accounting equation as an approach to producing accounting information when accounting records are incomplete;
- use memorandum control accounts to identify missing information;
- use cost structures to identify missing information; and
- prepare a statement of assets and liabilities.

15.5 End of chapter questions and suggested solutions

Question 1

The following information relates to Odeku Enterprise as at December 31,

	2024	2023
	₦	₦
Property	2,000,000	2000,000
Equipment	900,000	600,000
Trade receivables	800,000	400,000
Cash	150,000	100,000
Overdraft	900,000	600,000
Payables	300,000	500,000

Drawings and additional capital made during the year were ₦450,000 and ₦500,000 respectively.

Required:

Determine the net profit for the year ended December 31, 2024.

Suggested solution

	2024	2023
	₦	₦
Total assets	3,850,000	3,100,000
Total liabilities	(1,200,000)	(1,100,000)
Capital	<u>2,650,000</u>	<u>2,000,000</u>
Closing capital		2,650,000
Opening capital		<u>(2,000,000)</u>
		650,000
Drawings		450,000
Additional Capital		<u>(500,000)</u>
Net profit		<u>600,000</u>

Question 2

The following information was extracted from the books of Alji Binuyo as at July 31, 2025

Bank account			
	₦'000		₦,000
Balance b/f	1,348	Trade payables	21,149
Cash sales	12,476	Salaries	11,900
Trade receivables	36,584	Advertisement	2,000
		Electricity	246
		Rent and rates	712
		General expenses	6,434
		Drawings	1,800
		Balance c/f	<u>6,167</u>
	<u>50,408</u>		<u>50,408</u>

Additional information

a.

	2025	2024
	₦'000	₦'000
Inventory	6,278	4,118
Trade receivables	7,860	5,600
Trade payables	6,900	6,300
Accrued electricity	172	140
Rent and rates	120	84

- b. The original cost of non-current assets was ₦150,000,000 with a carrying amount of ₦10,600,000 as at August 1, 2024. Depreciation on the non-current assets is charged at 10% on cost.

Required:

- Prepare the statement of profit or loss for the year ended July 31, 2025
- Prepare the statement of financial position as at July 31, 2025

Suggested solution

Alji Binuyo

a. Statement of profit or loss for the year ended July 31, 2025

	N'000
Revenue (w1)	51,320
Cost of sales (w2)	(19,509)
Gross profit	31,811
Administration expenses (w6)	<u>22,788</u>
Profit for the period	<u>9,023</u>

b. Statement of financial position as at July 31 2025

	N'000	N'000
Non-current assets		9,100
Current assets:		
Inventory	6,278	
Trade receivables	7,860	
Rent and rates prepaid	120	
Cash	<u>6,167</u>	
Total current assets		<u>20,425</u>
Total assets		<u>29,525</u>
Equity and liabilities		
Capital	15,230	
Profit for the period	9,023	
Drawings	<u>(1,800)</u>	
Total equity		22,453
Current liabilities:		
Trade payables	6,900	
Accrued electricity	<u>172</u>	
Total liabilities		<u>7,072</u>
Total equity and liabilities		<u>29,525</u>

Workings

1. Trade receivables ledger control account

	N'000		N'000
Balance b/f	5,600	Cash	36,584
Sales	<u>38,844</u>	Balance c/f	<u>7,860</u>
	<u>44,444</u>		<u>44,444</u>
Balance b/f	7,860		

Total sales = N'000 (38,844 + 12,476) = N51,000,000

2. Trade payables control account

	N'000		N'000
Cash	21,149	Balance b/f	6,380
Balance c/f	<u>6,900</u>	Purchases	<u>21,669</u>
	<u>28,049</u>		<u>28,049</u>
		Balance b/f	6,900

Cost of sales

	N'000
Opening inventory	4,118
Purchases	<u>21,669</u>
	25,787
Closing inventory	<u>(6,278)</u>
Cost of sales	<u>19,509</u>

3. Electricity account

	N'000		N'000
Cash	246	Balance b/f	140
Balance c/f	<u>172</u>	Expenses	<u>278</u>
	<u>418</u>		<u>418</u>
		Balance c/f	172

4. Rent and rates

	N'000		N'000
Balance b/f	84	Expenses	676
Cash	<u>712</u>	Balance c/f	<u>120</u>
	<u>796</u>		<u>796</u>
Balance c/f	120		

5. Allowances for depreciation account

	N'000		N'000
		Balance b/f	4,400
Balance c/f	<u>5,900</u>	Depreciation	<u>1,500</u>
	<u>5,900</u>		<u>5,900</u>

Balance b/f

5,900

6. Administration expenses

	N'000
Salaries	11,900
Advertisement	2,000
Electricity	278
Rent and rates	676
Depreciation	1,500
General expenses	<u>6,434</u>
	<u>22,788</u>

7. Determination of capital as at August 1, 2025

	N'000	N'000
Assets:		
Non-current assets	10,600	
Inventory	4,118	
Trade receivables	5,600	
Prepaid rent and rates	84	
Cash	<u>1,348</u>	21,750
Liabilities:		
Trade payables	6,380	
Accrued electricity	<u>140</u>	<u>7,780</u>
Opening capital		<u>15,230</u>

Question 3

A business suffered a fire on the last day of its financial year. The only remaining inventory after the fire was valued at N3,000. You are given the following data:

Opening inventory: N12,000

Purchases during the year: N85,000

Sales during the year: N120,000

The business applies a mark-up of $33\frac{1}{3}\%$ on cost

Required:

- Calculate the gross profit and cost of sales for the year.
- Estimate the value of closing inventory that should have been present before the fire.
- Compute the value of inventory lost in the fire.
- Explain briefly how this approach helps in preparing accounts from incomplete records.

Suggested solution

(a) Gross Profit and Cost of Sales

Given:

Sales = ₦120,000

Mark-up = 33⅓% on cost

Step 1: Convert Mark-up to Gross Profit Margin

If Gross Profit is 33⅓% of cost, i.e. $\frac{100}{300} = \frac{100}{300+100}$ of sales = $\frac{100}{400}$ or $\frac{1}{4}$ or 25%

Step 2: Calculate Gross Profit and Cost of Sales

Gross Profit = 25% of ₦120,000 = ₦30,000

Cost of Sales = Sales – Gross Profit = ₦120,000 – ₦30,000 = ₦90,000

Gross Profit = ₦30,000,

Cost of Sales = ₦90,000

(b) Estimated Closing Inventory before the Fire

We use the formula:

Closing Inventory = Opening Inventory + Purchases – Cost of Sales

= ₦12,000 + ₦85,000 – ₦90,000 = ₦7,000 =

Estimated Closing Inventory = ₦7,000

(c) Inventory Lost in the Fire

Only ₦3,000 worth of inventory remained after the fire.

Inventory Lost = Expected Closing Inventory – Actual Remaining Inventory = ₦7,000 – ₦3,000 = ₦4,000

Inventory Lost = ₦4,000

(d) Explanation of the Approach

This approach is useful in preparing accounts from incomplete records because:

i) Estimation with Known Ratios:

It uses known gross profit ratios (mark-up or margin) to estimate unknowns like cost of sales and closing inventory.

ii) Supports Insurance Claims:

In events like fire or theft, it helps determine the value of lost inventory, aiding in insurance recovery.

iii) Reconstructing Accounts:

Helps reconstruct missing financial data for the preparation of income statements and balance sheets when primary records are lost or incomplete.

iv) Ensures Continuity:

Allows the business to prepare reliable financial statements despite disruptions.

Conclusion:

This method is a vital tool in estimating figures logically and systematically when full records are unavailable.

SOLUTIONS TO PRACTICE QUESTIONS

Solution		1
	₦	
Net assets at 31 December (376,000 – 108,000)	268,000	
Net assets at 1 January (314,000 – 87,000)	<u>(227,000)</u>	

Increase in net assets	41,000
Drawings	55,000
New capital introduced in the year	(25,000)
Profit for the year	71,000

	₦		₦
Opening balance	2,400	Money banked	12,500
Sales (bal fig)	12,100	Bad debt written off	200
		Closing balance	1,800
	<u>14,500</u>		<u>14,500</u>

	₦		₦
Cash paid	11,300	Opening balance	1,400
Closing balance	1,900	Purchases (bal fig)	11,800
	<u>13,200</u>		<u>13,200</u>

Solution 4
Cash and bank memorandum account

	₦		₦
Opening balance, cash in hand	100	Payments to suppliers	38,200
Opening balance, bank	2,400	Payments to employees	3,400
Receipts	51,700	Drawings (= balancing figure)	7,250
		Closing balance, cash in hand	150
		Closing balance, bank	5,200
	<u>54,200</u>		<u>54,200</u>

Solution**5**

Cost of sales		N
Opening inventory		3,100
Purchases	42,100	
Less: closing inventory	(4,000)	
	41,200	
Mark-up at 40%	16,480	
Sales (41,200 ÷ 140%)	57,680	

Solution**6**

	N	N	N	N
Sales	8,000	15,000	10,000	20,000
Opening inventory	1,000	2,000	1,000	2,000
Purchases	5,000	8,700	7,500	15,000
Closing inventory	6,000	10,700	8,500	17,000
	(1,200)	(1,500)	(500)	(2,000)
Cost of sales	(4,800)	(9,200)	(8,000)	(15,000)
Gross profit	3,200	5,800	2,000	5,000
GP as a % of sales	40%	38.7%	20%	25%
GP as a % of cost	66.7%	63%	25%	33.3%

Solution**7**

	₦	%
Sales	98,000	140
Cost of sales		
Opening inventory	5,000	
Purchases	71,200	
Less: closing inventory (balancing figure)	(6,200)	
Working:	70,000	100
Cost of sales = $\frac{100}{140} \times \text{Sales} \Rightarrow \frac{100}{140} \times 98,000 = 70,000$		

Solution**8**

	₦
Inventory at 1 March	127,000
Purchases for March	253,000
	380,000
Closing inventory	(76,000)
Cost of sales + cost of lost inventory	304,000
Cost of sales (~~₦~~ 351,000 70%)	(245,700)
Inventory lost in the fire	58,300

16

PREPARATION OF NOT-FOR-PROFIT ACCOUNTS

Contents

- 16.0 Learning objective
- 16.1 Learning outcomes
- 16.2 Not-for-profit organisations
- 16.3 Receipt and payment accounts
- 16.4 Income and expenditure account
- 16.5 Chapter review
- End of chapter questions and suggested solutions

16. Preparation of Not-For-Profit Accounts

16.0 Learning objective

This chapter explains the nature of not for profit organisations and how to compile the financial statements of not for profit organisations.

16.1 Learning outcomes

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

- a. explain what a not for profit organisation is;
- b. prepare a receipt and payment account from information provided; and
- c. prepare an income and expenditure account from information provided.

16.2 Not-For-Profit Organisations

16.2.1 Introduction

Many organisations exist to achieve other objectives than making profit. Such organisations are called not for profit organisations. Examples of such organisations include:

- a. clubs and societies;
- b. charities;
- c. hospitals; and
- d. government bodies.

Not-for-profit organisations have income (revenue) which they raise (or are given) and costs which must be paid just like other organisations. A not-for-profit organisation will try to operate at a level where its income is slightly bigger than its costs. This sounds very much as if the not-for-profit organisation is trying to make a profit but that is not the case.

- a. A not-for-profit organisation might try to operate at a slight surplus so that it can continue to provide its service in the future.
- b. A profit making entity tries to make as much surplus as possible in order to enhance the wealth of its owners.

Not-for-profit organisations need accounting records. They could not continue to operate if their costs were consistently bigger than their income

16.2.3 Accounting by not-for-profit organisations

Not-for-profit organisations might be subject to less regulation than profit making organisations (though this is by no means true of all not for profit organisations).

Some organisations may not be required to prepare accruals based financial information. These may prepare a cash based, receipt and payment account instead. Organisations that do this might include clubs, societies and perhaps some charities.

Other not-for-profit organisations prepare an income and expenditure account (I & E account) instead of a statement of comprehensive income. This is similar to a statement

of comprehensive income in that it is prepared on the accruals basis but there are differences.

Different terminology is used.

- a. What a statement of comprehensive income would describe as profit for the period, an income and expenditure account describes as a **surplus of income overexpenditure**.
- b. What a statement of comprehensive income would describe as loss for the period, an income and expenditure account describes this as a **deficit of income overexpenditure**
- c. In the statement of financial position a company has equity reserves whereas a not for profit organisation has equity fundaccounts.
- d. In the statement of financial position a company would add the profit for the year (deduct a loss) to an equity account called retained profits. A not for profit organisation would add the surplus (deduct a deficit) to an equity account called an accumulated fund (or accumulated surplus of income over expenditure).

Comment on charities

Charities are only mentioned above for completeness. This chapter proceeds to explain more about income and expenditure account using the circumstances of clubs and societies.

Some charities are very large organisations and are run very professionally. Such charities may be subject to separate accounting regulation in some jurisdictions and may maintain detailed accounting records to the same standard as those expected of a company.

Comment on government bodies

These bodies are only mentioned above for completeness. This chapter proceeds to explain more about income and expenditure account using the circumstances of clubs and societies.

Public sector organisations often administer very large sums of money in order to provide services that the government believes to be beneficial to citizens.

Such bodies are subject to separate accounting regulation and must maintain detailed accounting records to the same standard as those expected of a company.

Government bodies might use a separate set of accounting standards called IPSAS (International Public Sector Accounting Standards). These are based on IFRS but also include other standards to cover topics that are not relevant to profit making entities. IPSAS will be covered in a later paper.

16.3 Receipt and Payment Accounts

16.3.1 Introduction

As stated above some organisations may not be required to prepare accruals based financial information but might prepare a receipt and payment account instead.

A receipt and payment account is a summary of cash receipts and payments during the accounting period. The accruals concept is not applied so a receipt and payment account includes all cash receipts and payments in a period including capital and revenue amounts and whether they relate to that period or not.

All cash receipts are recorded on debit side (receipts side) and all cash payments are recorded on credit side (payments side) of receipts and payments account.

16.3.2 Features of a receipt and payment account

Feature	Comment
Summary of cash transactions	All cash receipts and payments made by the concern during the accounting period are recorded in this book. Therefore, the receipts and payments account is a summary of cash transactions.
Cash and bank items in one column.	All receipts either cash or bank are recorded in receipts column of receipts side where all cash and bank payments are recorded in one column of payment column of receipts and payments account. The cash and bank transactions are merged to avoid contra entries of cash and bank transactions.
No distinction between capital and revenue.	All cash receipts and cash payments irrespective of capital and revenue nature are recorded in receipts and payments account. No distinction is made for capital receipts, revenue receipts, capital expenditures and revenue expenditures.
Opening and closing balance of cash	A receipts and payments account shows the opening and closing balances of cash and bank. All cash and cheque receipts are recorded on debit side whereas all cash and cheque payments are recorded on credit side of receipts and payments account.

Illustration

Receipt and payment account			
Balance b/d	X	Donation	X
Subscriptions	X	Repairs	X
Functions	X	Telephone	X
Sale of land	X	Extension of club house	X
Bank interest	X	Furniture	X
Bequest	X	Heat and light	X
Sundry income	X	Salary and wages	X
		Sundry expenses	X
		Balance c/d	X
Balance b/d			

A receipt and payment account gives far less information than a set of financial statements based on the accruals concept.

For all practical purposes this is a cash account just like those that you have come across in other chapters.

16.3.3 Subscriptions calculation

The main source of cash for a club will be membership fees. It may be necessary to calculate the cash received from members during the year. This can be complicated by the fact that at each year end there will usually be some members who have paid their subscriptions in advance and some who are in arrears.

- Members who pay their fees in advance are creditors of the club (the club owes them a period of membership).
- Members who are in arrears are debtors of the club.

The amount of cash received in the year can be calculated using a subscriptions T account.

- Opening and closing balances for members who have paid in advance and those who are in arrears are recognised.
- The total membership fees that should have been collected (number of members $\times$ annual fee) are debited to the account.
- The cash received is a balancing figure on the credit side of the account.

Illustration: Subscription account

Subscription account			
	₦		₦
Balance b/d (members in arrears)	X	Balance b/d (members Who have prepaid)	X
		Cash	X
Income and expenditure	X		
Balance c/d (members who have prepaid)	X	Balance c/d (members in arrears)	X
	X		
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X

Example: Subscription

account A club has 500 members.

Annual membership fees are ₦1,000.

Therefore membership fees for the year should be ₦500,000.

The club's subscription records for the year ended 31 December 2019 show the following:

	At 31 December 2018	At 31 December 2018
Subscriptions received in advance	10,000	6,000
Subscriptions in arrears	18,000	22,000

Cash received is calculated as follows:

Subscriptions

	₦		₦
Balance b/d: Members in arrears	18,000	Balance b/d: Advance payments	10,000
Membership fees for the year	500,000	Cash (balancing figure)	492,000
Balance c/d: Advance payments	6,000	Balance c/d: Members in arrears	22,000
	524,000		524,000
Balance b/d:	22,000	Balance b/d:	6,000

16.4 Income and Expenditure account

16.4.1 Format

An income and expenditure account is an accruals based statement listing the different types of income of a club followed by the different categories of expenditure of the club.

A club may have several categories of income including:

- a. Membership fees and subscriptions;
- b. Life membership fees;
- c. Donations to the club;
- d. Investment income;
- e. Surplus from running a coffee bar or a shop;
- f. Surplus from running an event;

Note that if a club has a coffee bar or shop or runs an event the “profit” from these is generally calculated separately (in an account known as a trading account) and presented as a line in the income and expenditure account.

Illustration: Coffee bar trading account

	₦	₦
Income		
Sales		X
Opening inventory	X	
Purchases	X	
	X	
Closing inventory	(X)	
Cost of sales		(X)
Gross profit (this figure to the face of the income and expenditure account)		
		X

There are no mandatory formats for such a statement. A typical format is illustrated below.

Illustration: Income and expenditure account for the year ending XX/XX/XX

	₦	₦
Income		
Subscription income		X
Donations		X
Interest on bank deposit		X
Coffee bar/shop profit		X
Tournament income	X	
Less: Prizes	(X)	
		X
		X
Expenditure		
Club expenses	X	
Rent	X	
Electricity	X	
Depreciation	X	
Repairs	X	
		X
Surplus (deficit) of income over expenditure		X

16.4.2 Subscriptions account

At each year end there will usually be some members who have paid their subscriptions in advance and some who are in arrears. These are both included as balances brought down and carried down on a single subscription account. Cash received is credited to this account and the balance on the account is transferred to the income and expenditure account (as income for the year).

The subscription account illustration is reproduced here for your convenience.

Illustration: Subscription account

Subscription account			
	₦		₦
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X
Income and expenditure	X	Cash	X
Balance c/d (members who have prepaid)	X	Balance c/d (members in arrears)	X
	X		
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X

Balance b/d:	₦	Balance b/d:	₦
Members in arrears	48,000	Advance payments	12,000
Membership fees for the year (tol&E)	576,000	Cash	624,000
Balance c/d:		Balance c/d:	
Advance payments (26 × 1,200)	31,200	Members in arrears (16 × 1,200)	19,200
	655,200		655,200
Balance b/d:	19,200	Balance b/d:	31,200

16.4.3 Life membership fees

A club should have an accounting policy for these. Possible policies include:

- Recognition as income when received.
- Recognition as income over a specified period.
- Recognition in an equity reserve (an accumulated fund).

Recognition as income when received

Illustration: Double entry for life membership fees

	Debit	Credit
Bank (cash received)	X	
Income and expenditure account		X

Recognition as income over a specified period

Illustration: Double entry for life membership fees

On receipt:	Debit	Credit
Bank (cash received)	X	
Deferred income (accredit account on the face of the statement of financial position)		X
Each year over the a specified future period:		
Deferred income	X	
Income and expenditure account		X

This treatment recognises the amount received as income over several years.
Recognition in an equity reserve (an accumulated fund)

Illustration: Double entry for life membership fees

	Debit	Credit
Bank(cash received)	X	
Life membership fund (an accumulated fund account in equity)		X

This might then be transferred to the accumulated surplus of income over expenditure over a pre-defined period or on the death of the member.

16.4.5 Donations

A club might receive a donation or bequest.

If the donation has not been made for a specific purpose the club might recognise the donation as income in the period in which it is received.

A club might receive a donation for a particular purpose. For example, an member might donate money for a new football pitch. In this case the money is credited to a fund account set up for the purpose.

Illustration: Double entry for donations

	Debit	Credit
Bank (cash received)	X	
Football pitch fund (an accumulated fund account in equity)		X

16.5 Chapter review**Chapter review**

Before moving to the next chapter, check that you are now able to:

- explain what a not for profit organisations;
- prepare a receipt and payment account from information provided; and
- prepare an income and expenditure account from information provided.

16.6 End of chapter questions and suggested solution**Question 1**

You have been appointed as the treasurer of a cultural club. In your first meeting, members complain that they do not understand how their contributions are spent. There has never been a formal financial report, and the only record available is a list of cash receipts and expenses.

Required:

- Explain the importance of preparing a **Receipt and Payment Account** and an **Income**

and Expenditure Account for the club.

- b) Explain how each account helps members understand the financial position and performance of the club.

Suggested solution

- a) Importance of Preparing a Receipt and Payment Account and an Income and Expenditure Account

As treasurer of the cultural club, preparing both a Receipt and Payment Account and an Income and Expenditure Account is essential for transparency, accountability, and sound financial management. Their importance is outlined below:

- i) Receipt and Payment Account:

- It is a summary of all cash and bank transactions during a period, showing how money was received and spent.
- It includes both capital and revenue items, and does not follow the accruals concept.
- It helps in tracking the actual cash movements of the club.

- ii) Income and Expenditure Account:

- This is similar to a profit and loss account but is prepared on an accrual basis.
- It reflects the club's true financial performance for the period by matching income earned to expenses incurred, regardless of cash received or paid.
- It shows whether the club made a surplus or deficit during the year.

By preparing these accounts:

- Members can see how their contributions were used.
- The club can identify whether it is financially stable or at risk.
- It ensures compliance with sound financial practices and promotes trust among members and donors.

- b) How Each Account Helps Members Understand the Financial Position and Performance of the Club

- i) Receipt and Payment Account:

- Provides a clear record of cash inflows and outflows, helping members understand where money comes from and how it is spent.
- Shows the opening and closing bank balances, making it easy to see how much cash is available at any time.
- Helps identify whether the club is managing its funds responsibly.

- ii) Income and Expenditure Account:

- Distinguishes between recurring operating items and one-time transactions, offering a better view of ongoing financial performance.
- Accrual accounting ensures that income and expenses are matched to the correct period, providing a more accurate picture of financial performance.
- The resulting surplus or deficit helps members assess whether the club is operating within its means or facing financial strain.

Together, these accounts help members:

- Gain confidence in the financial leadership of the club.
- Evaluate the sustainability of club activities.

- Make informed decisions about future projects, membership dues, and fundraising needs.

Question 2

You are provided with the following information from the books of Eden Youth Club for the year ended 31 December 2024:

Cash Balances:

- Cash in hand at 1 January 2024: ₦5,000
- Cash at bank at 1 January 2024: ₦80,000

Receipts during the year:

- Members' subscriptions received: ₦120,000
- Donations: ₦25,000
- Sale of old equipment: ₦10,000
- Entrance fees: ₦15,000

Payments during the year:

- Rent and rates: ₦40,000
- Electricity: ₦12,000
- Staff salaries: ₦55,000
- Repairs and maintenance: ₦18,000
- Purchase of new equipment: ₦30,000

Additional Information:

- Cash in hand at 31 December 2024: ₦4,500

Required:

Prepare the Receipts and Payments Account for the year ended 31 December 2024.

Suggested solution

Eden Youth Club Receipts and Payments Account For the Year Ended 31 December 2024

Receipts	₦	Payments	₦
Balance b/f:		Rent and rates	40,000
- Cash in hand	5,000	Electricity	12,000
- Cash at bank	80,000	Staff salaries	55,000
Members' subscriptions received	120,000	Repairs and maintenance	18,000
Donations	25,000	Purchase of new equipment	30,000
Sale of old equipment	10,000	Balance c/d:	
Entrance fees	15,000	Cash in hand	4,500
		Cash at bank	95,500
Total Receipts	255,000	Total Payments	255,000
Balance b/d:			
- Cash in hand	4,500		
- Cash at bank	70,000		

Question 3

The following balances were extracted from the books of Grace Welfare Society as at 31 December 2024:

	(₦)
Subscriptions received	283,000
Donations received	60,000
Salaries paid	120,000
Stationery	18,000
Rent and rates	35,000
Equipment purchased	100,000
Bank balance (1 January 2024)	45,000
Equipment at cost (1 January 2024)	200,000
Accumulated depreciation (1 January 2024)	50,000
Subscriptions in arrears (1 January 2024)	10,000
Subscriptions in arrears (31 December 2024)	12,000
Salaries outstanding (31 December 2024)	5,000
Depreciation on equipment for the year	20,000

Required:

- Prepare the Income and Expenditure Account for the year ended 31 December 2024.
- Prepare the Statement of Financial Position as at 31 December 2024.

Suggested solutionn

Grace Welfare Society

a) Income and Expenditure Account

For the year ended 31 December 2024

Expenditure	₦	Income	₦
Salaries (2)	125,000	Subscriptions Income (1)	283,000
Stationery	18,000	Donations received	60,000
Rent and rates	35,000		
Depreciation on equipment	20,000		
Surplus for the year c/d	<u>145,000</u>		
Total Expenditure	<u>312,000</u>	Total Income	<u>312,000</u>
		Surplus for the year b/d	145,000

b) Statement of Financial Position

As at 31 December 2024

Non-Current Assets:

Equipment (3)

Current Assets:

₦
230,000

Subscriptions in arrears	12,000
Bank balance	93,000
Total current assets	<u>105,000</u>
Total assets	<u>335,000</u>

Liabilities and accumulated fund

Liabilities

Outstanding salaries	5,000
Accumulated fund	
Opening Fund	185,000
Surplus for the year	<u>145,000</u>
Closing fund	<u>330,000</u>
Total liabilities and fund	<u>335,000</u>

Assets

Workings

1. Subscriptions

Subscriptions received	281,000
Add: Subscriptions in arrears (closing)	12,000
Less: Subscriptions in arrears (opening)	<u>(10,000)</u>
Adjusted Subscriptions Income	<u>283,000</u>

2. Salaries

Salaries paid	120,000
Add: Salaries outstanding	<u>5,000</u>
	<u>125,000</u>

3 Equipment

Equipment at cost (~~₦~~200,000 + ~~₦~~100,000) 300,000

Less: Accumulated Depreciation:

- Opening balance	50,000
- Add: Depreciation for the year	<u>20,000</u>
Total Depreciation	<u>(70,000)</u>

Net Book Value 230,000

4. Accumulated fund brought forward

Bank balance (1 January 2024)	45,000
Equipment at cost (1 January 2024)	200,000
Accumulated depreciation (1 January 2024)	(50,000)
Subscriptions in arrears (1 January 2024)	(10,000)
Opening fund	<u>185,000</u>

IAS 7: STATEMENT OF CASH FLOWS AND INTRODUCTION TO STATEMENT OF CHANGES IN EQUITY

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17. IAS7: Statement of Cash Flows and Introduction to Statement of Changes in Equity

17.0 Learning objectives

This chapter explains how to prepare a statement of cash flows.

17.1 Learning outcomes

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

- a. prepare part or all of a statement of cash flows from information provided

17.2 Statement of Cash Flows: Introduction

17.2.1 Importance of cash flow for business

Businesses must have sufficient cash; otherwise they cannot survive.

- a. A business can make a loss but still survive if it has sufficient cash or access to liquidity (cash, assets that can be quickly turned into cash and new sources of borrowing).
- b. On the other hand, a business that is profitable cannot survive if it cannot pay its obligations when they fall due, because it does not have enough cash or access to other sources of liquidity.

Cash flow is therefore extremely important, and it is appropriate that entities should present a statement of cash flows as a financial statement.

The purpose of a statement of cash flows is to show what the cash flows of the entity have been. It can also be used to make assessments of what the cash flows of the entity might be in the future.

17.2.2 Profit and cash flow

When a business makes a profit of ₦1,000, this does not mean that it receives ₦1,000 more in cash than it has spent. Profit and cash flow are different, for several reasons:

There are items of cost in the statement of comprehensive income that do not represent a cash flow. Examples are:

- a. depreciation and amortisation charges; and
- b. the gain or loss on the disposal of non-current assets.

There are items of cash flow that do not appear in the statement of comprehensive income. Examples are:

- a. Cash flows relating to the acquisition or disposal of investments, such as the purchase of new non-current assets, and cash from the sale of non-current assets. (The statement of comprehensive income includes gains or losses on the disposal of non-current assets, but this is not the same as the cash proceeds from the sale.)
- b. Cash flows relating to financial transactions, such as obtaining cash by issuing shares or obtaining loans, the repayment of loans and the payment of dividends to ordinary shareholders.

17.2.3 IAS 7: Statement of cash flows

IAS 1 states that a complete set of financial statements should include a statement of cash flows. IAS 7: **Statement of cash flows** sets out the detailed requirements for the format and content of the statement.

A statement of cash flows provides information about where a business obtained its cash during the financial period, and how it made use of its cash.

A statement of cash flows, groups inflows and outflows of cash, under three broad headings:

- a. cash from operating activities;
- b. cash used in (or obtained from) investing activities; and
- c. cash paid or received in financing activities.

It also shows whether there was an increase or a decrease in the amount of cash held by the entity between the beginning and the end of the period.

Illustration:

Cash from operating activities	X/(X)
Cash used in (or obtained from) investing activities	X/(X)
Cash paid or received in financing activities.	<u>X/(X)</u>
Net cash inflow (or outflow) during the period	X/(X)
Cash and cash equivalents at the beginning of the period	<u>X/(X)</u>
Cash and cash equivalents at the end of the period	<u>X/(X)</u>

Any of the items may be positive **or negative cash flows**.

The cash inflow (or outflow) during the period can be either a positive or a negative amount.

For the purpose of a statement of cash flows, cash and cash equivalents are treated as the same:

- a. Cash = cash in hand (= petty cash and other cash not in the bank) + cash in the business bank account
- b. Cash equivalents = items that are the equivalent of cash and could be converted into cash very quickly without risk of loss (= for example cash in a deposit account or a savings account)

17.2.4 Overall approach

IAS 7 requires that cash flows are analysed over three headings.

Theoretically this could be done by analysing every entry in and out of the cash account(s) over the course of a period. However, the cash account is often the busiest account in the general ledger with potentially many thousands of entries. Documents that summarise the transactions are needed.

These documents already exist! They are the other financial statements (statement of financial position and statement of comprehensive income).

Illustration:

A business might buy 100 new non-current assets over the year. There would be 100 different entries for these in the cash account.

However, it should be easy to estimate the additions figure from comparing the opening and closing balances for non-current assets and isolating any other causes of movement.

For example if we know that property plant and equipment has increased by ₦100,000 and that the only other cause of movement was depreciation of ₦15,000 then additions must have been ₦115,000.

A lot of the numbers in statement of cash flows are derived from comparing opening and closing positions of line items in the statement of financial position. Other causes of movement can then be identified leaving the cash double entry as a balancing figure.

17.3 Statement of Cash Flows: Format

17.3.1 Format IAS 7 does not include a format that must be followed. However it gives illustrative examples of formats that meet the requirements in the standard.

Illustration: Statement of cash flows		
	₦	₦
Net cash flow from operating activities		75,300
Cash flows from investing activities:		
Acquisition of shares (debentures, etc.)	(5,000)	
Purchase of property, plant and machinery	(35,000)	
Proceeds from sale of non-current assets	6,000	
Interest received/dividends received	<u>1,500</u>	
Net cash used in investing activities		(32,500)
Cash flows from financing activities:		
Proceeds from issue of shares	30,000	
Proceeds from new loan	10,000	
Repayment of loan	(17,000)	
Dividends paid to shareholders	<u>(25,000)</u>	
Net cash used in financing activities		(2,000)
Net increase/decrease in cash/cash equivalents		40,800
Cash/cash equivalents at the beginning of the year		<u>5,000</u>
Cash/cash equivalents at the end of the year		<u>45,800</u>

Operating cash flows

The operations of the business are probably the most significant source of cash.

IAS 7 allows two approaches to identifying the cash flows from operating activities:

- Direct method; and
- Indirect method

For clarity, what this means is that there are two approaches to arriving at the figure of **₦75,300** in the above example.

While IAS 7 recognises both direct and indirect methods, it encourages or prefers the direct method.

You are expected to understand both methods.

17.3.2 The indirect method

The indirect method identifies the cash flows from operating activities by adjusting the profit before tax figure. It arrives at the cash from operating activities figure indirectly by reconciling a profit figure to a cash figure.

The adjustments remove the impact of accruals and non-cash items and also relocate some figures to other positions in the statement of cash flows.

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the indirect method.

Illustration:		
Statement of cash flows: indirect method		
	₦	₦
Cash flows from operating activities		
Profit before taxation	80,000	
Adjustments for:		
Depreciation and amortisation charges	20,000	
Interest charges in the statement of comprehensive income	2,300	
Gains on disposal of non-current assets	(6,000)	
Losses on disposal of non-current assets	<u>4,500</u>	
	100,800	
Increase/decrease in:		
Increase in trade and other receivables	(7,000)	
Decrease in inventories	2,000	
Increase in trade payables	<u>3,000</u>	
Cash generated from operations	98,800	
Taxation paid (tax on profits)	(21,000)	
Interest charges paid	<u>(2,500)</u>	
Net cash flow from operating activities		75,300

17.3.3 The direct method

The direct method calculates the cash flow from operating activities by calculating cash received from customers, cash paid to suppliers and so on.

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the direct method.

Illustration:

Statement of cash flows: direct method

Cash flows from operating activities

	R
Cash receipts from customers	348,800
Cash payments to suppliers	(70,000)
Cash payments to employees	(150,000)
Cash paid for other operating expenses	(30,000)
Cash generated from operations	98,800
Taxation paid (tax on profits)	(21,000)
Interest charges paid	(2,500)
Net cash flow from operating activities	75,300

The remainder of the statement of cash flows using the direct method is exactly the same as for the indirect method.

17.4 Cash Flows From Operating Activities: The Indirect Method

17.4.1 Profit before taxation

The starting point for the statement of cash flows for a company is the operating profit after deducting interest but before taxation.

This profit figure is adjusted to calculate the amount of cash received by the business or the amount of cash paid out as a consequence of its trading operations.

The adjustments are to remove the effect of:

- a. Non-cash items, for example:
 - i. Depreciation and amortisation (depreciation of intangible non-current assets);
 - ii. Profit or loss on disposal of non-current assets;and
- b. Accruals based figures, for example:
 - i. Interest expense or income;
 - ii. Movement on working capital items (receivables, payables and inventory).

17.4.2 Non-cash items Depreciation and amortisation

Depreciation charges and amortisation charges are not cash flows. They are expenses in the statement of comprehensive income, but do not represent payments of cash.

In order to obtain a figure for cash flow from the figure for profit, charges for depreciation and amortisation must therefore be added back to the profit figure.

Gains or losses on disposal of non-current assets

Gains or losses on the disposal of non-current assets are not cash flows. The gain or loss is calculated as the difference between:

- c. the net cash received from the disposal; and
- d. the carrying amount (net book value) of the asset at the date of disposal.

The effect of the gain or loss on disposal (a non-cash item) from the operating profit is removed by:

- e. deducting gain on disposal; and
- f. adding back losses on disposal.

The relevant cash flow is the net cash received from the sale. This is included in cash flows from investing activities as the net cash flows received from the disposal of non-current assets.

Example:

A company disposed of an item of equipment for ~~N~~40,000. The equipment had originally cost ~~N~~60,000 and the accumulated depreciation charged up to the date of disposal was ~~N~~32,000.

	N
Cost	60,000
Accumulated depreciation	(32,000)
Carrying value at date of disposal	<u>28,000</u>
Cash proceeds from sale	(40,000)
Gain on disposal	<u>12,000</u>

In the statement of cash flows, the gain on disposal of ~~N~~12,000 is deducted as an adjustment to the operating profit.

The cash proceeds of ~~N~~40,000 is included as a cash inflow under the heading: 'Cash flows from investing activities'.

Practice question**1**

A company made a loss on the disposal of a company motor vehicle of ~~£~~8,000.

The vehicle originally cost ~~£~~50,000 and at the date of disposal, accumulated depreciation on the vehicle was ~~£~~20,000.

What are the items that should be included for the disposal of the vehicle in the statement of cash flows for the year:

- a) In the adjustments to get from operating profit to cash flow from operations?
- b) Under the heading: 'Cash flows from investing activities'?

17.4.3 Accruals based figures -Interest

The accruals concept is applied in accounting.

Interest charge in the statement of comprehensive income is an accrual based figure. It is added back to profit and the actual cash interest paid is deducted further down the statement of cash flows.

The final items in the operating cash flows part of a statement of cash flows are the amount of interest paid and the amount of tax paid (see later).

This figure must be calculated as follows:

Illustration:

	£
Interest liability at the beginning of the year	X
Interest charge for the year (statement of comprehensive income figure)	<u>X</u>
	X
Interest liability at the end of the year	<u>(X)</u>
Interest paid in the year (cash)	<u>X</u>

Take a few minutes to make sure that you are happy about this. The same approach is used to calculate other figures.

The interest liability at the start of the year and the interest charge during the year is the most the business would pay. If the business had paid nothing it would owe this figure. The difference between this amount and the liability at the end of the year must be the amount that the business has paid.

An aside – taxation paid

The tax paid is the last figure in the operating cash flow calculation.

There is no adjustment to profit in respect of tax. This is because the profit figure that we start with is profit before tax; therefore tax is not in it to be adjusted!

However, there is a tax payment and this must be recognised as a cash flow. It is calculated in the same way as shown above.

Example:

A company had liabilities in its statement of financial position at the beginning and at the end of 2019, as follows:

Liabilities	Interest accrual	Taxation
Beginning of 2019	~~₦~~ 4,000	~~₦~~ 53,000
End of 2019	~~₦~~ 3,000	~~₦~~ 61,000

During the year, interest charges in the statement of comprehensive income were ~~₦~~22,000 and taxation on profits were ~~₦~~77,000.

The amounts of interest payments and tax payments (cash flows) for inclusion in the statement of cash flows can be calculated as follows:

	Tax	Interest
	~~₦~~	~~₦~~
Liability at the beginning of the year	53,000	4,000
Taxation charge/interest charge for the year	77,000	22,000
	130,000	26,000
Liability at the end of the year	(61,000)	(3,000)
Cash paid during the year	69,000	23,000

17.5 Indirect Method: Adjustments For Working Capital

17.5.1 Working capital adjustments: introduction

Definition

Working capital is current assets less current liabilities.

The previous section showed that taxation and interest cash flows can be calculated by using a figure from the statement of comprehensive income and adjusting it by the movement on the equivalent balances in the statement of financial position.

This section shows how this approach is extended to identify the cash generated from operations by making adjustments for the movements between the start and end of the year for:

- g.** trade receivables and prepayments;
- h.** inventories;and
- i.** trade payables and accruals.

Assuming that the calculation of the cash flow from operating activities starts with a profit (rather than a loss) the adjustments are as follows:

Balance	Increase in balance from start to the end of the year	Decrease in balance from start to the end of the year
Receivables	Subtract from profit before tax	Add back to profit before tax
Inventory	Subtract from profit before tax	Add back to profit before tax
Payables	Add back to profit before tax	Subtract from profit before tax

These are known as the working capital adjustments and are explained in more detail in the rest of this section.

17.5.2 Working capital

Working capital is made up of the following balances:

Illustration:

	£
Inventory	X
Trade and other receivables	X
Cash	X
Trade payables	(X)
Working capital	X

Trade and other receivables include any prepayments.

Trade payables include accrued expenses, provided the accrued expenses do not relate to other items dealt with separately in the statement of cash flows, in particular:

- j. accrued interest charges; and
- k. taxation payable.

Interest charges and payments for interest are presented separately in the statement of cash flows, and so accrued interest charges should be excluded from the calculation of changes in trade payables and accruals.

Similarly, taxation payable is dealt with separately; therefore taxation payable is excluded from the calculation of working capital changes.

Accrued interest and accrued tax payable must therefore be deducted from the total amount for accruals, and the net accruals (after making these deductions) should be included with trade payables.

Changes in working capital and the effect on cash flow

When working capital increases, the cash flows from operations are less than the operating profit, by the amount of the increase.

Similarly, when working capital is reduced, the cash flows from operations are more

than the operating profit, by the amount of the reduction.

This important point will be explained with several simple examples.

17.5.3 Changes in trade and other receivables

Sales revenue in a period differs from the amount of cash received from sales by the amount of the increase or decrease in receivables during the period.

When trade and other receivables go up during the year, cash flows from operations are less than operating profit by the amount of the increase.

When trade and other receivables go down during the year, cash flows from operations are more than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for receivables is therefore:

- l.** subtract the increase in receivables during the period (the amount by which closing receivables exceed opening receivables); or
- m.** add the reduction in receivables during the period (the amount by which opening receivables exceed closing receivables).

Prepayments in the opening and closing statement of financial position should be included in the total amount of receivables.

Example: trade and other receivables

A company had receivables at the beginning of the year of ~~N~~6,000 and at the end of the year receivables were ~~N~~9,000.

During the year, sales were ~~N~~50,000 in total. Purchases were ~~N~~30,000 all paid in cash.

The company holds no inventories. The profit before tax for the year was ~~N~~20,000 (~~N~~50,000 – ~~N~~30,000).

The cash flow from operations is calculated as follows:

Profit before tax	~~N~~ 20,000
Adjustments for:	
Increase in receivables (9,000 – 6,000)	(3,000)
	<u>17,000</u>

Proof

Cash flow from operations can be calculated as follows:

	~~N~~
Receivables at the beginning of the year	6,000
Sales in the year	<u>50,000</u>
	56,000
Receivables at end of the year	<u>(9,000)</u>
Cash received	47,000
Cash paid (purchases)	<u>(30,000)</u>

17.5.4 Possible complication: Allowances for doubtful debts

A question might provide information on the allowance for doubtful debts at the start and end of the year.

There are two ways of dealing with this:

- n. Adjust the profit for the movement on the allowance as a non-cash item and adjust the profit figure for the movement in receivables using the gross amounts (i.e. the balances before any deduction of the allowance for doubtful debts); or
- o. Make no adjustments for the movement on receivables as a non-cash item adjust the profit figure for the movement in receivables using the net amounts (i.e. the balances after the deduction of the allowance for doubtful debts).

Example: Allowance for doubtful debts The following information is available:

	2018 (~~£~~ m)	2019 (~~£~~ m)
Receivables	5,000	7,100
Allowance for doubtful debts	(500)	(600)
Net-amount	4,500	6,500
	~~£~~ m	or ~~£~~ m
Profit before taxation	10,000	10,000
Adjustments for non- cash items:		
Increase in allowance for doubtful debts	100	0
	10,100	10,000
Increase in receivables:		
Gross amounts: (7,100 - 5,000)	(2,100)	
Net amounts: (6,500 - 4,500)		(2,000)
	8,000	8,000

17.5.5 Changes in inventory

Purchases in a period differ from the cost of sales by the amount of the increase or decrease in inventories during the period.

If all purchases were paid for in cash, this means that cash payments and the cost of sales (and profit) would differ by the amount of the increase or decrease in inventories.

When the value of inventory goes up between the beginning and end of the year, cash flows from operations are less than operating profit by the amount of the increase.

When the value of inventory goes down between the beginning and end of the year, cash flows from operations are more than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for inventories is therefore:

- a. subtract the increase in inventories during the period (the amount by which closing inventory exceeds opening inventory); or
- b. add the reduction in inventories during the period (the amount by which opening inventory exceeds closing inventory).

Example: Inventory

A company had inventory at the beginning of the year of ₦5,000 and at the end of the year the inventory was valued at ₦3,000.

During the year, sales were ₦50,000 and there were no receivables at the beginning or end of the year.

Purchases were ₦28,000, all paid in cash.

The operating profit for the year was ₦20,000, calculated as follows:

	₦
Sales	50,000
Opening inventory	5,000
Purchases in the year (all paid in cash)	28,000
	33,000
Closing inventory	(3,000)
Cost of sales	(30,000)
Profit before tax	20,000

Example (continued)

	N
Profit before tax	20,000
Adjustments for:	
decrease in inventory (5,000 – 3,000)	2,000
	22,000

Proof: The cash flow from operations is calculated as follows:

	N
Cash from sales in the year	50,000
Purchases paid in cash	(28,000)
Cash flow from operations	22,000

17.5.6 Changes in trade payables

Payments for purchases in a period differ from purchases by the amount of increase or decrease in trade payables during the period.

When trade payables go up between the beginning and end of the year, cash flows from operations are more than operating profit by the amount of the increase.

When trade payables go down between the beginning and end of the year, cash flows from operations are less than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for trade payables is therefore:

- a. add the increase in trade payables during the period (the amount by which closing trade payables exceed opening trade payables); or
- b. subtract the reduction in trade payables during the period (the amount by which opening trade payables exceed closing trade payables).

Accruals in the opening and closing statement of financial position should be included in the total amount of trade payables.

However, deduct interest payable and tax payable from opening and closing payables, if the total for payables includes these items.

The cash flow is N2,500 more than the operating profit, because trade payables were increased during the year by N2,500.

Example: trade payables

A company had no inventory and no receivables at the beginning and end of the year. All its sales are for cash, and sales in the year were ₦50,000.

Its purchases are all on credit. During the year, its purchases were ₦30,000.

Trade payables at the beginning of the year were ₦4,000 and trade payables at the end of the year were ₦6,500.

The operating profit for the year was ₦20,000 (₦50,000 – ₦30,000)

Profit before tax	20,000
Adjustments for:	
Increase in payables (6,500 – 4,000)	2,500
	<u>22,500</u>

Proof: The cash flow from operations is calculated as follows:

	₦
Trade payables at the beginning of the year	4,000
Purchases in the year	30,000
	<u>34,000</u>
Trade payables at the end of the year	(6,500)
Cash paid to suppliers	<u>27,500</u>
Cash from sales	(50,000)
Cash flow from operations	<u>22,500</u>

The cash flow is ₦2,500 more than the operating profit, because trade payables were increased during the year by ₦2,500.

Example:

A company made an operating profit before tax of ₦16,000 in the year just ended.

Depreciation charges were ₦15,000.

There was again of ₦5,000 on disposals of non-current assets and there were no interest charges. Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	₦9,000	₦3,000	₦4,000
End of the year	₦6,000	₦5,000	₦6,500

Taxation paid was ₦4,800.

Required

Calculate the amount of cash generated from operations, as it would be shown in a statement of cash flows using the indirect method.

Answer

	₦	₦
Cash flows from operating activities		
Profit before taxation	16,000	
Adjustments for:		
Depreciation and amortisation charges	15,000	
Gains on disposal of non-current assets	(5,000)	
	26,000	
Decrease in trade and other receivables	3,000	
Increase in inventories	(2,000)	
Increase in trade payables	2,500	
	29,500	
Cash generated from operations	29,500	
Taxation paid (tax on profits)	(4,800)	
Net cash flow from operating activities		24,700

Practice question**2**

During 2019, a company made a profit before taxation of ₦60,000. Depreciation charges were ₦25,000 and there was a gain on the disposal of a machine of ₦14,000.

Interest charges and payments of interest in the year were the same amount, ₦10,000.

Taxation payments were ₦17,000.

Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	₦32,000	₦49,000	₦17,000
End of the year	₦27,000	₦53,000	₦11,000

Calculate the net cash from operating activities, as it would be shown in a statement of cash flows (indirect method).

17.5.7 Lack of detail

A question might not provide all the detail needed to split out working capital into all of its component parts. If this is the case the adjustment must be made using whatever totals are available in the question.

Example:

A company made an operating profit before tax of ₦16,000 in the year just ended. Depreciation charges were ₦15,000.

There was a gain of ₦5,000 on disposals of non-current assets and there were no interest charges. Values of working capital items at the beginning and end of the year were:

	Current assets	Trade payables
Beginning of the year	₦12,000	₦4,000
End of the year	₦11,000	₦6,500

Taxation paid was ₦4,800.

Required

Calculate the amount of cash generated from operations, as it would be shown in a statement of cash flows using the indirect method.

Answer

	₦	₦
Cash flows from operating activities		
Profit before taxation	16,000	
Adjustments for:		
Depreciation and amortisation charges	15,000	
Gains on disposal of non-current assets	(5,000)	
	26,000	
Decrease in current assets	1,000	
Increase in trade payables	2,500	
Cash generated from operations	29,500	
Taxation paid (tax on profits)	(4,800)	
Net cash flow from operating activities		24,700

17.6 Cash Flows from Operating Activities: The Direct Method

17.6.1 Cash from sales

The format for the direct method of presenting a statement of cash flows is as follows:

Illustration:

Statement of cash flows: direct method		₹
Cash flows from operating activities		
Cash receipts from customers		348,800
Cash payments to suppliers		(70,000)
Cash payments to employees		(150,000)
Cash paid for other operating expenses		(30,000)
Cash generated from operations		98,800
Taxation paid (tax on profits)		(21,000)
Interest charges paid		(2,500)
Net cash flow from operating activities		75,300

The task is therefore to establish the amounts for cash receipts and cash payments. In an examination, you might be expected to calculate any of these cash flows from figures in the opening and closing statements of financial position, and the statement of comprehensive income.

The cash receipts from sales during a financial period can be calculated as follows:

Illustration:

	₹
Trade receivables at the beginning of the year	X
Sales in the year	X
	X
Trade receivables at the end of the year	(X)
Cash from sales during the year	X

AT-account could also be used to calculate the cash receipt

Receivables			
Balance b/f	X		
Sales	X	Cash (balancing figure)	X
		Balance c/f	X
	X		X

17.6.2 Cash paid for materials supplies

To calculate the amount of cash paid to suppliers, you might need to calculate first the amount of material purchases during the period.

Illustration: Calculation of purchases in the year

	N
Closing inventory at the end of the year	X
Cost of sales	X
	<u>X</u>
Opening inventory at the beginning of the year	<u>(X)</u>
Purchases in the year	<u>X</u>

Having calculated purchases from the cost of sales, the amount of cash payments for purchases may be calculated from purchases and opening and closing trade payables.

Illustration:

	N
Trade payables at the beginning of the year	X
Purchases in the year (as above)	X
	X
Trade payables at the end of the year	<u>(X)</u>
Cash paid for materials	<u>X</u>

A T-account could also be used to calculate the cash paid

Payables			
		Balance b/f	X
		Purchases	X
Cash (balancing figure)	X		
Balance c/f	X		
	<u>X</u>		<u>X</u>

Note that if the business had paid for goods in advance at the start or end of the year they would have an opening or closing receivable but this situation would be quite unusual.

17.6.3 Cash paid for wages and salaries

Cash payments for wages and salaries can be calculated in a similar way.

Illustration:

	₦
Accrued wages and salaries at the beginning of the year	X
Wages and salaries expenses in the year	X
	X
Accrued wages and salaries at the end of the year	<u>(X)</u>
Cash paid for wages and salaries	X

AT- account could also be used to calculate the cash paid
Payables

		Balance b/f	X
Cash (balancing figure)	X	Purchases	X
Balance c/f	X		
	<u>X</u>		<u>X</u>

If wages and salaries had been paid in advance the business would have a receivable and the workings would change to the following.

Illustration:

	₦
Wages and salaries paid in advance at the beginning of the year	(X)
Wages and salaries expenses in the year	X
	X
Wages and salaries paid in advance at the end of the year	<u>X</u>
Cash paid for wages and salaries	X

AT- account could also be used to calculate the cash paid
Payables

Balance b/f	X		
Cash (balancing figure)	X	Purchases	X
		Balance c/f	X
	<u>X</u>		<u>X</u>

17.6.4 Cash paid for other expenses

Other expenses in the statement of comprehensive income usually include depreciation charges, which are not cash flows. Depreciation charges should therefore, be excluded from other expenses when calculating cash payments.

Cash payments for other expenses can be calculated as follows.

Illustration:

	₦
Payables for other expenses at the beginning of the year	X
Other expenses in the year, excluding depreciation and amortisation	X
	X
Payables for other expenses at the end of the year	(X)
Cash paid for other expenses	X

Payables for other expenses should exclude accrued wages and salaries, accrued interest charges and taxation payable.

Example:

The following information has been extracted from the financial statements of Abuja Plastics Limited for the year ended 31 December, 2019;

Sales	1,280,000
Cost of sales	(400,000)
Gross profit	880,000
Wages and salaries	(290,000)
Other expenses (including depreciation ₦25,000)	(350,000)
	240,000
Interest charges	(50,000)
Profit before tax	190,000
Tax on profit	(40,000)
Profit after tax	150,000

Extracts from the statement of financial position:

	At 1 January 2019 ₦	At 31 December 2019 ₦
Trade receivables	233,000	219,000
Inventory	118,000	124,000
Trade payables	102,000	125,000
Accrued wages and salaries	8,000	5,000
Accrued interest charges	30,000	45,000
Tax payable	52,000	43,000

Required

Present the cash flows from operating activities as they would be presented in a statement of cash flows using:

- the direct method; and
- the indirect method.

(W1) Cash from sales	₤
Trade receivables at 1 January 2019	233,000
Sales in the year	1,280,000
	<u>1,513,000</u>
Trade receivables at 31 December 2019	(219,000)
Cash from sales during the year	<u>1,294,000</u>

(W2) Purchases	₤
Closing inventory at 31 December 2019	124,000
Cost of sales	400,000
	<u>524,000</u>
Opening inventory at 1 January 2019	(118,000)
Purchases in the year	<u>406,000</u>

Answer: Direct method

Statement of cash flows: direct method	₤
Cash flows from operating activities	
Cash receipts from customers (W1)	1,294,000
Cash payments to suppliers (W3)	(383,000)
Cash payments to employees (W4)	(293,000)
Cash paid for other operating expenses	(325,000)
Cash generated from operations	<u>293,000</u>
Taxation paid (tax on profits) (W5)	(49,000)
Interest charges paid (W5)	(35,000)
Net cash flow from operating activities	<u>209,000</u>

Workings

Answer: Direct method (continued)**(W4) Cash paid for wages and salaries**

	₤
Accrued wages and salaries at 1 January 2019	8,000
Wages and salaries expenses in the year	290,000
	<u>298,000</u>
Accrued wages and salaries at 31 December 2019	(5,000)
Cash paid for wages and salaries	<u>293,000</u>

(W5) Interest and tax payments

	Tax ₤	Interest ₤
Liability at the beginning of the year	52,000	30,000
Taxation charge/interest charge for the year	40,000	50,000
	<u>92,000</u>	<u>80,000</u>
Liability at the end of the year	(43,000)	(45,000)
Tax paid/interest paid during the year	<u>49,000</u>	<u>35,000</u>

Answer: Indirect method**Statement of cash flows: indirect method****Cash flows from operating activities**

Profit before taxation	190,000
Adjustments for:	
Depreciation and amortisation charges	25,000
Interest charges in the statement of comprehensive income	50,000
	<u>265,000</u>
Decrease in receivables (233,000 – 219,000)	14,000
Increase in inventories (124,000 – 118,000)	(6,000)
Increase in trade payables (125,000 + 5,000) – (102,000 + 8,000)	20,000
	<u>293,000</u>
Cash generated from operations	293,000
Taxation paid	(49,000)
Interest charges paid	(35,000)
Net cash flow from operating activities	<u>209,000</u>

17.7 Cash Flows From Investing Activities

17.7.1 Cash paid for the purchase of property, plant and equipment

This is the second part of a statement of cash flows, after cash flows from operating activities.

The most important items in this part of the statement are cash paid to purchase non-current assets and cash received from the sale or disposal of non-current assets but it also includes interest received and dividends received on investments.

It is useful to remember the following relationship:

Illustration: Movement on non-current assets

	£
Carrying amount at the start of the year	X
Depreciation	(X)
Disposals	(X)
Additions	X
Revaluation	X/(X)
Carrying amount at the end of the year	<u>X</u>

When there are no disposals or revaluations during the year

When there are no disposals or revaluations of non-current assets during the year, purchases of non-current assets (normally assumed to be the amount of cash paid for these purchases) may be calculated as follows:

Illustration:

Using cost:	£
Non-current assets at the end of the year at cost	X
Non-current assets at the beginning of the year at cost	<u>X</u>
Additions to non-current assets	<u>X</u>
Alternatively carrying amount (NBV) can be used	£
Non-current assets at the beginning of the year at NBV	X
Non-current assets at the end of the year at NBV	<u>(X)</u>
	X
Depreciation	<u>X</u>

Example: Cash paid for property, plant and equipment

The plant and equipment of PM Company at the beginning and the end of its
There were no disposals of plant and equipment during the year.

The cash paid for plant and equipment in the year (additions) may be calculated

	At cost	Accumulated depreciation	Net book value
	₦	₦	₦
Beginning of the year	180,000	(30,000)	150,000
End of the year	240,000	(50,000)	190,000

	₦		₦
At cost at the end of the year	240,000	Carrying amount (NBV) at the end of the year	190,000
At cost at the beginning of the year	180,000	Carrying amount (NBV) at the beginning of the year	150,000
Additions	<u>60,000</u>	Increase in NBV	<u>40,000</u>
		Depreciation charge for the year (50,000 – 30,000)	20,000
		Additions	<u>60,000</u>

Note that in the above example it is assumed that the purchases have been made for cash. This might not be the case. If the purchases are on credit the figure must be adjusted for any amounts outstanding at the year end.

Example: Cash paid for property, plant and equipment

PM company has purchased various items of property, plant and equipment on credit during the year. The total purchased was ~~N~~60,000.

The statements of financial position of PM company at the beginning and end of 2019 include the following information:

	2018 (~~N~~ m)	2019 (~~N~~ m)
Payables:		
Suppliers of non-current assets	4,000	12,000

The cash paid to buy property, plant and equipment in the year can be calculated as follows:

Additions	~~N~~ m 60,000
Less: increase in payables that relate to these items	(8,000)
Cash paid in the year	<u>52,000</u>

This can be thought of as the payment of the ~~N~~4,000 owed at the start and a payment of ~~N~~48,000 towards this year's purchases.

If the payables had decreased the movement would be added to the additions figure to find the cash outflow.

Example: Cash paid for property, plant and equipment

PM company has purchased various items of property, plant and equipment on credit during the year. The total purchased was ~~N~~60,000.

The statements of financial position of PM company at the beginning and end of 2019 include the following information:

	2018 (~~N~~ m)	2019 (~~N~~ m)
Payables		
Suppliers of non-current assets	14,000	4,000

The cash paid to buy property, plant and equipment in the year can be calculated as follows:

	~~N~~ m
Additions	60,000
Add: decrease in payables that relate to these items	10,000
Cash paid in the year	<u>70,000</u>

This can be thought of as the payment of the ~~N~~14,000 owed at the start and a payment of ~~N~~56,000 towards this year's purchases.

When there are disposals during the year

When there are disposals of non-current assets during the year, the purchases of non-current assets may be calculated as follows:

Illustration: Movement on non-current assets

				₦
Assets at cost at the end of the year				X
Assets at cost at the beginning of the year				X
				X
Disposals during the year: original asset cost				X
Purchases				X
	At cost	Accumulated depreciation	Carrying amount	
	₦	₦	₦	
Beginning of the year	150,000	(105,000)	45,000	
End of the year	180,000	(88,000)	92,000	

Assets at cost at the end of the year	180,000
Assets at cost at the beginning of the year	150,000
	30,000
Disposals during the year: original asset cost	60,000
Purchases	<u>90,000</u>

Alternatively using carrying amount (NBV):	₦
Assets at carrying amount (NBV) at the end of the year	92,000
Assets at carrying amount (NBV) at the beginning of the year	(45,000)

	47,000
Disposals during the year (carrying amount): (60,000 – 45,000)	15,000
Depreciation (88,000 – (105,000 – 45,000))	<u>28,000</u>
Purchases	<u>90,000</u>

Example: Cash paid for property, plant and equipment with disposals

The motor vehicles of PM Company at the beginning and the end of its financial year were as follows:

During the year a vehicle was disposed of for a gain of ₦3,000. The original cost of this asset was ₦60,000. Accumulated depreciation on the asset was ₦45,000.

The cash paid for plant and machinery in the year (=purchases) maybe calculated as follows.

When there are revaluations during the year

When there are revaluations of non-current assets during the year, the purchases of non-current assets should be calculated as follows.

Illustration: Movement on non-current assets

	₦
At cost or valuation, at the end of the year	X
At cost or valuation, at the beginning of the year	X
	X
Add: Cost/re-valued amount of assets disposed of in the year	X
Subtract: Any upward asset revaluation during the year (or deduct a downward revaluation)	(X)
Purchases during the year	X

Example:

The statements of financial position of Grand Company at the beginning and end of 2019 include the following information:

Property, plant and equipment	2018	2019
	₦	₦
At cost/re-valued amount	1,400,000	1,900,000
Accumulated depreciation	350,000	375,000
Carrying value	1,050,000	1,525,000

During the year, some property was re-valued upwards by ₦200,000. An item of equipment was disposed of during the year at a profit of ₦25,000. This equipment had an original cost of ₦260,000 and accumulated depreciation of ₦240,000 at the date of disposal.

Depreciation charged in the year was ₦265,000.

Purchases of property, plant and equipment during the year were as follows:

	₦
At cost/re-valued amount, at the end of the year	1,900,000
At cost/re-valued amount, at the beginning of the year	1,400,000
	500,000
Add: Cost of assets disposed of in the year	260,000
Subtract: Asset revaluation during the year	(200,000)
Purchases during the year	560,000

Example (continued)

Alternatively using carrying amount (NBV):	₦
Assets at carrying amount (NBV) at the end of the year	1,525,000
Assets at carrying amount (NBV) at the beginning of the year	1,050,000
	475,000
Revaluation during year	(200,000)
Carrying amount of assets disposed of in the year (260,000 – 240,000)	20,000
Depreciation charged during the year	265,000
Purchases during the year	560,000

17.7.2 Cash from disposals of property, plant and equipment

A statement of cash flows should include the net cash received from any disposals of non-current assets during the period.

This might have to be calculated from the gain or loss on disposal and the carrying amount of the asset at the time of its disposal.

Illustration: Disposal of property, plant and equipment

	₦
At cost (or re-valued amount at the time of disposal)	X
Accumulated depreciation, at the time of disposal	(X)
Net book value/carrying amount at the time of disposal	X
Gain or (loss) on disposal	X
Net disposal value (= assumed cash flow)	X

If there is a gain on disposal, the net cash from the disposal is more than the net book value.

If there is a loss on disposal the net cash from the disposal is less than the net book value.

Example:

During an accounting period, an entity disposed of some equipment and made a gain on disposal of ₦6,000.

The equipment originally cost ₦70,000 and at the time of its disposal, the accumulated depreciation on the equipment was ₦56,000.

Required:

Ascertain the amount of cash obtained from the disposal of the asset

This cash flow would be included in the cash flows from investing activities.

Suggested solution**Disposal of equipment**

At cost

₦
70,000
(56,000)

Practice question

At 1 January 2019, the property, plant and equipment in the statement of financial position of NC Company amounted to ₦329,000 at revaluation.

At the end of the year, the property, plant and equipment was valued at ₦300,000 at cost or valuation.

During the year, a non-current asset that cost ₦40,000 (and had been re-valued) was disposed of at a loss of ₦4,000. The accumulated depreciation on this asset at the time of disposal was ₦21,000.

Another non-current asset was re-valued upwards during the year from ₦67,000 (cost) to ₦102,000.

Required:

Calculate the following amounts, for inclusion in the cash flow statement of the company's statement of cash flows for 2019:

- Purchases of property, plant and equipment
- Proceeds from the sale of non-current assets

Accumulated depreciation, at the time of disposal

Net book value/carrying amount at the time of disposal	14,000
Gain on disposal	6,000
Net disposal value (assumed cash flow)	20,000

Note that in the above example it is assumed that the cash received for the disposal has been received. This might not be the case. If the disposal was on credit the figure must be adjusted for any amounts outstanding at the year end.

17.7.3 Additional Notes

You may be presented with a summary of movements in property, plant, and equipment (PPE) during the year, including a disclosure of the sale proceeds from disposed assets. In such cases, the following can be determined:

- i) PPE acquired for cash during the year: This refers to the cost of additions during the year that were paid for in cash.

- ii) PPE sold for Cash during the year: This is the amount disclosed as the selling price of disposed assets and is recorded as cash inflow.

If no further details are given in the notes regarding acquisition through non-cash means (For example, credit purchase or exchange), then the line item "Additions during the year" is treated as the net cash outflow for the acquisition of PPE.

The amount stated as the selling price of the disposed asset represents cash inflow from the sale.

The gain or loss on sale of PPE is computed as:

Selling Price – Carrying Amount

Where:

Carrying Amount = Cost (or revalued amount) – Accumulated Depreciation

If any portion of the PPE was acquired or disposed of on credit, such credit elements must be adjusted separately when preparing the statement of cash flows.

Illustration:

	Property	Plant & Equipment	Motor Vehicle	Total
Cost/Revaluation				
Opening Balance (1 July 2024)	500,000	120,000	70,000	690,000
Fair Value Increase	100,000			100,000
Additions During the Year		35,000		35,000
Disposal During the Year			(15,000)	(15,000)
Closing Balance (30 June 2025)	600,000	155,000	55,000	810,000
	Property	Plant & Equipment	Motor Vehicle	Total
Depreciation				
Opening Balance (1 July 2024)	(70,000)	(72,000)	(14,000)	(156,000)
Depreciation Charge	(8,000)	(31,000)	(11,000)	(50,000)
Disposal Adjustment			9,000	9,000
Closing Balance (30 June 2025)	(78,000)	(103,000)	(16,000)	(197,000)
• Carrying Amount (30 June 2025) =	~~N~~ 613,000			
• Carrying Amount (1 July 2024) =	~~N~~ 534,000			
Additional Information:				
• A motor vehicle was sold during the year for	~~N~~ 4,500,000.			
Application in the Statement of Cash Flows				
Under Cash Flows from Investing Activities:				
Description	Amount (~~N~~ '000)			
Purchase of PPE	(35,000)			
Proceeds from sale of motor vehicle	4,500			
Under Cash Flows from Operating Activities (Indirect Method):				
• A gain on disposal of	~~N~~ 1,500,000 is adjusted:			
Selling Price – Carrying Amount				
~~N~~ 4,500,000 – (~~N~~ 15,000,000 – ~~N~~ 9,000,000)				
= ~~N~~ 4,500,000 – ~~N~~ 6,000,000 =	~~N~~ (1,500,000) gain			
This gain is deducted from the profit before tax as it does not involve a cash flow.				

17.7.3 Cash paid for the purchase of investments and cash received from the sale of investments

A statement of cash flows should include the net cash paid to buy investments in the period and the cash received from the sale of investment in the period.

It is useful to remember the following relationship:

Illustration: Movement on investments

	₦
Carrying amount at the start of the year	X
Disposals	(X)
Additions	X
Revaluation	X/(X)
Carrying amount at the end of the year	<u>X</u>

The issues to be considered in calculating cash paid for investments or cash received on the sale of investments are very similar to those for the purchase and sale of property, plant and equipment except for the absence of depreciation.

	1,000
Investments at the start of the year (given)	
Disposal (carrying amount of investments sold = ~~₦250m~~ – ~~₦50m~~)	(200)
Revaluation gains (given)	150
	<u>950</u>
Additions (as balancing figure):	550
Investments at the end of the year (given)	<u>1,500</u>

17.8 Cash Flows from Financing Activities

17.8.1 Cash from new share issues

The cash raised from new share issues can be established by comparing the equity share capital and the share premium in the statements of financial position at the beginning and the end of the year.

Illustration:

	₦
Share capital + Share premium at the end of the year	X
Share capital + Share premium at the beginning of the year	X
Cash obtained from issuing new shares in the year	<u>X</u>

	1 January 2019	31 December 2019
	₦	₦
Equity shares of ₦1 each	600,000	750,000
Share premium	800,000	1,100,000

Example:

The statements of financial position of P Limited at 1 January and 31 December included the following items:

The cash obtained from issuing shares during the year is calculated as follows:

	₦
Share capital + Share premium at the end of 2019	1,850,000
Share capital + Share premium at the beginning of 2019	1,400,000
= Cash obtained from issuing new shares in 2019	<u>450,000</u>

17.8.2 Cash from new loans/cash used to repay loans

Cash from new loans or cash paid to redeem loans in the year can be calculated simply by looking at the difference between the liabilities for loans and bonds at the beginning and the end of the year.

- c. An increase in loans or bonds means there has been an inflow of cash.
- d. A reduction in loans or bonds means there has been a payment (outflow) of cash.

Remember to add any loans, loan notes or bonds repayable within one year (current liability) to the loans, loan notes or bonds repayable after more than one year (non-current liability) to get the total figure for loans, loan notes or bonds.

Illustration:

	£
Loans at end of year (current and non-current liabilities)	X
Loans at beginning of year (current and non-current liabilities)	X
Cash inflow or outflow	<u>X</u>

Note: The same calculation can be applied to bonds or loan notes that the company might have issued. Bonds and loan notes are long-term debt.

	January 1 2019	December 31 2019
	£	£
Loans repayable within 12 months	760,000	400,000
Loans repayable after 12 months	1,400,000	1,650,000

17.8.3 Dividend payments to equity shareholders

These should be the final dividend payment from the previous year and the interim dividend payment for the current year. The dividend payments during the year are shown in the statement of changes in equity (SOCIE).

You might be expected to calculate dividend payments from figures for retained earnings and the profit after tax for the year.

The equity dividend payments can be calculated as follows:

Illustration:

	N
Retained earnings at the beginning of the year	X
Profit for the year after tax	X
Any other transfer into the account	X
Increase in the retained earnings reserve	X
Retained earnings at the end of the year	(X)
Equity dividend payments	X

Example:

From the following information, calculate the cash flows from investing activities for Company X in 2019.

	Beginning of 2019	End of 2019
	N	N
Share capital (ordinary shares)	400,000	500,000
Share premium	275,000	615,000
Retained earnings	390,000	570,000
	1,065,000	1,685,000
Loans repayable after more than 12 months	600,000	520,000
Loans repayable within 12 months or less	80,000	55,000

The company made a profit of N420,000 for the year after taxation.

Required:

Calculate for 2019, for inclusion in the statement of cash flows:

- The cash from issuing new shares
- The cash flows received or paid for loans
- The payment of dividend to ordinary shareholders

Answer

Workings

Proceeds from new issue of shares	₦
Share capital and share premium:	
At the end of the year (500,000 + 615,000)	1,115,000
At the beginning of the year (400,000 + 275,000)	<u>(675,000)</u>
Proceeds from new issue of shares during the year	<u>440,000</u>

Repayment of loans	₦
Loans repayable:	
At the end of the year (520,000 + 55,000)	575,000
At the beginning of the year (600,000 + 80,000)	<u>(680,000)</u>
Repayment of loans during the year	<u>105,000</u>

Payment of dividends	₦
Retained earnings at the beginning of the year	390,000
Profit after taxation for the year	<u>420,000</u>
	810,000
Retained earnings at the end of the year	<u>(570,000)</u>
Dividends paid during the year	<u>240,000</u>

Cash flows from financing activities can now be presented as follows.

Cash flows from financing activities:	₦	₦
Proceeds from issue of shares	440,000	
Repayment of loans	(105,000)	
Dividends paid to shareholders	<u>(240,000)</u>	
Net cash from financing activities		95,000

17.8.4 Financing of a sole proprietor or a partnership

You may face a question asking for the preparation of a statement of cash flows for a sole proprietor or partnership. Such a question might require the calculation of cash flows between the owners and the business. These cash flows would be capital introduced and drawings.

It is useful to remember the following relationship:

Illustration:

	₹
Capital at the beginning of the year	X
Profit (loss) for the year after tax	X/(X)
Capital introduced	X
Drawings	(X)
Capital at the end of the year	<u>X</u>

The drawings and capital introduced figures might be provided in the question in which case you simply have to slot the figures into the cash flow statement.

Other questions might need you to identify one or other of these as balancing figure.

17.9 Statement Of Cash Flows – Specimen Formats

IAS 7 does not specify formats for the statement of cash flows. However, it includes illustrative statements in an appendix.

The illustrations below are based on the illustrative examples but have been modified to exclude some items not in this syllabus.

17.9.1 Direct method

Illustration:

	₦	₦
Cash flows from operating activities		
Cash receipts from customers	X	
Cash paid to suppliers	(X)	
Cash paid employees	(X)	
<i>Cash generated from operations</i>	X	
Interest paid	(X)	
Income taxes paid	(X)	
<i>Net cash from operating activities</i>		X
Cash flows from investing activities		
Purchase of property, plant and equipment	(X)	
Proceeds from sale of equipment	X	
Interest received	X	
Dividends received	X	
<i>Net cash used in investing activities</i>		X
Cash flows from financing activities		
Proceeds from issue of share capital	X	
Proceeds from long-term borrowings	X	
Dividends paid	(X)	
<i>Net cash used in financing activities</i>		X
Net increase in cash and cash equivalents		X
Cash and cash equivalents at beginning of period		X
Cash and cash equivalents at end of period		X

17.9.2 Indirect method
Illustration:

	~~₹~~	~~₹~~
Cash flows from operating activities		
Profit before taxation		
Adjustments for:		
Depreciation	X	
Investment income	(X)	
Interest expense	X	
Operating profit before working capital changes	X/(X)	
Increase/decrease in trade and other receivables	(X)/X (X)/X	
Increase/decrease in inventories		
Increase/decrease in trade payables		
Cash generated from operations	X	
Interest paid	(X)	
Income taxes paid	(X)	
<i>Net cash from operating activities</i>		X
Cash flows from investing activities		
Purchase of property, plant and equipment	(X)	
Proceeds from sale of equipment	X	
Interest received	X	
Dividends received	X	
<i>Net cash used in investing activities</i>		X
Cash flows from financing activities		
Proceeds from issue of share capital	X	
Proceeds from long-term borrowings	X	
Dividends paid	(X)	
<i>Net cash used in financing activities</i>		X
Net increase in cash and cash equivalents		X
Cash and cash equivalents at beginning of period		X
Cash and cash equivalents at end of period		X

17.10 Introduction To Statement Of Changes In Equity(Socie)

17.10.1 Introduction

The Statement of Changes in Equity (SOCIE) is one of the primary financial statements required under IAS 1: Presentation of Financial Statements. It explains the changes in an entity's equity over a reporting period and provides users with a comprehensive view of movements in the components of equity.

It shows movements in:

- a. share capital;
- b. share premium;
- c. reserves (For example, revaluation reserves, other comprehensive income);
- d. retained earnings; and
- e. non-controlling interests (if applicable).

17.10.2 Importance of the statement

The SOCIE serves as a vital tool for understanding how equity changes over time. Its key functions are outlined below:

17.10.3 Shows movements in equity components

It presents a detailed reconciliation of each component of equity such as:

- a. share capital;
- b. share premium;
- c. retained earnings;
- d. revaluation surplus; and
- e. other reserves (For example, fair value reserves, foreign exchange reserves).

This allows users to track changes resulting from profit, revaluations, dividend payments, share issues, and other transactions.

17.10.4 Highlights profit distribution

The SOCIE discloses:

- a. profit for the year (as reported in the statement of profit or loss); and
- b. dividends declared and paid, which reduce retained earnings.

This level of detail helps users understand how much profit was retained in the business versus how much was distributed to shareholders.

17.10.5 Communicates other comprehensive income (OCI)

Some gains and losses do not pass through the profit or loss but are recognised in Other Comprehensive Income (OCI). These are shown separately in the SOCIE and include:

- a. revaluation gains;
- b. foreign currency translation differences; and
- c. actuarial gains/losses on defined benefit plans.

The SOCIE shows:

- i. the separate impact of these OCI items on equity; and
- ii. their realisation and transfer, such as from revaluation reserve to retained earnings.

17.10.6 Enhances transparency and accountability

The SOCIE improves clarity by disclosing:

- a. opening and closing balances of each equity component;
- b. transactions with owners (e.g., new share issues, dividends); and

- c. internal transfers (e.g., revaluation reserve to retained earnings).

The SOCIE builds trust and enables stakeholders to trace equity movements with confidence.

17.10.7 Supports financial analysis

Investors, creditors, and analysts use SOCIE to:

- a. assess the entity's profit retention capacity;
- b. understand a company's dividend policy;
- c. track capital structure changes; and
- d. Monitor trends in reserves and equity injections.

This can influence investment decisions, lending terms, or assessments of financial stability.

17.10.8 Compliance with IFRS

IAS 1 mandates the inclusion of the SOCIE in the full set of financial statements. This requirement ensures:

- a. consistency in reporting; and
- b. comparability across periods and with other entities.

3. Components of equity

Component	Description
Share capital	Amount contributed by shareholders for shares issued.
Share premium	Excess amount paid over the par value of shares.
Retained earnings	Accumulated profit or loss not distributed as dividends.
Revaluation reserve	Surplus from revaluation of assets (For example, PPE).
Other reserves	Includes translation reserves, fair value reserves, etc.
Non-controlling interest (NCI)	Share of equity in subsidiaries not attributable to the parent (if group accounts).

4. Required disclosures (IAS 1, para 106)

The statement must include:

- a. total comprehensive income for the period, showing separately the amounts attributable to owners and NCI.
- b. effects of retrospective application or restatement, where applicable.
- c. reconciliations for each component of equity showing:
 - Opening balance
 - Profit/loss for the period
 - OCI items
 - Transactions with owners (For example, dividends, share issues)
 - Transfers between components of equity
 - Closing balance

5. Common transactions reflected in SOCIE

Transaction	Effect
Profit for the year	Increase in retained earnings
Dividends declared	Decrease in retained earnings
Revaluation of assets	Increase in revaluation reserve (OCI)
Share issue	Increase in share capital and/or share premium
Correction of errors	Adjusted in opening retained earnings
Change in accounting policy	Adjusted in opening retained earnings

6. Sample layout

A simplified format of the SOCIE is as follows:

Particulars	Share Capital	Share Premium	Retained Earnings	Revaluation Reserve	Total Equity
Opening balance	Xxx	xxx	xxx	xxx	xxx
Profit for the year	—	—	xxx	—	xxx
Other comprehensive income	—	—	—	xxx	xxx
Dividends	—	—	(xxx)	—	(xxx)
Transfer from revaluation reserve	—	—	xxx	(xxx)	—
Share issue	Xxx	xxx	—	—	xxx
Closing balance	Xxx	xxx	xxx	xxx	xxx

Example

The following information was extracted from the books of Enofe Ltd for the year ended December 31, 2020:

	N'000
Profit after tax 31/12/2020	4,200
Share premium	2,000
Accumulated profit	7,500
Revaluation reserve	5,000
Equity capital	21,000

At the end of December 31, the land and building was revalued causing a reserve of ₦5,000,000 but an increase in depreciation by ₦300,000. Enofe Ltd has a policy of transferring the revaluation surplus included in equity to retained earnings as it is realised. Interim dividend paid during the year was ₦200,000.

Required:

Prepare the statement of changes in equity for the year ended December 31, 2020.

Suggested solution

Enofe Ltd**Statement of changes in equity for the year ended December 31, 2020**

	Share capital	Share premium	Revaluation reserve	Retained profits	Total
	N'000	N'000	N'000	N'000	N'000
Balance at beginning of year	21,000	2,000	0	7,500	30,500
Dividend paid				(200)	(200)
Profit for the period				4,200	4,200
Other comprehensive income:					
Revaluation of non-current asset			5,000		
Transfer of excess depreciation on revaluation			(300)	300	0
Balance at end of year	21,000	2,000	4,700	11,800	39,500

17.11 Chapter review**Chapter review**

On completion of this chapter, check that you are now able to:

- prepare part or all of a statement of cash flows from information provided; and
- understand the statement of changes in equity

17.12 End of chapter questions and suggested solutions**Question 1**

BoldTech Ltd acquired equipment worth ₦2,000,000 during 2024, but only ₦1,200,000 was paid in cash. The remaining balance was financed through a vendor loan. The equipment was correctly capitalised, and depreciation of ₦200,000 was charged for the year. The company did not disclose the non-cash element in the statement of cash flows.

During a review, auditors noted this omission and flagged it as non-compliance with IAS 7.

Required:

- a. Explain the treatment of non-cash investing and financing activities under IAS 7.
- b. Discuss the implications of failing to disclose non-cash transactions in financial statements.
- c. Draft a note to the financial statements to properly disclose this transaction in accordance with IAS 7.

Suggested solution

- a) Treatment of Non-Cash Investing and Financing Activities under IAS 7
IAS 7 – **Statement of Cash Flows** requires that only cash flows (inflows and outflows of cash and cash equivalents) be included in the statement of cash flows. However, it also recognises the importance of non-cash transactions in understanding a company's financial position.
Treatment:
 - Non-cash investing and financing activities must not be included in the main body of the statement of cash flows.
 - Instead, such transactions should be disclosed separately in the notes to the financial statements.
 - These disclosures ensure users are informed of significant financing and investing activities that affect the financial position but not the cash flow.Examples include:
 - Acquisition of assets through vendor financing.
 - Conversion of debt to equity.
 - Leased assets capitalised under finance leases.
- b) Implications of Failing to Disclose Non-Cash Transactions
Failing to disclose non-cash transactions, such as BoldTech's vendor-financed equipment purchase, has several negative implications:
 - i. Non-Compliance with IAS 7:
 - It constitutes a breach of international financial reporting standards and may lead to audit qualifications or regulatory sanctions.
 - ii. Misleading Financial Statements:
 - Users may assume that all asset acquisitions were paid in cash, overstating the company's investing cash outflows and underestimating its financing obligations.
 - iii. Poor Transparency and Decision-Making:
 - Investors, lenders, and other stakeholders may make suboptimal decisions due to the lack of clarity about how assets were financed.
 - iv. Audit and Reputational Risks:
 - It may raise concerns about internal controls and transparency, affecting credibility with regulators and the public.
- c) Draft Note to the Financial Statements (in accordance with IAS 7)
Note X: Non-Cash Investing and Financing Activities
During the year ended 31 December 2024, BoldTech Ltd acquired equipment with a total cost of ₦2,000,000. Of this amount, ₦1,200,000 was paid in cash and ₦800,000 was financed through a vendor loan agreement. This transaction has been correctly capitalised in the financial statements. However, the non-cash component of ₦800,000

has not been included in the statement of cash flows, in accordance with the requirements of IAS 7, paragraph 43, which requires such non-cash transactions to be disclosed separately in the notes.

Question 2

The following information relates to Star Ltd for the year ended 31 December 2024:
Statements of Financial Position:

	31 Dec 2023 (N)	31 Dec 2024 (N)
Property, Plant & Equipment	2,000,000	2,600,000
Accumulated Depreciation	(600,000)	(720,000)
Inventory	450,000	380,000
Trade Receivables	600,000	800,000
Cash and bank	200,000	300,000
Trade Payables	300,000	350,000
Tax Payable	50,000	40,000
Bank Loan (due after 1 year)	500,000	700,000
Share Capital	1000,000	1,300,000
Retained Earnings	800,000	970,000

Additional Information:

- Depreciation for the year was N180,000.
- Dividends paid during the year amounted to N250,000.
- Equipment costing N200,000 with a net book value of N120,000 was sold for N100,000.
- The profit before tax for the year was N500,000.
- Income tax paid during the year was N60,000.

Required:

Prepare the Statement of Cash Flows for the year ended 31 December 2024 using the indirect method, in accordance with IAS 7.

Suggested solution

STAR LTD

Statement of Cash Flows for the year ended 31 December 2024 using the indirect method, in accordance with IAS 7.

	N'000	N'000
Profit before tax		500,000
Adjustments for:		
Depreciation		180,000
Loss on disposal of equipment		<u>20,000</u>
Operating profit before working capital changes		700,000
Changes in working capital:		
Increase in trade receivables	(200,000)	
Decrease in inventory	70,000	
Increase in trade payables	<u>50,000</u>	
Net change in working capital		<u>(80,000)</u>
Cash generated from operations		620,000
Income tax paid		(70,000)
Net cash from operating activities		550,000

Cash flows from investing activities		
Proceeds from sale of equipment	100,000	
Purchase of new equipment	<u>(800,000)</u>	
Net cash used in investing activities		(700,000)
Cash flows from financing activities		
Proceeds from issue of shares	300,000	
Proceeds from bank loan	200,000	
Dividend paid	<u>(250,000)</u>	
Net cash from financing activities		<u>250,000</u>
Net increase in cash and cash equivalents		100,000
Net and cash equivalents at beginning of year		<u>200,000</u>
Cash and cash equivalents at end of year		<u>300,000</u>

Question

The following balances were extracted from the books of Delta Ltd as at 1 January 2024:

Item	N'000
Share Capital	30,000
Share Premium	5,000
Retained Earnings	12,000
Revaluation Reserve –	

Additional information for the year ended 31 December 2024 includes:

- Profit after tax for the year amounted to N9,500,000.
- A revaluation of buildings resulted in a surplus of N6,000,000.
- Depreciation increased by N600,000 due to the revaluation. The company transfers this depreciation annually from the revaluation reserve to retained earnings.
- An interim dividend of N2,000,000 was paid during the year.
- The company issued new ordinary shares for cash: N5,000,000 at par value of N1 per share. The shares were issued at a premium of N2 per share.

Required:

Prepare the Statement of Changes in Equity for Delta Ltd for the year ended 31 December 2024.

Suggested solution

Delta Ltd

Statement of Changes in Equity for the year ended 31 December 2024

All figures in N'000

Particulars	Share Capital	Share Premium	Retained Earnings	Revaluation Reserve	Total Equity
Opening Balance (1 Jan 2024)	30,000	5,000	12,000	–	47,000
Profit for the year	–	–	9,500	–	9,500
Other Comprehensive Income:					

Particulars	Share Capital	Share Premium	Retained Earnings	Revaluation Reserve	Total Equity
Revaluation surplus	–	–	–	6,000	6,000
Transfer of excess depreciation	–	–	600	(600)	–
Dividend paid	–	–	(2,000)	–	(2,000)
Share Issue:					
New share capital (~~N~~ 5m @ ~~N~~ 1)	5,000	–	–	–	5,000
Share premium (~~N~~ 5m @ ~~N~~ 2)	–	10,000	–	–	10,000
Closing Balance (31 Dec 2024)	35,000	15,000	20,100	5,400	75,500

Workings:

- Retained earnings closing balance:
Opening ~~N~~12,000 + Profit ~~N~~9,500 – Dividend ~~N~~2,000 + Transfer from revaluation ~~N~~600 = ~~N~~20,100
- Revaluation reserve:
Revaluation ~~N~~6,000 – Depreciation transfer ~~N~~600 = ~~N~~5,400
- Share Capital:
Opening ~~N~~30,000 + ~~N~~5,000 (new issue) = ~~N~~35,000
- Share Premium:
Opening ~~N~~5,000 + ~~N~~10,000 (5,000 shares × ~~N~~2) = ~~N~~15,000

SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

- (a) In the adjustments to get from the operating profit to the cash flow from operations, the loss on disposal of ₦8,000 should be added.
- (b) Under the heading 'Cash flows from investing activities', the sale price of the vehicle of ₦22,000 should be included as a cash inflow.

Workings:

Original cost of vehicle	50,000
Accumulated depreciation at date of disposal	(20,000)
Net book value at the time of disposal	30,000
Loss on disposal	(8,000)
Therefore, net sales proceeds	22,000

Solutions

2

	₦
Profit before taxation	60,000
Adjustments for:	
Depreciation	25,000
Interest charges	10,000
Gain on disposal of non-current asset	(14,000)
	81,000
Reduction in trade and other receivables	5,000
Increase in inventories	(4,000)
Reduction in trade payables	(6,000)
	76,000
Taxation paid	(17,000)
Interest charges paid	(10,000)
Cash flows from operating activities	49,000

Solutions**3****Property, plant and equipment purchases****₤**

At cost or valuation at the end of the year	381,000
At cost or valuation at the beginning of the year	(329,000)
	52,000
Add: Cost of assets disposed of in the year	40,000
Subtract: Asset revaluation during the year (102,000–67,000)	(35,000)
Purchases during the year	57,000

Disposal of equipment**₤**

At cost	40,000
Accumulated depreciation, at the time of disposal	(21,000)
Net book value/carrying amount at the time of disposal	19,000
Loss on disposal	(4,000)
Net disposal value (= assumed cash flow)	15,000

INTERPRETATION OF FINANCIAL STATEMENTS**Contents**

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18. Interpretation to Financial Statements

18.0 Learning objective

This chapter explains the importance and purpose of financial statement analysis. It also guides on computing financial ratios and interpreting whether the calculated ratios indicate an improvement or deterioration compared to benchmarks.

18.1 Learning outcomes

After completing this topic, readers should be able to:

- a. explain the need for interpreting financial statements.
- b. identify and calculate different types of financial ratios, including profitability, liquidity, and long-term solvency ratios.
- c. compare and contrast financial ratios to assess a company's financial performance and position.
- d. interpret financial ratios to identify trends and patterns in a company's financial performance.
- e. assess whether the ratios indicate improvement or deterioration in performance.
- f. apply financial statement interpretation to make informed business decisions.

18.2 Interpretation Of Financial Statements

18.2.1 Introduction

Financial statements are formal reports that provide information about a company's financial performance and position. The two primary financial statements are:

- a. Statement of Financial Position – shows a company's assets, liabilities, and equity at a specific point in time.
- b. Statement of Comprehensive Income – shows a company's revenues and expenses over a specific period.

Interpreting financial statements involves analysing and explaining the data to extract meaningful insights and conclusions.

18.2.2 Need for Interpretation of Financial Statements

Although financial statements provide valuable numerical information, they are essentially raw data. To make informed decisions, stakeholders must interpret these figures to understand a company's financial health, performance, and position.

The main reasons for interpreting financial statements are to:

- a. evaluate financial performance: Assess a company's profitability, operational efficiency, and growth potential.
- b. make informed decisions: Use financial insights to support investment, lending, or strategic business decisions.
- c. identify trends and patterns: Recognise changes in financial data that may reveal risks or opportunities.

18.2.3 Financial Ratios

Ratios are powerful tools for interpreting financial statements. A ratio expresses one number relative to another, usually as a fraction or percentage, allowing for effective comparison and decision-making.

Financial ratios are commonly grouped into four categories:

- d. Profitability ratios
- e. Liquidity (short-term solvency) ratios

- f. Long-term solvency or stability ratios
- g. Shareholders' ratios

At this foundation level, we will focus on basic ratios and their interpretation. This foundation will help prepare readers for more advanced analysis at the professional level and in real-world applications.

18.3 Profitability Ratios

18.3.1 Introduction

Profitability ratios measure a company's ability to generate profits from its sales, assets, and equity. They provide valuable insights into financial performance and help stakeholders make informed decisions. These include:

18.3.2 Purpose

Profitability ratios are used to:

- a. Measure how well a company converts revenue into profit.
- b. Assess the company's financial health and operational efficiency.
- c. Compare profitability over time or with other firms in the same industry.
- d. Support decision-making by management, investors, and creditors.

18.3.3 Types

Profitability ratios come in various forms, each providing a different perspective on a company's ability to generate profit. Some focus on profit relative to sales, while others examine returns based on capital or equity. The following are the key types of profitability ratios commonly used in financial analysis:

i) Gross Profit Margin

It is expressed as a percentage

Formula:

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{sales}} \times 100\%$$

Significance:

Indicates how efficiently a company manages its production costs relative to revenue. A higher margin suggests strong pricing power and cost control.

ii) Net Profit Margin

It is expressed as a percentage

Formula:

$$\text{Net Profit Margin} = \frac{\text{Net profit}}{\text{sales}} \times 100\%$$

Significance

Shows how much net profit is generated from revenue. A higher net margin reflects better cost management and profitability.

iii) Return on Capital Employed (ROCE)

It is expressed as a percentage

Formula:

$$\text{ROCE} = \frac{\text{Profit before interest and tax}}{\text{capital employed}} \times 100\%$$

Calculation:

Capital Employed = Total Assets – Current Liabilities

Profit before interest and tax (PBIT) = Operating Profit

Significance

Measures how effectively a company uses its capital to generate profit. A higher ROCE indicates efficient use of capital.

iv) Asset Turnover Ratio

It is expressed as a number of times.

Formula:

$$\text{Asset Turnover} = \frac{\text{sales}}{\text{Total assets}}$$

Significance:

Indicates how effectively a company uses its assets to generate sales. A higher ratio suggests efficient asset utilisation.

v) Return on Equity (ROE)

It is expressed as a percentage

Formula:

$$\text{ROE} = \frac{\text{Net Profit}}{\text{Total equity}} \times 100\%$$

Calculation:

Total Equity = Total Assets – Total Liabilities

Significance:

Measures the return on shareholders' equity. A higher ROE means greater profitability for shareholders.

vi) Operating Profit Margin

It is expressed as a percentage

Formula:

$$\text{Operating Profit Margin} = \frac{\text{Operating Profit}}{\text{sales}} \times 100\%$$

Calculation:

Operating Profit = Gross Profit – Operating Expenses

Significance:

Indicates the percentage of sales remaining after covering operating costs. A higher margin suggests effective cost control and strong core operations.

Illustration

The following information is extracted from the books of Eko Limited:

- i) Sales revenue – ~~N~~45,000,000
- ii) Cost of sales – ~~N~~27,000,000
- iii) Total expenses – ~~N~~12,000,000
- iv) Included in (iii) is interest expense - ~~N~~750,000
- v) Income tax - ~~N~~1,800,000
- iv) Total assets – ~~N~~15,000,000
- v) Total current liabilities – ~~N~~2,500,000
- vi) Total equity – ~~N~~10,000,000

Required:

Calculate and interpret the following ratios:

- Gross Profit Margin
- Net Profit Margin
- Return on Capital Employed (ROCE)
- Asset Turnover ratio
- Return on Equity (ROE)
- Operating Profit Margin

Suggested solution

- a) Gross Profit Margin

$$\text{Gross Profit} = \text{N}45,000,000 - \text{N}27,000,000 = \text{N}18,000,000$$

$$\text{Gross Profit Margin} = \frac{\text{Gross profit}}{\text{sales}} \times 100\%$$

$$\text{Gross Profit Margin} = \frac{18,000,000}{45,000,000} \times 100\% = 40\%$$

Interpretation: Eko Ltd earns 40 kobo in gross profit for every ~~N~~1 of sales. This reflects effective cost control relative to revenue.

- b) Net Profit Margin

$$\text{Net Profit} = \text{N}45,000,000 - \text{N}27,000,000 - \text{N}12,000,000 = \text{N}6,000,000$$

$$\text{Then, deduct tax} = \text{N}6,000,000 - \text{N}1,800,000 = \text{N}4,200,000$$

$$\text{Net Profit Margin} = \frac{\text{Net profit}}{\text{sales}} \times 100\%$$

$$\text{Net Profit Margin} = \frac{4,200,000}{45,000,000} \times 100\% = 9.33\%$$

Interpretation: After accounting for all expenses, including interest and tax, Eko Ltd earns ~~N~~0.0933 (or 9.33%) net profit on every ~~N~~1 of sales revenue. This indicates a healthy bottom line, reflecting the company's ability to manage its overall costs and still deliver reasonable profitability.

- c. Return on Capital Employed (ROCE)

$$\begin{aligned} \text{Profit before interest and taxes (operating profit)} &= \text{N}6,000,000 + \text{N}750,000 \\ &= \text{N}6,750,000 \end{aligned}$$

$$\begin{aligned} \text{Capital Employed} &= \text{Total Assets} - \text{Current Liabilities} \\ &= \text{N}15,000,000 - \text{N}2,500,000 = \text{N}12,500,000 \end{aligned}$$

$$\text{ROCE} = \frac{\text{Profit before interest and tax}}{\text{capital employed}} \times 100\%$$

$$\text{ROCE} = \frac{6,750,000}{12,500,000} \times 100\% = 54\%$$

Interpretation: The company generates a 54% return on capital employed. This high ROCE indicates efficient use of capital in generating profits from operations.

d) Asset Turnover ratio

$$\text{Asset Turnover} = \frac{\text{sales}}{\text{Capital employed}} \times 100\%$$

$$\text{Asset Turnover} = \frac{45,000,000}{15,000,000} = 3 \text{ times}$$

Interpretation: Eko Ltd generates three naira in sales for every naira invested in total assets. This shows strong asset utilization.

e) Return on Equity (ROE)

$$\text{ROE} = \frac{\text{Net Profit}}{\text{Total equity}} \times 100\%$$

$$\text{ROE} = \frac{6,000,000 - 1,800,000}{10,000,000} \times 100\% = 42\%$$

Interpretation: Eko Ltd generated a 42% return on shareholders' equity, indicating a strong performance in using owners' funds to generate profit. A return of this magnitude suggests efficient management and high profitability relative to the equity invested by shareholders.

f) Operating Profit Margin

$$\frac{\text{Operating Profit}}{\text{sales}} \times 100\%$$

$$\begin{aligned} \text{Operating profit} &= \text{profit before interest and tax} = \text{N}6,000,000 + \text{N}750,000 \\ &= \text{N}6,750,000 \end{aligned}$$

$$\frac{6,750,000}{45,000,000} \times 100\% = 15\%$$

Interpretation: The company retains 15% of its sales as operating profit before interest and tax. This indicates moderate operating efficiency.

18.4 Efficiency Ratios

18.4.1 Introduction

Efficiency ratios are key financial metrics that assess how effectively a company employs its assets and manages its operational processes. These ratios help assess the speed and effectiveness with which a business converts its resources, such as inventory, receivables, and payables, into revenue and ultimately cash. They provide valuable insights into the internal workings of a company's operations, highlighting areas of strength and those needing improvement.

18.4.2 Purpose

Managers use efficiency ratios to identify strengths and weaknesses in operations. These ratios help management maximise output from existing resources, optimise asset utilisation, improve cash flow management, and enhance overall competitiveness.

Investors and analysts use efficiency ratios to evaluate a company's operational effectiveness and financial health. The insights gained can highlight areas needing improvement, expose inefficiencies, and support informed investment decisions.

Efficiency ratios are most meaningful when compared to historical performance or industry benchmarks, as this provides context for evaluating trends and measuring progress over time.

18.4.3 Types

The following are key types of efficiency ratios, each providing specific insights into different aspects of operational performance:

i) Inventory Turnover Ratio

It is expressed as a number of times.

Formula:

$$\frac{\text{Cost of sales}}{\text{Average inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening inventory} + \text{closing inventory}}{2}$$

Significance

Measures how efficiently inventory is managed by showing how many times it is sold and replaced during a period.

ii) Receivables Turnover Ratio

It is expressed as a number of times

Formula:

$$\frac{\text{Net credit sales}}{\text{Average trade receivables}}$$

Net credit sales refer to the revenue a company earns from goods or services sold on credit, excluding:

- Cash sales, and
- Sales returns and allowances related to credit sales.

Significance

Indicates how effectively the company collects debts from customers.

iii) **Payables Turnover Ratio**

It is expressed as a number of times

Formula:

$$\frac{\text{Credit purchases}}{\text{Average trade payables}}$$

Significance

Reflects how quickly the company settles its obligations to suppliers.

iv) **Asset Turnover Ratio**

It is expressed as a number of times

Formula

$$\frac{\text{Net sales}}{\text{Average total assets}}$$

Significance

Shows how effectively the company uses its total assets to generate revenue.

v) **Working Capital Turnover Ratio**

It is expressed as a number of times

Formula:

$$\frac{\text{Net sales}}{\text{Average working capital}}$$

Working Capital = Current Assets – Current Liabilities

Significance

Assesses how efficiently the company uses its working capital to generate sales.

vi) **Non-current Asset Turnover Ratio**

It is expressed as a number of times

Formula:

$$\frac{\text{Net sales}}{\text{Average non – current assets}}$$

Significance

Indicates how well the company is utilising its fixed assets to produce revenue.

vii) **Operating Cycle**

It is expressed in number of days.

Formula: Inventory Days + Receivable Days

Inventory Days =

$$\frac{\text{Average inventory}}{\text{cost of sales}} \times 365, \text{ or}$$

$$\frac{365}{\text{Inventory turnover}}$$

Receivable Days =

$$\frac{\text{Average trade receivables}}{\text{Net credit sales}} \times 365, \text{ or}$$

$$\frac{365}{\text{Receivable turnover}}$$

Significance

Shows the average time it takes to turn inventory into cash through sales and collections.

viii) Cash Conversion Cycle (CCC)

It is expressed in number of days.

Formula: Inventory Days + Receivable Days – Payable Days

This same as operating cycle – payable days

Payable Days =

$$\frac{\text{Average trade payables}}{\text{Credit purchases}} \times 365 \text{ or}$$

$$\frac{365}{\text{Payable turnover}}$$

Significance

Measures how long it takes to convert inventory and receivables into cash, accounting for the payment period to suppliers.

Illustration

The following information was extracted from the books of Aba Limited for the year ended 31 December 2024:

Statement of profit or loss:

Net sales revenue: ₦24,000,000

Cost of sales: ₦14,400,000

Credit purchases: ₦10,800,000

Statement of financial position:

Item	1 Jan 2024 (₦)	31 Dec 2024 (₦)
Inventory	1,200,000	1,600,000
Trade receivables	1,800,000	2,200,000
Trade payables	1,500,000	1,800,000
Working capital	3,000,000	3,600,000
Net non-current assets	6,000,000	7,200,000
Total assets	10,800,000	12,000,000

Required:

- a. Calculate the following **efficiency ratios** for the year 2024:
- Inventory turnover ratio
 - Receivables turnover ratio
 - Payables turnover ratio
 - Asset turnover ratio
 - Workingcapital turnover ratio
 - Non-current asset turnover ratio
 - Operating cycle (in days)
 - Cash conversion cycle (in days)
- b. Interpret each ratio and comment on what it reveals about the company's operational efficiency.

Solution

Inventory Turnover Ratio

It is expressed as a number of times.

$$\frac{\text{Cost of sales}}{\text{Average inventory}}$$

$$\text{Average Inventory} = \frac{\text{Opening inventory} + \text{closing inventory}}{2}$$

$$\frac{14,400,000}{1,400,000} = 10.29 \text{ times}$$

$$\text{Average Inventory} = \frac{1,200,000 + 1,600,000}{2} = 1,400,000$$

Interpretation: Inventory was sold and replaced approximately 10.3 times during the year. This indicates that the company is efficiently managing its inventory.

Receivables Turnover Ratio

$$\frac{\text{Net credit sales}}{\text{Average trade receivables}}$$

$$\frac{24,000,000}{2,000,000} = 12 \text{ times}$$

Interpretation: Receivables were collected 12 times during the year, indicating strong credit collection.

Payables Turnover Ratio

$$\frac{\text{Credit purchases}}{\text{Average trade payables}}$$

$$\frac{10,800,000}{1,650,000} = 6.55 \text{ times}$$

Interpretation: The company paid its suppliers about 6.6 times during the year. This indicates that the company is paying its suppliers regularly but not too quickly, allowing it to benefit from short-term credit.

$$\frac{\text{Asset Turnover Ratio}}{\frac{\text{Net sales}}{\text{Average total assets}}}$$

$$\frac{24,000,000}{11,400,000} = 2.11 \text{ times}$$

Interpretation: Each naira of total assets generated ₦2.11 in sales, showing efficient use of assets.

Solution continued

$$\frac{\text{Working Capital Turnover Ratio}}{\frac{\text{Net sales}}{\text{Average working capital}}}$$

$$\frac{24,000,000}{3,300,000} = 7.27 \text{ times}$$

Interpretation: The company generated ₦7.27 in sales for every naira of working capital. This reflects strong turnover and operational efficiency, but it also requires monitoring to ensure the company retains enough liquidity for ongoing obligations.

Non-current Asset Turnover Ratio

$$\frac{\text{sales}}{\text{Average non – current assets}}$$

$$\frac{24,000,000}{6,600,000} = 3.64 \text{ times}$$

Interpretation: Each naira invested in non assets generated ₦3.64 in sales. This is a positive indicator of asset efficiency and operational strength, provided it aligns well with industry benchmarks and does not result from underinvestment in infrastructure.

Operating Cycle (CC)

Inventory Days + Receivable Days

$$\text{Inventory Days} = \frac{\text{Average inventory}}{\text{cost of sales}} \times 365 = \frac{1,400,000}{14,400,000} \times 365 = 35.5 \text{ days}$$

Interpretation: It takes about 36 days to sell inventory.

$$\text{Receivable Days} = \frac{365}{\text{Receivables turnover}} = \frac{365}{12} = 30.4$$

Interpretation: It takes about 30 days to collect receivables.

$$\text{CC} = 35.5 \text{ days} + 30.4 \text{ days} = 65.9 \text{ days}$$

Interpretation: The company's operating cycle is about 66 days.

Cash Conversion Cycle (CCC)

Operating Cycle – Payable Days

$$\text{Payable Days} = \frac{365}{\text{Payables turnover}} = \frac{365}{6.55} = 55.8$$

$$\text{CCC} = 65.9 - 55.8 = 10.1 \text{ days}$$

Interpretation: It takes about 10 days to convert inventory and receivables into cash after paying suppliers.

18.5 Liquidity Or Short-Term Solvency Ratios

18.5.1 Introduction

Liquidity ratios assess a company's ability to meet its short-term obligations, such as paying suppliers, creditors, and other current liabilities. These ratios help stakeholders evaluate the company's liquidity position and make informed financial decisions.

18.5.2 Purpose

Liquidity and short-term ratios are used to assess a company's ability to meet its short-term financial obligations as they fall due. They help evaluate whether the company has enough liquid assets to cover its current liabilities without needing to secure additional financing.

These ratios serve the following purposes:

- They measure the company's ability to pay its short-term debts, which is essential for maintaining operational stability and creditor confidence;
- They indicate how well the company can handle unexpected expenses or downturns in cash flow;
- Management uses these ratios to manage working capital more effectively, ensuring that the business operates smoothly without liquidity constraints;
- Investors, creditors, and analysts rely on liquidity ratios to evaluate the financial soundness of a company before extending credit or making investment decisions; and
- While primarily focused on liquidity, these ratios can also reflect how efficiently current assets and liabilities are managed within the business cycle.

18.5.3 Types

The following are the key types of liquidity and short-term ratios commonly used in financial analysis.

i) Current Ratio

Formula:

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

Expressed as X:1 (e.g., 2:1, 1.5:1)

Calculation:

Current Assets = Cash + Accounts Receivable + Inventory + Prepaid Expenses

Current Liabilities = Accounts Payable + Short-term Loans + Taxes Payable + Accrued Expenses

Significance:

The current ratio measures a company's ability to cover its current liabilities with

current assets. A higher ratio suggests stronger short-term financial health, though excessively high values may indicate inefficient use of assets.

ii) Quick Ratio (Acid-Test Ratio)

Formula:

$$\text{Quick Ratio} = \frac{\text{current assets} - \text{inventory}}{\text{current liabilities}}$$

Expressed as X:1 (for example, 1.5:1, 1:1)

Calculation:

Quick Assets = Cash + Accounts Receivable (or Current Assets – Inventory – Prepaid Expenses)

Current Liabilities = Accounts Payable + Short-term Loans + Taxes Payable

Significance:

The quick ratio evaluates a company's ability to meet its short-term obligations without relying on inventory, which may not be quickly convertible to cash. A higher ratio implies better liquidity.

iii) Cash Ratio

Formula:

$$\text{Cash Ratio} = \frac{\text{cash and cash equivalent}}{\text{current liabilities}}$$

Expressed as X:1 (for example, 1:1, 0.8:1)

Calculation:

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

Current Liabilities = Accounts Payable + Short-term Loans + Taxes Payable

Significance:

The cash ratio is the most conservative measure of liquidity. It assesses a company's ability to pay off current liabilities using only its most liquid assets—cash and equivalents.

Note: Other receivables and other payables are excluded from receivable and payable days calculations as they do not directly impact operating cash flow timing.

Advantages of a Shorter Cash Conversion Cycle

- a. Improved liquidity
- b. Reduced need for short-term financing
- c. Increased ability to invest in growth opportunities
- d. Enhanced financial flexibility

Disadvantages of a Longer Cash Conversion Cycle

- a. Reduced liquidity
- b. Increased need for short-term financing
- c. Decreased ability to invest in growth opportunities
- d. Reduced financial flexibility

Illustration

The following information is extracted from the books of XYZ Ltd:

- Current assets: ₦5,000,000 (including inventory of ₦1,500,000 and cash and cash equivalents of ₦1,000,000)
- Total current liabilities: ₦2,000,000

Required:

Calculate and interpret the following ratios:

- Current ratio
- Quick assets ratio
- Cash ratio

Suggested solution

(a) Current ratio

$$\text{Current Ratio} = \frac{\text{current assets}}{\text{current liabilities}} = \frac{5,000,000}{2,000,000} = 2.5:1$$

Interpretation: The company has ₦2.50 in current assets for every ₦1 of current liabilities, indicating that it is in a strong liquidity position, that is, it can comfortably meet its short-term obligations

(b) Quick assets ratio

$$\begin{aligned}\text{Quick assets ratio} &= \frac{\text{current assets} - \text{inventory}}{\text{current liabilities}} = \frac{5,000,000 - 1,500,000}{2,000,000} \\ &= \frac{3,500,000}{2,000,000} = 1.75:1\end{aligned}$$

Interpretation: XYZ Ltd has ₦1.75 in quick assets for every ₦1 of current liabilities. This reflects a strong short-term liquidity position, showing that XYZ Ltd can meet its current liabilities without depending on the sale of inventory.

(c) Cash ratio

$$\text{Cash ratio} = \frac{\text{cash and cash equivalent}}{\text{current liabilities}} = \frac{1,000,000}{2,000,000} = 0.50:1$$

Interpretation: The company has ₦0.50 in cash for every ₦1 of current liabilities. This suggests that the company cannot fully cover its current obligations with cash alone, but it does have some immediate liquidity.

18.6 Long-Term Stability Ratios

18.6.1 Introduction

Long-term stability ratios, also known as solvency or capital structure ratios and they measure a company's ability to meet its long-term obligations and maintain financial health over time. These ratios are essential for evaluating a company's financial structure, risk profile, and long-term solvency.

18.6.2 Purpose

Their primary uses include:

- helping determine the level of financial risk by assessing how much of a company's capital structure is made up of debt versus equity;
- showing whether a company can sustain its current level of borrowing without endangering its future operations or solvency;
- judging whether a company is financially stable and capable of long-term growth, especially when considering investing in bonds or shares;
- assessing the risk of lending money to the company and to determine appropriate interest rates or credit terms;
- evaluating the effectiveness of capital structure decisions and to plan future financing strategies; and
- helping to compare a company's solvency position to industry norms, revealing whether it is over-leveraged or conservatively financed.

18.6.3 Types

The following are key types of long-term stability ratios used to evaluate a company's solvency and financial resilience.

i) Debt-to-Equity Ratio

Formula:

$$\text{Debt-to-Equity Ratio} = \frac{\text{total debt}}{\text{total equity}}$$

Expressed as a percentage or ratio

Calculation:

Total Debt = Long-term Debt + Short-term Debt

Total Equity = Total Assets – Total Liabilities

Significance:

This ratio assesses the proportion of debt used to finance the company compared to equity. A higher ratio indicates greater financial leverage and potential risk, as more of the company's financing comes from debt.

ii) Interest Coverage Ratio

Formula:

$$\text{Interest Coverage Ratio} = \frac{EBIT}{\text{Interest}}$$

Expressed as a number of times

Calculation:

EBIT = Net Profit + Interest Expenses + Taxes

Interest Expenses = Total interest paid during the period

Significance:

This ratio evaluates the company's ability to pay interest on outstanding debt. A higher ratio implies greater capacity to meet interest obligations comfortably.

iii) **Long-term Debt-to-Capitalisation Ratio**

Formula:

$$\text{Long-term Debt-to-Capitalisation Ratio} = \frac{\text{Total long-term debt}}{\text{Long-term debt} + \text{total equity}}$$

Expressed as a percentage or ratio

Calculation:

Long-term Debt = Total long-term debt

Equity = Share Capital + Reserves

Significance:

This ratio reveals how much of the company's capital structure is funded by long-term debt. A higher ratio suggests heavier reliance on debt, which could signal financial vulnerability in the long run.

iv) **Long-term Debt-to-total assets**

Formula:

$$\text{Long-term Debt-to-Total Assets Ratio} = \frac{\text{Total long-term debt}}{\text{total assets}}$$

Expressed as a percentage or ratio

Calculation:

Long-term Debt = Total long-term debt

Total assets = current assets + non-current assets

Significance:

This ratio shows the percentage of a company's assets that are financed by long-term debt, indicating the level of financial leverage and long-term risk.

Illustration

The following information is extracted from the records of ABC Ltd:

Profit after tax: ₦2,800,000

Interest: ₦1,000,000

Income tax: ₦1,200,000

Current liabilities: ₦2,000,000

Long-term debt: ₦8,000,000

Share capital: ₦12,000,000

Reserves: ₦8,000,000

Current assets: ₦7,200,000

Non-current assets: ₦22,800,000

Required:

Calculate and interpret the following ratios:

- Debt-to-Equity Ratio
- Interest Coverage Ratio
- Long-term Debt-to-Capitalisation Ratio
- Long-term Debt-to-Total Assets Ratio

Suggested solution

a) Debt-to-Equity Ratio

$$\text{Debt-to-Equity Ratio} = \frac{\text{total debt}}{\text{total equity}} = \frac{10,000,000}{20,000,000} = 0.50 : 1$$

$$\text{Total Debt} = \text{N}8,000,000 + \text{N}2,000,000 = \text{N}10,000,000$$

$$\text{Total Equity} = \text{N}12,000,000 + \text{N}8,000,000 = \text{N}20,000,000$$

Interpretation:

ABC Ltd has ~~N~~0.50 in total debt for every ~~N~~1 of equity. This suggests that the company is half-debt-financed, indicating a moderate level of financial leverage. While not excessively risky, this leverage level still calls for prudent debt management to maintain financial stability.

b) Interest Coverage Ratio

$$\text{Interest Coverage Ratio} = \frac{\text{EBIT}}{\text{Interest}} = \frac{5,000,000}{1,000,000}$$

$$\text{EBIT} = \text{N}2,800,000 + \text{N}1,000,000 + \text{N}1,200,000 = \text{N}5,000,000$$

Interpretation:

ABC Ltd can cover its interest expense 5 times with its earnings before interest and taxes. This suggests a strong ability to meet interest obligations.

c) Long-term Debt-to-Capitalisation Ratio

$$\text{Long-term Debt-to-Capitalisation Ratio} = \frac{\text{Total long-term debt}}{\text{Long-term debt} + \text{total equity}}$$

$$= \frac{8,000,000}{28,000,000} = 0.286 \text{ or } 28.6\%$$

$$\text{Equity} = \text{N}8,000,000 + \text{N}12,000,000 + \text{N}8,000,000 = \text{N}28,000,000$$

Interpretation:

28.6% of ABC Ltd's long-term capital is financed through debt. The company is primarily equity-financed, which may indicate financial stability.

d) Long-term Debt-to-total assets

$$\text{Long-term Debt-to-Total Assets Ratio} = \frac{\text{Total long-term debt}}{\text{total assets}} = \frac{8,000,000}{30,000,000} = 0.267 \text{ or } 26.7\%$$

$$\text{Total assets} = \text{N}7,200,000 + \text{N}22,800,000 = \text{N}30,000,000$$

Interpretation:

Long-term debt accounts for 26.7% of the company's total assets, reflecting a conservative use of long-term borrowings in asset financing.

18.7 Comparative Financial Statements Analysis

18.7.1 Introduction

We have examined financial ratios for a single year. However, analyzing comparative financial statements over multiple years helps users detect trends and evaluate performance changes. Below is an example comparing XYZ Ltd's financial results for 2023 and 2024.

18.7.2 Purpose

The main uses include:

- a. helping to identify patterns in revenue, expenses, profits, and other financial indicators over time, revealing growth, decline, or consistency.
- b. comparing results across periods, helps management and stakeholders to assess how well the company has performed relative to past periods.
- c. providing a basis for informed decision-making regarding investments, budgeting, cost control, and strategic planning.
- d. allowing for the monitoring of changes in key financial components like assets, liabilities, and equity, helping to assess the company's evolving financial health.
- e. Helping to identify the reasons for significant variances in figures from one period to another, which can then be investigated and addressed.
- f. benchmarking performance against competitors or industry standards when paired with external data.
- g. presenting a clear picture to investors, lenders, and regulators about how the company is progressing or facing challenges over time.

Example

XYZ Ltd's financial results for 2023 and 2024.

Comparative Statement of Profit or Loss *or the years ended December 31, 2024 and 2023*

	(₹'000)	
Year	2024	2023
Revenue	200,000	150,000
Cost of Sales	120,000	90,000
Gross Profit	80,000	60,000
Operating Expenses	(40,000)	(30,000)
Operating Profit	40,000	30,000
Interest Expense	(7,000)	(5,000)
Profit Before Tax	33,000	25,000
Income Tax Expense	(4,600)	(3,200)
Profit for the Year	28,400	21,800

Example Continued

Comparative Statement of Financial Position
As at December 31, 2024 and 2023
(N'000)

Item	2024	2023
Non-current Assets	220,000	170,000
Current Assets	100,000	80,000
Total Assets	320,000	250,000
Equity Share Capital	120,000	100,000
Retained Earnings	40,000	30,000
Total Equity	160,000	130,000
Non-current Liabilities	100,000	80,000
Current Liabilities	60,000	40,000
Total Equity & Liabilities	320,000	250,000

Required:

Calculate the following ratios for 2024 and 2023, then determine whether each ratio shows improvement in 2024 compared to 2023.

- a. Profitability Ratios
 - i. Gross Profit Margin
 - ii. Net Profit Margin
 - iii. Return on Capital Employed (ROCE)
 - iv. Return on Equity (ROE)
 - v. Operating Profit Margin
- b. Efficiency ratios
 - i. Inventory turnover ratio
 - ii. Receivable turnover ratio
 - iii. Payable turnover ratio
 - iv. Asset turnover ratio
 - v. Working capital turnover ratio
 - vi. Non-current assets turnover ratio
 - vii. Operating cycle
 - viii. Cash operating cycle
- c. Liquidity Ratios
 - i. Current Ratio
 - ii. Quick Ratio
 - iii. Cash Ratio
- d. Long-term Solvency Ratios
 - i. Debt-to-Equity Ratio
 - ii. Interest Coverage Ratio
 - iii. Long-term Debt-to-Capitalisation Ratio

Additional Information:

Cash Balance: N30,000,000 (2024), N20,000,000 (2023), N15,000,000 (2022)

Inventory Balance: N40,000,000 (2024), N30,000,000 (2023), N25,000,000 (2022)

Non-current liabilities N60,000,000 (2022)

Current liabilities N30,000,000 (2022)

Current assets: ~~N~~60,000,000 (2022)
 Non-current assets ~~N~~150,000,000 (2022)
 Total assets ~~N~~210,000,000 (2022)

Suggested solution

a. Profitability Ratios

Ratio	2024 (%)	2023 (%)	Change
Gross Profit Margin	40.00	40.00	No Change
Net Profit Margin	14.20	14.53	Slight Decline
Return on Capital Employed	14.04	10.53	Improved
Return on Equity	19.59	15.03	Improved
Operating Profit Margin	20.00	20.00	No Change

Workings

Gross Profit Margin

2024: (~~N~~80,000 / ~~N~~200,000) × 100 = 40%

2023: (~~N~~60,000 / ~~N~~150,000) × 100 = 40%

Comment: There was no change in performance between the two years.

Net Profit Margin :

2024: (~~N~~28,400 / ~~N~~200,000) × 100 = 14.2%

2023: (~~N~~21,800 / ~~N~~150,000) × 100 = 14.53%

Comment: There was a decline in performance in 2024, from 14.53% to 14.2%. This indicates that the company's ability to maintain profitability has weakened slightly.

Return on Capital Employed (ROCE):

2024: (~~N~~28,400 / ~~N~~260,000) × 100 = 10.9%

2023: (~~N~~21,800 / ~~N~~210,000) × 100 = 10.4%

Comment: There was slight improvement in ROCE, which suggests that the company is generating more profit from the capital employed.

Return on Equity (ROE):

2024: (~~N~~28,400 / ~~N~~160,000) × 100 = 17.75%

2023: (~~N~~21,800 / ~~N~~130,000) × 100 = 16.77%

Comment: The company's ROE also improved slightly in 2024, which suggests that the company is creating more value for the shareholders.

Operating Profit Margin

2024: (~~N~~40,000 / ~~N~~200,000) × 100 = 20%

2023: (~~N~~30,000 / ~~N~~150,000) × 100 = 20%

Comment: There has been no improvement or deterioration in the company's operating efficiency and profitability.

Suggested solution continued

Efficiency Ratios

Ratio	2024	2023	Change
Inventory Turnover	3.43	3.27	Increased
Receivable Turnover	6.67	6.00	Increased
Payable Turnover	2.60	2.71	Decreased slightly
Asset Turnover	0.70	0.65	Increased
Working Capital Turnover	5.00	5.00	No change
Non-current Assets Turnover	1.03	0.94	Increased
Operating Cycle (days)	161.1	172.4	Decreased (faster)
Cash Operating Cycle (days)	20.7	37.7	Decreased (shorter)

Workings

i. Inventory Turnover Ratio

- 2024: $120,000 \div 35,000 = 3.43$ times
- 2023: $90,000 \div 27,500 = 3.27$ times
- Comment: Improved in 2024 — inventory is being turned over more frequently.

ii. Receivable Turnover Ratio

- 2024: $200,000 \div 30,000 = 6.67$ times
- 2023: $150,000 \div 25,000 = 6.00$ times
- Comment: Improved — receivables are being collected faster in 2024.

iii. Payable Turnover Ratio

- 2024: $130,000 \div 50,000 = 2.60$ times
- 2023: $95,000 \div 35,000 = 2.71$ times
- Comment: Slight decline — company is taking longer to pay its suppliers in 2024.

iv. Asset Turnover Ratio

- 2024: $200,000 \div 285,000 = 0.70$ times
- 2023: $150,000 \div 230,000 = 0.65$ times
- Comment: Improved — assets are being used more efficiently to generate sales in 2024.

v. Working Capital Turnover Ratio

- 2024: $200,000 \div 40,000 = 5.00$ times
- 2023: $150,000 \div 30,000 = 5.00$ times
- Comment: No change — the efficiency of working capital remained constant.

vi. Non-Current Assets Turnover Ratio

- 2024: $200,000 \div 195,000 = 1.03$ times
- 2023: $150,000 \div 160,000 = 0.94$ times
- Comment: Improved — better utilisation of long-term assets in 2024.

vii. Operating Cycle

- Inventory Days = $365 \div \text{Inventory Turnover}$
 - 2024: $365 \div 3.43 = 106.4$ days
 - 2023: $365 \div 3.27 = 111.6$ days
- Receivable Days = $365 \div \text{Receivable Turnover}$
 - 2024: $365 \div 6.67 = 54.7$ days
 - 2023: $365 \div 6.00 = 60.8$ days
- Operating Cycle = Inventory Days + Receivable Days

- 2024: $106.4 + 54.7 = 161.1$ days
- 2023: $111.6 + 60.8 = 172.4$ day
- Comment: Improved — faster operating cycle in 2024.

Suggested solution continued

Efficiency Ratios

Workings continued

viii. Cash Operating Cycle

Payable Days = $365 \div \text{Payable Turnover}$

2024: $365 \div 2.60 = 140.4$ days

2023: $365 \div 2.71 = 134.7$ days

Cash Operating Cycle = Operating Cycle – Payable Days

2024: $161.1 - 140.4 = 20.7$ days

2023: $172.4 - 134.7 = 37.7$ days

Comment: Improved — company is converting operations to cash faster in 2024.

Suggested solution continued

Liquidity Ratios

Ratio	2024	2023	Change
Current Ratio	1.67	2.00	Weakened
Quick Ratio	1.00	1.25	Weakened
Cash Ratio	0.50	0.50	No Change

Workings

Current Ratio

2024: $\frac{\text{N}100,000}{\text{N}60,000} = 1.67:1$

2023: $\frac{\text{N}80,000}{\text{N}40,000} = 2:1$

Comment: The decline in current ratio suggests that the company's ability to meet its short-term obligations on time may be weakening

Quick Ratio

2024: $\frac{(\text{N}100,000 - \text{N}40,000)}{\text{N}60,000} = 1:1$

2023: $\frac{(\text{N}80,000 - \text{N}30,000)}{\text{N}40,000} = 1.25:1$

Comment: A decline in both the company's current and quick ratios is a strong indication of a deterioration in the company's liquidity position.

Cash Ratio:

2024: $\frac{\text{N}300,000}{\text{N}600,000} = 0.5:1$

2023: $\frac{\text{N}200,000}{\text{N}400,000} = 0.5:1$

Comment: The cash ratio remaining at 0.5:1, suggest no improvement or deterioration in cash and cash equivalents. A cash ratio of 0.5:1 is relatively low, indicating that the company may face liquidity challenges

Suggested solution continued

Long-term Solvency Ratios

Ratio	2024	2023	Change
Debt-to-Equity Ratio	1.00	0.92	Weakened
Interest Coverage Ratio	5.71	6.00	Slight Decline
Long-term Debt/Capitalisation	38.46%	38.10%	Slight Increase

Workings:

Debt-to-Equity Ratio:

2024: $\text{N}160,000 / \text{N}160,000 = 1.0:1$ or 100%

2023: $\text{N}120,000 / \text{N}130,000 = 0.92:1$ or 92%

Comment: The debt equity ratios of 100% in 2024 and 92% in 2023 indicate that the company's debt levels are nearly equal to its shareholders' equity. It suggests a relatively high level of financial leverage

Interest Coverage Ratio:

2024: $\text{N}40,000 / \text{N}7,000 = 5.71$ times

2023: $\text{N}30,000 / \text{N}5,000 = 6$ times

Comment: There is a slight decline in interest coverage ratio in 2024. Although an interest coverage of 5.71 is still relatively healthy, the decline suggests that the company's cash flows or profitability may be under pressure.

Long-term Debt-to-Capitalisation Ratio:

2024: $\text{N}100,000 / (\text{N}100,000 + \text{N}160,000) = 38.46\%$

2023: $\text{N}80,000 / (\text{N}80,000 + \text{N}130,000) = 38.10\%$

Comment: The long-term capitalisation ratio remaining stable indicates that the company's reliance on long-term debt financing has not changed significantly.

18.8 Benefit and limitations of ratio analysis

18.8.1 Benefits of Ratio Analysis

Ratio analysis is a vital tool in financial evaluation that transforms raw financial data into meaningful indicators of a company's performance and position. By applying various ratios to financial statements, stakeholders can gain clearer, more actionable insights. The key benefits of ratio analysis are outlined below:

- Simplifies complex financial data:** Expresses complex financial information in a concise and easily understandable format.
- Facilitates comparison:** Enables comparisons between companies, industries,

- and time periods to identify trends and patterns.
- c. **Identifies strengths and weaknesses:** Helps pinpoint a company's financial strengths and weaknesses, allowing management to take corrective actions.
- d. **Provides insights into financial performance:** Offers detailed insights into profitability, liquidity, and solvency.
- e. **Aids decision-making:** Provides a structured framework to evaluate financial data and make informed decisions.

18.8.2 Limitations of Ratio Analysis

While ratio analysis is a powerful tool for evaluating financial performance, it is not without its shortcomings. Users must be cautious when interpreting ratios, as several inherent limitations can affect the accuracy and reliability of the insights derived. The main limitations are as follows:

- a. **Ignores qualitative factors:** Focuses only on quantitative data, overlooking qualitative aspects such as management quality, industry trends, and market conditions.
- b. **Can be misleading:** May produce inaccurate conclusions if underlying data is incomplete or incorrect.
- c. **Difficulty in comparing companies with differing accounting policies:** Differences in accounting methods and standards can lead to inconsistencies, making meaningful comparison between companies challenging.
- d. **Ignores inflation and external factors:** Does not account for inflation or other external economic conditions affecting performance.
- e. **Limited to historical data:** Based on past financial information, providing no direct insight into future prospects.
- f. **Subject to manipulation:** Financial ratios can be manipulated by management to present a more favorable picture.
- g. **Requires expertise:** Accurate interpretation requires knowledge of accounting and finance.

18.9 Chapter review

Chapter review

Before moving to the next chapter check that you are now able to:

- a. interpret financial statements using ratios;
- b. calculate and apply profitability ratios to interpret financial performance;
- c. calculate and apply efficiency ratios to assess operational effectiveness;
- d. calculate and apply liquidity ratios to evaluate short-term financial health;
- e. calculate and apply long-term stability ratios to assess financial structure;
- f. perform comparative analysis of financial ratios across periods; and
- g. understand the benefits and limitations of ratio analysis.

18.10. End of chapter questions and suggested solutions

Question 1

As part of a strategic review, the management of Beta Ltd wants to assess their company's position using ratio analysis. You are given the following narrative:

"While sales and profits have increased steadily over the past two years, liquidity ratios have declined, and leverage has risen significantly. Management is concerned about potential cash flow difficulties and the company's ability to meet long-term obligations if the current trend continues."

Required:

- a) Identify and explain five key ratios you would use to evaluate the company's profitability, liquidity, and long-term stability
- b) explain three benefits of using ratio analysis in strategic decision-making
- c) List and briefly explain two limitations of ratio analysis that management should keep in mind

Suggested solutions

- a) Five Key Ratios for Evaluating Profitability, Liquidity, and Long-Term Stability
 - i. Net Profit Margin (Profitability)
 - Formula: $\text{Net Profit} \div \text{Revenue}$
 - Indicates how much profit is generated from each naira of sales after all expenses. An increasing net margin confirms operational efficiency and profitability growth.
 - ii. Return on Assets (ROA) (Profitability)
 - Formula: $\text{Net Profit} \div \text{Total Assets}$
 - Measures how effectively the company uses its assets to generate profit. A declining ROA may signal inefficient asset utilisation despite higher profits.
 - iii. Current Ratio (Liquidity)
 - Formula: $\text{Current Assets} \div \text{Current Liabilities}$
 - Assesses the company's ability to meet short-term obligations. A declining current ratio suggests potential cash flow or working capital issues.
 - iv. Quick Ratio (Acid Test) (Liquidity)
 - Formula: $(\text{Current Assets} - \text{Inventory}) \div \text{Current Liabilities}$
 - Excludes inventory to test immediate liquidity. A low quick ratio confirms the risk of cash shortages, especially if sales are growing on credit.
 - v. Debt-to-Equity Ratio (Long-term Stability)
 - Formula: $\text{Total Debt} \div \text{Equity}$
 - Evaluates the degree of financial leverage. A rising ratio indicates increased dependence on external debt, which can heighten financial risk and strain long-term solvency.
- b) Three Benefits of Using Ratio Analysis in Strategic Decision-Making
 - i. Supports trend analysis and forecasting
 - Ratios help management identify performance trends over time, aiding in forecasting and long-term strategic planning.
 - ii. Facilitates performance benchmarking
 - Ratios enable comparison with industry standards or competitors, helping management evaluate the company's market position.

- iii. Enhances financial discipline and risk awareness
 - Highlights areas of concern (e.g., rising leverage or declining liquidity) early, prompting timely corrective actions and informed decision-making.
- c)
- i. Two Limitations of Ratio Analysis Based on historical data
 - Ratios are derived from past financial statements and may not reflect current market dynamics or future performance potential.
 - ii. Affected by accounting policies and estimates
 - Variations in accounting methods (for example, depreciation, inventory valuation) can distort ratios, limiting the reliability of inter-company or inter-period comparisons.

Question 2

The following information relates to Malik Ltd

	N'000
Credit sales for the year ended December 31, 2024	11,200
Credit purchases for the year ended December 31, 2024	9,000
Trade receivables days at the year ended December 31, 2024	1,380
Trade payables the year ended December 31, 2024	900
Cost of sales for the year ended December 31, 2024	4,500
The company's cash conversion cycle was 105 days.	

Required:

- a. Calculate the cost of inventory held by the company at December 31, 2024
- b. Comment on the cash conversion cycle of Malik Ltd

Suggested solution

- a. Cash conversion is derived by: Inventory days + receivable days –payable days

Receivable days = $1,380/11,200 \times 365$ days = 45 days

Payable days = $500/9,000 \times 365$ days = 20 days

That means that 105 days = Inventory days + 45 days - 20 days

Hence inventory days = 105 days + 20 days - 45 days = 80 days

80 days is derived by (Inventory/ cost of sales) x 365 days

Inventory cost/~~N~~4,500 x 365 day = 80 days

Therefore inventory cost = ~~N~~4,500/365 x 80 = ~~N~~986. 30

- b. The cash conversion cycle (CCC) measures the time it takes for a company to sell its inventory, collect receivables and pay its payables. A shorter CCC indicates better liquidity and working capital management.

Malik Ltd's CCC is 105 days, broken down into:

- i. Inventory turnover period: 80 days (holds inventory for about 2.7 months)
- ii. Receivables turnover period: 45 days (takes about 1.5 months to collect from customers)

- iii. Payables turnover period: 20 days (takes about 0.7 months to pay suppliers)
- iv. The company's CCC seems relatively long, which might indicate:
 - v. Inefficient inventory management (high inventory levels or slow sales)
 - vi. Lenient credit terms or poor receivables collection
 - vii. Potential cash flow strain
- viii. In the context of working capital management, it's generally beneficial for a company to have a longer payable period (i.e., take longer to pay suppliers) and a shorter receivable period (i.e., collect from customers quickly). This allows companies to trade with suppliers' fund, thereby conserve cash and reduce its working capital requirements.
However, in Malik Ltd's case:
 - The company takes 45 days to collect from customers (receivable days)
 - But only takes 20 days to pay suppliers (payable days)
 - This indicates that Malik Ltd is financing its customers' purchases for 25 days (45 - 20) more than it is being financed by its suppliers. This can put pressure on the company's working capital and cash flow.

Remedial measures

To improve the cash conversion cycle, the following remedial measures are recommended:

- i. Negotiate longer payment terms with suppliers to increase payable days.
- ii. Implement more efficient receivables collection processes to reduce receivable days.
- iii. Optimise inventory levels to reduce inventory turnover period through measures like just-in-time and ABC inventory control, economic order quantity and suppliers' collaboration.
- iv. Consider offering discounts for early payment to customers.
- v. Review and adjust credit terms to balance sales growth with working capital requirements.

Question 3

The following figures relate to JKL Limited for the year ended 31 December 2024:

Revenue: ~~N~~360,000,000

Cost of Sales: ~~N~~220,000,000

Operating Expenses: ~~N~~80,000,000

Interest Expense: ~~N~~10,000,000

Income Tax: ~~N~~12,000,000

Total Assets: ~~N~~400,000,000

Non-current Assets: ~~N~~250,000,000

Current Assets: ~~N~~150,000,000

Inventory: ~~N~~50,000,000

Trade Receivables: ~~N~~40,000,000

Cash: ~~N~~20,000,000

Current Liabilities: ~~N~~100,000,000

Required:

Calculate the following ratios and briefly comment on the ratios:

- a) Gross Profit Margin
- b) Operating Profit Margin
- c) Net Profit Margin

- d) Current Ratio
- e) Quick Ratio
- f) Inventory Turnover
- g) Receivables Turnover
- h) Asset Turnover
- i) Working Capital
- j) Return on Assets

Suggested solution

a) Gross Profit Margin

Formula:

$$\text{Gross Profit Margin} = (\text{Gross Profit} / \text{Revenue}) \times 100$$

Calculation:

$$\text{Gross Profit} = \text{N}360,000,000 - \text{N}220,000,000 = \text{N}140,000,000$$

$$\text{Gross Profit Margin} = (\text{N}140,000,000 / \text{N}360,000,000) \times 100 = 38.89\%$$

Interpretation:

JKL Ltd retains about 39 kobo from every ₦1 of sales after covering direct costs. This is a healthy margin.

b) Operating Profit Margin

Formula:

$$\text{Operating Profit Margin} = (\text{Operating Profit} / \text{Revenue}) \times 100$$

Calculation:

$$\text{Operating Profit} = \text{Gross Profit} - \text{Operating Expenses} = \text{N}140,000,000 - \text{N}80,000,000 = \text{N}60,000,000$$

$$\text{Operating Profit Margin} = (\text{N}60,000,000 / \text{N}360,000,000) \times 100 = 16.67\%$$

Interpretation:

16.67% of revenue remains after paying for both direct and operating expenses—moderately strong.

c) Net Profit Margin

Formula:

$$\text{Net Profit} = \text{Revenue} - (\text{Cost of Sales} + \text{Operating Expenses} + \text{Interest} + \text{Tax})$$

$$\text{Net Profit Margin} = (\text{Net Profit} / \text{Revenue}) \times 100$$

Calculation:

$$\text{Net Profit} = \text{N}360,000,000 - \text{N}220,000,000 - \text{N}80,000,000 - \text{N}10,000,000 - \text{N}12,000,000 = \text{N}38,000,000$$

$$\text{Net Profit Margin} = (\text{N}38,000,000 / \text{N}360,000,000) \times 100 = 10.56\%$$

Interpretation:

JKL Ltd earns approximately 11 kobo of profit per ₦1 sales after all expenses—a reasonable return.

d) Current Ratio

Formula:

$$\text{Current Ratio} = \text{Current Assets} / \text{Current Liabilities}$$

Calculation:

$$= \text{N}150,000,000 / \text{N}100,000,000 = 1.5 : 1$$

Interpretation:

The company has ₦1.50 in current assets for every ₦1 of short-term liabilities—

adequate liquidity.

e) **Quick Ratio**

Formula:

Quick Ratio = (Current Assets – Inventory) / Current Liabilities

Calculation:

= (~~₦~~150,000,000 – ~~₦~~50,000,000) / ~~₦~~100,000,000 = ~~₦~~100,000,000 / ~~₦~~100,000,000 = 1.0 : 1

Interpretation:

Excluding inventory, the company can meet short-term obligations comfortably.

f) **Inventory Turnover**

Formula:

Inventory Turnover = Cost of Sales / Inventory

Calculation:

= ~~₦~~220,000,000 / ~~₦~~50,000,000 = 4.4 times

Interpretation:

Inventory is sold and replaced 4.4 times during the year—a fair efficiency level.

g) **Receivables Turnover**

Formula:

Receivables Turnover = Revenue / Trade Receivables

Calculation:

= ~~₦~~360,000,000 / ~~₦~~40,000,000 = 9.0 times

Interpretation:

On average, the company collects its receivables 9 times per year—suggesting good credit control.

h) **Asset Turnover**

Formula:

Asset Turnover = Revenue / Total Assets

Calculation:

= ~~₦~~360,000,000 / ~~₦~~400,000,000 = 0.9 times

Interpretation:

Each ~~₦~~1 of assets generates 90 kobo in revenue—reasonable use of assets.

i) **Working Capital**

Formula:

Working Capital = Current Assets – Current Liabilities

Calculation:

= ~~₦~~150,000,000 – ~~₦~~100,000,000 = ~~₦~~50,000,000

Interpretation:

JKL Ltd has ~~₦~~50 million excess current assets over current liabilities—positive liquidity.

j) **Return on Assets (ROA)**

Formula:

ROA = (Net Profit / Total Assets) × 100

Calculation:

= (~~₦~~38,000,000 / ~~₦~~400,000,000) × 100 = 9.5%

Interpretation:

JKL Ltd earns a return of 9.5% on its total assets—moderately efficient.

**COMPUTERISED AND VIRTUAL
ACCOUNTING SYSTEMS****Contents**

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- 19.1 Learning outcomes
- 19.2 Computerised accounting systems
- 19.3 Digitisation in financial accounting
- 19.4 Uses of data structure
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- 19.6 The use of artificial intelligence (AI) in financial accounting
- 19.7 Virtual accounting principles and practice
- 19.8 Fraud opportunities arising from working remotely
- 19.9 Chapter review
- 19.10 End of chapter questions and answers

19. Computerised and Virtual Accounting System

19.0 Learning objective

This chapter explains the benefits, challenges, and practices involved in computerised and virtual accounting. It also introduces several terminologies and concepts related to information technology and accounting. The chapter explains key topics such as digitisation, blockchain technology, data structures, remote working environments, fraud risks, and the principles and practices of virtual accounting.

In addition, it discusses other fundamental concepts that form the foundation for understanding the ongoing transformation of the accounting profession in response to technological advancements.

19.1 Learning outcomes

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

- a. explain the benefits, challenges, and practical applications of computerised and virtual accounting systems;
- b. identify and define key terminologies and concepts related to information technology and their relevance to accounting;
- c. describe the processes and implications of digitisation and blockchain technology in modern accounting;
- d. understand basic data structures and how they support digital accounting systems;
- e. evaluate the impact of remote working environments on accounting operations and controls;
- f. recognise potential fraud risks associated with virtual accounting and propose appropriate preventive measures;
- g. apply the principles and practices of virtual accounting in simulated or real-world scenarios; and
- h. discuss the broader technological advancements shaping the accounting profession and how professionals can adapt to these changes.

19.2 Computerised Accounting Systems

19.2.1 Introduction

A computerised accounting system is a powerful tool that enables businesses to efficiently manage their financial transactions, records and reports. This system automates many accounting tasks, reducing manual errors and increasing productivity. With features such as automated data entry, financial reporting and data analysis, computerised accounting systems provide businesses with real-time insights into their financial performance, enabling informed decision-making and strategic planning.

19.2.2 Types of accounts in computerised and manual accounting systems

In both computerised and manual accounting systems, the types of accounts used are similar. These include asset accounts, such as cash and receivable accounts, liability

accounts, like accounts payable and loans payable, equity accounts, income accounts and expense accounts.

However, the way these accounts are maintained and processed differs significantly between the two systems. The table below outlines the key differences:

Feature	Manual Accounting	Computerised Accounting
Method of Recording	Entries are made manually using pen and paper in physical books (journals, ledgers).	Entries are made using software applications and stored digitally.
Speed	Slower due to manual calculations and posting.	Faster processing with automated calculations and updates.
Accuracy	Prone to human errors, especially in calculations.	More accurate due to built-in formulas and error-checking mechanisms.
Storage	Requires physical space for storing books and files.	Digital storage requires less physical space and offers quick access and backup options.
Updating Records	Updating records can be tedious and time-consuming.	Records update automatically across related accounts and reports.
Financial Reporting	Reports must be prepared manually, which is time-consuming.	Reports can be generated instantly and in multiple formats.
Data Security	Physical records are vulnerable to theft, fire, or loss.	Digital records can be password-protected, encrypted, and backed up automatically.
Audit Trail	Tracking changes and corrections is difficult.	Changes are logged automatically, providing a clear audit trail.
Cost	Lower initial cost but higher long-term labour costs.	Higher initial software/setup cost but lower ongoing costs due to automation.
Scalability	Difficult to scale with increased transaction volume.	Easily scalable to handle more transactions and users.

a. Forms of accounting records

In a computerised accounting system, various forms of accounting records are utilised to capture and process financial data. These records include source documents, ledgers and financial statements. Source documents, such as invoices, receipts and purchase orders, serve as the foundation for recording financial transactions. Ledgers, on the other hand, are automated to record and categorise transactions based on source documents, providing real-time tracking of financial transactions.

ii Functions of accounting records

The computerised accounting system records transactions in a well-designed database, eliminating the need for physical books of accounts. This automation enables businesses to maintain accurate and up-to-date financial records. Additionally, a computerised accounting system provides automated data entry, reducing manual errors and increasing efficiency. The system also generates financial reports, such as statement of financial positions and statement of comprehensive income, which are essential for businesses to track their financial health.

These systems offer several key features that enhance their functionality, such as:

- automated invoice generation;
- support for multiple currencies;
- customisable financial reports;
- document management capabilities;
- automated data validation;
- error correction; and
- data analysis capabilities.

b Utilising accounting tools and packages

Accounting tools and packages offer various features and functionalities that enable businesses to efficiently manage their financial transactions, records, and reports. These tools can be used to validate data, correct errors, and analyse financial information.

i. Data validation and error correction

- Accounting tools can perform automated checks on data entries, such as verifying dates and numbers, and display error messages when data entries are invalid. They can also be configured with data validation rules to ensure data consistency and accuracy. Additionally, these tools can identify and correct errors, provide features for reversing transactions or editing data entries and maintain audit trails to track changes.

ii. Data analysis

- Accounting tools can generate financial reports, such as statement of financial positions and statement of comprehensive income, to provide insights into a company's financial performance. They can also provide data visualisation features, enable ad-hoc analysis and support budgeting and forecasting.

c. Types of accounting packages

Various software packages cater to specific business needs.

- Enterprise Resource Planning (ERP)** systems are comprehensive solutions that integrate accounting with other business functions, such as human resources, supply chain management, and customer relationship management. Examples of ERP systems include SAP and Oracle. These systems provide a unified platform for managing various aspects of a business.
- Accounting software**, on the other hand, focuses specifically on accounting functions. These packages are designed to manage financial reporting, invoicing and expense tracking. Examples of accounting software include QuickBooks, Sage, Tally, Wave and Xero. These tools are ideal for small to medium-sized businesses that require a dedicated accounting solution.
- Cloud-based accounting software**. These packages are hosted online, allowing users to access their accounting data from anywhere, at any time.

Examples of cloud-based accounting software include QuickBooks Online and Zoho Books. This type of software offers flexibility and convenience, making it an attractive option for businesses with remote teams or multiple locations. They allow users to access their financial data from anywhere, at any time. Zoho Books offers features such as invoicing, expense tracking and financial reporting.

- iv. **Industry-specific accounting software** is designed for specific industries, such as construction, healthcare, or non-profit organisations. These packages often include features tailored to the unique needs of that industry. For instance, construction accounting software may include features for managing project costs, while non-profit accounting software may include features for tracking donations and grants.

d. **Features of specific accounting software**

There are various types of computerised accounting software available, ranging from basic packages for small businesses to sophisticated enterprise-level solutions. These programs help automate recording, classifying, summarising and reporting financial transactions.

- i. **QuickBooks:** One of the most widely used accounting software for small and medium-sized enterprises (SMEs). It supports invoicing, payroll, inventory management, tax calculation and financial reporting.
- ii. **Sage Accounting:** Popular in the UK and internationally, Sage offers scalable solutions for small and large businesses. It supports multi-currency transactions, budgeting, and detailed financial reporting.
- iii. **Xero:** Xero is Cloud-based accounting software known for its user-friendly interface. It facilitates bank reconciliation, invoicing, expense and cash flow tracking, payroll, real-time financial reporting and project management.
- iv. **Tally:** Widely used in Africa and Asia, Tally ERP is known for handling financial accounting, inventory, payroll, and statutory compliance, including Value Added Tax (VAT) and Goods and Services Tax (GST). Tally offers features such as financial accounting and reporting, inventory management, payroll processing and statutory compliance. Tally is widely used by business of all sizes due to its flexibility, scalability and compliance features.
- v. **Wave Accounting:** A free online accounting solution ideal for freelancers and small businesses facilitating invoicing, payment tracking, and basic reporting tools.
- vi. **Microsoft Dynamics:** Part of Microsoft's suite of enterprise resource planning (ERP) systems, suitable for medium to large organisations needing integrated financial and operational management

e. **Uses of accounting packages**

Accounting packages can be used for various purposes, including:

- i. **Financial Reporting:** Generating financial statements to provide insights into a company's financial performance.
- ii. **Invoicing and Billing:** Creating and managing invoices, tracking payments and sending reminders.

- iii. **Expense Tracking:** Recording and categorising expenses to monitor financial performance.
- iv. **Budgeting and Forecasting:** Creating budgets and forecasts to manage financial performance.
- v. **Compliance and Taxation:** Managing tax compliance and generating tax reports.
- vi. **Financial Analysis:** Providing real-time financial insights to inform business decisions.

f. **Benefits of accounting packages**

The benefits of using accounting packages are numerous.

- i. One of the primary benefits is increased efficiency. Accounting packages automate many accounting tasks, reducing manual errors and improving productivity.
- ii. Another benefit is improved accuracy. Accounting packages ensure accurate financial data and reduce the risk of errors. This is particularly important for businesses that require precise financial reporting.
- iii. Enhanced decision-making is another benefit of accounting packages. These tools provide real-time financial insights, enabling businesses to make informed decisions.
- iv. Better compliance is also a significant benefit of accounting packages. These tools help businesses ensure regulatory compliance and reduce the risk of penalties.
- v. Finally, accounting packages are scalable, supporting business growth and adapting to changing financial needs. This makes them an essential tool for businesses of all sizes.

Factors to consider when choosing an accounting package

When deciding on which accounting package to use or buy, several key factors should be considered to ensure the chosen system meets the business's needs. These factors include:

- i. **Cost:** The total cost of ownership, including software costs, setup fees, and ongoing operational expenses.
- ii. **Flexibility:** The ease with which the system can be amended, updated, or upgraded to adapt to changing business needs.
- iii. **Types of processing:** The input and output mediums associated with the package, such as batch processing or real-time processing.
- iv. **Timing of processing:** The speed at which the accounting package processes data, including transaction processing and report generation.
- v. **Hardware requirements:** The necessary hardware and network configurations required to run the accounting package efficiently.
- vi. **Degree of reliability:** The accuracy and reliability of the outputs from the application package in meeting the information needs of users.
- vii. **Integration with other systems:** The ability of the accounting package to integrate seamlessly with existing systems, such as enterprise resource planning (ERP) or customer relationship management (CRM) systems.

viii. **User processing requirements:** The extent to which the application package meets the processing needs of users, including ease of use, functionality and performance.

g. **Editing accounting data with tools**

When editing accounting data, various tools and features can be utilised to ensure accuracy and efficiency.

i. **Data editing features**

- **Find and replace:** Allows users to quickly find and replace specific data.
- **Data validation:** Checks data entries for errors and alerts users to correct them.
- **Undo and redo:** Enables users to undo and redo changes made to data entries.

ii. **Editing transactions**

- **Transaction editing:** Allows users to edit transactions to correct errors or update information.
- **Batch editing:** Enables users to edit multiple transactions at once.

iii. **Data analysis and review**

- **Data filtering:** Allows users to filter data to identify specific transactions or trends.
- **Data sorting:** Enables users to sort data by various criteria.

iv. **Best practices**

- **Backup data:** Backup data before making significant edits to prevent losses.
- **Verify changes:** Verify changes made to data for accuracy and completeness.
- **Document changes:** Document changes made to data, including reasons for edits.

v. **Limitations of computerised accounting systems**

Despite their numerous advantages, computerised accounting systems also have some limitations:

- **High initial setup cost:** The cost of purchasing software, hardware, installation, and training can be significant, especially for small businesses.
- **Risk of data loss:** In the absence of regular backups, system failures (e.g., due to viruses or power outages) may result in loss of valuable data.
- **Dependency on technology:** Business operations can be disrupted if the system crashes or there is a network failure.

- **Security threats:** Cybersecurity breaches such as hacking or phishing can compromise financial data if adequate security measures are not in place.
- **Staff training:** Employees must be trained to use the system correctly; otherwise, errors may still occur, or the system may be underutilised.
- **Software limitations:** Generic accounting software may not fully address industry-specific needs without expensive customisation.

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19.3 Digitisation in financial accounting

19.3.1 Digitisation

Advancement in technology has transformed many aspects of business operations including accounting. The use of technologically advanced software that is faster and can perform more complex functions, has made accounting efficient and easier especially in the area of data analysis, organisation of financial information, and measuring economic activities.

Digitisation is the process of converting information from a physical format into a digital (that is, a computer-readable) format. In accounting, digitisation relates to the use of digital technologies to convert invoices, receipts, all forms of paper files into machine readable format that can be processed with minimal human interface.

a. Digitisation vs digitalisation

- i. Digitisation is the process of converting information from a physical format into a digital one. When this process is leveraged to improve business processes, it is called digitalisation.
- ii. Digitisation is the conversion of analog to digital, whereas digitalisation is the use of digital technologies and digitised data to impact how work gets done, transform how customers and companies engage and interact, and create new (digital) revenue streams.
- iii. For digitalisation to occur, there must be digitisation.

b. Example of digitisation vs digitalisation

When an invoice is scanned and saved in PDF format, in a computer system perhaps on the desktop, this process is known as digitisation.

If on the other hand, this PDF invoice is saved in the cloud, for example, in a Google drive, then this is digitalisation.

19.3.2 Digital technologies in accounting system

Digital technologies in accounting system include:

(a) Machine learning and artificial intelligence

Machine learning and artificial intelligence (AI), the fast evolving technologies, enable the software to learn on its own and improve results without requiring human intervention. Additionally, AI-powered accounting applications can:

- i. perform data entry and data sorting tasks, more efficiently and accurately;
- ii. automatically reconcile accounts and do the classification of accounting transactions based on patterns in historic data; and
- iii. utilise machine-learning-powered fraud management applications and expense management systems to flag fraudulent transactions and validate expenses, respectively.

(b) Data analytics

The deployment of Data Analytics helps in identifying trends, patterns, and insights that can otherwise remain hidden. It uses statistical methods and modelling to analyse data.

(c) Mobile accounting

With mobile applications dedicated to accounting functions, one can create and send invoices, capture receipts, gather signatures, and create expense claims. Further, one can use customer management software on mobile devices to improve customer communication and support. With the help of customer relations management (CRM) software and increased connectivity, one can build better relationships with clients.

(d) Specialised accounting software

The rising popularity and easy accessibility to specialised accounting software and more efficient processing tools, has diminished the use of traditional pen, ledger, and desk calculator. These tools allow quicker input and computation of data, with higher degree of accuracy. Now, the accountant is able to focus more on how to protect and grow the client's business.

19.3.3 Impact of digitisation on businesses

(a) Economies of scale: Digitisation of operations is not only beneficial for those working within the organisation, but also for the clients. There is enough evidence that the adoption of digital technologies by organisations not only improves the economies of managerial and operational processes but also mobilises extensive organisational and social effects.

(b) Digitisation affects the substance, form and provenance of accounting information with consequences on the functioning of enterprises widely.

- (c) **Time and cost savings:** Digitisation has reduced the need for on-site consultations as both accountants and clients are able to access real-time data remotely, and view, edit, and comment on their statements simultaneously. As a result, a company can connect with its clients in the most convenient ways and serve more clients due to faster and more efficient processes.
- (d) **Ease of operations:** As organisations face mounting pressure to optimise costs, pricing, and efficiency, they are creating a “paperless office” within their finance functions. With the necessary regulatory frameworks in place, organisations only need to implement the right systems and technologies, to start deriving benefits of digitised business environment in finance and accounting.

19.3.4 Disadvantages of digitisation

Low patronage of accounting professionals:

- (a) The share of accounting tasks done by machines will surge by 80 percent in the year 2025, according to the study, conducted by the Institute of Singapore Chartered Accountants (ISCA), Lee Kuan Yew Centre for Innovative Cities (LKYCIC) at the Singapore University of Technology and Design, and Ernst & Young Advisory Pte Ltd (EY);
- (b) Once tasks are automated, consolidated or outsourced, financial data will be available on demand through self-service portals and as an output from AI; and
- (c) Traditional tasks, such as audit, statutory and regulatory reporting and global business services will be automated and/or procured.

19.3.5 Maintaining the relevance of accounting professionals with digitisation

The next generation of accountancy and finance professionals should understand not just accounting and their industries but also AI, blockchain and advanced analytics/big data, as well as how these technologies work together.

Upscaled skills and knowledge of digital tools: It also suggested that the two most junior roles can be upskilled to assume next-level roles. They may converge or look at moving to the internal audit track to take up the senior internal auditor/internal auditor role. On the other hand, those holding mid-level jobs should focus on upskilling themselves.

With accelerated digitisation ongoing in the accounting and financial space, both employers and employees have to focus on reskilling and associations like Information Systems Audit and Control Association (ISACA) have to also assist and support their learning journeys.

Higher institutions and professional bodies need to educate students and members of the changes in the accounting profession by mapping what skills will be in demand and which will be redundant, and how they can protect their future and build their careers.

19.4 Uses of data structure

19.4.1 Data structure

Data structure can be defined as the collection of data objects which provides a way of storing and managing data in the computer so that it can be used. Data structures provide a means to manage large amounts of data efficiently for large databases and internet indexing services. Usually, efficient data structures are vital in designing efficient algorithms.

Data structures are widely used in almost every aspect of computer science for simple as well as complex computations, artificial intelligence, graphics, operating system, etc.

19.4.2 Forms of data structure

Data structure can take different forms. Examples of these forms are:

- (a) Linear - arrays, lists;
- (b) Tree - binary, heaps, space partitioning, etc;
- (c) Hash - distributed hash table, hash tree, etc;
- (d) Graphs - decision, directed, acyclic, etc;
- (e) Stack; and
- (f) Queue.

19.4.3 Uses of data structures

- (a) **Efficient data management:** Data structures are the key part of many computer algorithms as they allow the programmers to do data management in an efficient way.
- (b) **Efficient computer programming:** A right selection of data structure can enhance the efficiency of computer program or algorithm in a better way.
- (c) **Efficient memory use:** Efficient use of data structure causes optimal memory usage.
- (d) **Reusability:** Data structures can be reused at any other place. Implementation of data structures can be compiled into libraries which can be used by different clients.
- (e) **Abstraction:** Data structure serves as the basis of abstract data types, the data structure defines the physical form of abstract data type (ADT). ADT is theoretical and data structure gives physical form to them.
- (f) **Building blocks:** Data structures are the basic building blocks of any programming language, complex computations, etc.

19.5 Blockchain technology

19.5.1 Introduction

Disruptions in technology have affected many industries and their operations. After the transition from manual accounting to computerised accounting process, accounting for a while, has been shielded from these technology driven disruptions. The first phase of transition caused accountants to gain relevant computer skills and computer software knowledge to adapt to a machine-driven environment. In recent years, some of the roles of the accountant is being threatened with new innovations in technology. One of these innovations is the blockchain technology.

19.5.2 Definitions of blockchain technology

Several authors have attempted defining the concept of blockchain technology. A few of these definitions are highlighted below:

- (a) In the book, *"Blockchain technology: Beyond bitcoin. ApplInnov Rev 2:6–19"* (2016), Crosby states that "a blockchain is essentially a public ledger of transactions or events recorded and stored in chronologically- and linearly-connected blocks. Later blocks then maintain the hash of previous blocks".
- (b) In the book, *"Leaderless, Blockchain-Based Venture Capital Fund Raises \$100 Million, And Counting"* (2016), Morris explains "a blockchain as a distributed database that maintains a continuously-growing list of data records secured from tampering and revision. It consists of blocks, holding batches of individual transactions. Each block contains a timestamp and a link to a previous block".
- (c) In the report, *"Blockchain technology: opportunities and risks"* (2016), Condos states that "Blockchain as a type of distributed, electronic database (ledger) which can hold any information (e.g. records, events, transactions) and can set rules on how this information is updated".
- (d) In the book, *"Blockchain: Blueprint for a New Economy"* (2015), Swan describes "Blockchain technology as one that enables records to be shared by all network nodes, updated by miners, monitored by everyone, and owned and controlled by no one".
- (e) In the journal, *"Visions, Part 1: The Value of Blockchain Technology"* (2015), VitalikButerin explains the blockchain "as a magic computer that anyone can upload programs to and leave the programs to self-execute, where the current and all previous states of every program are always publicly visible, and which carries a very strong crypto economically secured guarantee that programs running on the chain will continue to execute in exactly the way that the blockchain protocol specifies".

- (f) In the article, “Why Bitcoin has value” (2014), Van Alstyne describes Blockchain technology as “a sequential distributed database where the entire earlier transaction history is stored and shared in a (block) chain in a public ledger”.

Summarily, a blockchain is a chain of blocks that contain information. It is a completely open and distributed ledger to record information, once any data is recorded in a blockchain it cannot be changed or tampered with easily. Blockchain in accounting may be defined as an open, distributed database or public ledger that can record all transactions or digital events between two parties efficiently and in a verifiable and permanent way. It is like a giant spreadsheet for registering all assets and an accounting system for transacting on these assets on a global scale.

19.5.3 The origin of blockchain technology

Haber and Stornetta (1991) in their article, ‘How to time stamp a digital document’, in the Journal of Cryptology, introduced a technological solution to reduce data manipulation or modification by placing a time stamp. Blockchain technology was introduced in order to track the origin of data and any subsequent attempt to modify same. In 1991, they first proposed computationally practical procedures that involved creating cryptographically secured chain of blocks via time stamps, so that it becomes impossible for a user, either to back-date or to forward-date a document. Their procedures claimed to maintain privacy and removed the need for record keeping or time stamping by a third party.

This concept of cryptographically secured chain of blocks laid the foundation of blockchain. Blockchain, in its current form became popular after Satoshi Nakamoto used blockchain as the public transaction ledger for Bitcoin. Since then, blockchain technology has been implemented in recording of events, medical records, transaction processing, among others, in virtually all sectors of the economy.

Blockchain is a ledger that shows the histories of accounts which are replicated and distributed to every participant. It creates authenticity and privacy of identity by using cryptography algorithms. It is also a decentralisation protocol for shared control, tolerating disruption and for transaction validation. The blocks are connected in the order of its chronological occurrence which provides a trail to analyse the transactions. The information are in the form of digital media which eliminates manual and paper documents.

19.5.4 Modus operandi of blockchain

Like the name suggests, in a typical blockchain process, there are peer-to-peer nodes. When a transaction is requested, the request is sent to these nodes. Nodes then verify the transactions with a computer algorithm. If majority of the nodes verify the transaction, a new time stamped block is created and added to the blockchain of all previously verified blocks. This completes the transaction and the ledger is updated.

19.5.5 Benefits of block chain technology in accounting

- (a) Standardisation would allow auditors to verify a large portion of the most important data behind the financial statements automatically.

- (b) The cost and time necessary to conduct an audit would decline considerably. Auditors could spend freed up time on areas they can add more value, for example, on very complex transactions or on internal control mechanism.
- (c) Using the blockchain makes it possible to prove integrity of electronic files easily. One approach is to generate a hash string of the file. That hash string represents the digital fingerprint of that file. Next, that fingerprint is immutably time stamped by writing it into the blockchain via a transaction. At any subsequent point in time, one can prove the integrity of that file by again generating the fingerprint and comparing it with the fingerprint stored in the blockchain. In case the fingerprints are identical, the document remained unaltered since first writing the hash to the blockchain.
- (d) Finally, blockchain technology allows for smart contracts, that is, computer programs that may execute under certain conditions. Think of an invoice paying for itself after checking that delivered goods have been received according to specifications and sufficient funds are available on the company's bank account.
- (e) The blockchain technology has the potential to shapeshift the nature of today's accounting. It may constitute a way to vastly automate accounting processes in compliance with regulatory requirements. A flow of new applications will likely follow that are built on top of each other, leading the way for new, unprecedented services.
- (f) With the use of blockchain technology in an organisation, manual procedure of recording and verification is reduced. Blockchain technology is the future of accounting, because instead of keeping separate records based on transaction receipts, companies can write their transactions directly into a joint register, creating an interlocking system of enduring accounting records.
- (g) The most effective method to reduce frauds and errors in recording and verification is by implementing the blockchain technology in the organisation. Since all entries are distributed and cryptographically sealed, falsification or destruction of such entries in order to hide activity is rendered practically impossible.
- (h) Blockchain finally allows traceable audit trails, automates the auditing processes and authentication of transactions.

19.5.6 Conclusion

Blockchain is currently one of the most widely debated technologies, because of its indestructible and incorruptible features. Blockchain accounting offers to record data in a way which can be simultaneously accessible by auditors and regulators. This could potentially reduce the need for accountants to record transactions in separate locations with almost no way to consolidate and validate same.

Blockchain accounting is capable of providing a more transparent and secured accounting framework to track transactions and assets. Hence, traditional accounting is at the verge of a disruption which will redefine the role and need for accountants in an industry. Instead of being record keepers, accountants will become interpreters of financial statements and direct facilitators in decision making.

19.6. The Use Of Artificial Intelligence (Ai) In Financial Accounting

19.6.1 Introduction

Artificial Intelligence (AI) is revolutionising financial accounting by automating tasks, improving accuracy, and enhancing decision-making. In essence, AI refers to the simulation of human intelligence in machines that are programmed to think, learn, and adapt. In the context of financial accounting, AI enables systems to perform tasks that traditionally require human judgment, such as data analysis, classification, and forecasting.

19.6.2 Activities AI can perform in financial accounting

a. Automation of routine tasks

AI-powered accounting software can handle repetitive and time-consuming tasks like:

- i. data entry and reconciliation
- ii. invoice processing
- iii. bank and credit card matching

This reduces manual effort, minimises errors, and increases efficiency.

b. Real-time financial analysis

AI systems can analyse financial data in real-time to:

- i. identify trends and anomalies
- ii. generate insights for better financial planning
- iii. produce real-time dashboards and financial reports

c. Fraud detection and risk management

AI uses pattern recognition and predictive analytics to detect irregularities in financial transactions, such as:

- i. duplicate payments;
- ii. suspicious transactions; and
- iii. unauthorised access to financial systems.

d. Audit and compliance

AI helps auditors by:

- i. analysing large volumes of data quickly;
- ii. identifying high-risk transaction; and
- iii. ensuring compliance with financial regulations.

19.6.3 Predictive forecasting

AI tools can forecast cash flows, revenue, and expenses using historical data, machine learning algorithms, and market trends. This aids strategic decision-making and budgeting.

19.6.4 Natural Language Processing (NLP)

AI with NLP capabilities can:

- a. interpret and summarise financial statements;
- b. extract relevant information from contracts and invoices; and
- c. assist in generating written financial reports.

19.6.5 Virtual assistants and chatbots

AI-powered chatbots can respond to routine accounting queries, such as account balances, tax deadlines, or invoice status, improving client and internal communication.

19.6.7 Conclusion

AI is transforming financial accounting from a transactional function to a strategic partner in business. By enhancing accuracy, speed, and insight, AI allows accountants to focus more on value-added services such as advising, planning, and decision support. However, this transformation also requires accounting professionals to develop digital competencies to remain relevant.

19.7 Opportunities For Fraud From Working Remotely

19.7.1 Introduction

Remote working has increased since the advent of the pandemic. Consequently, organisations need to put controls in place to protect against the risk of fraud. Remote working provides companies with the opportunity to save money by spending less on fixed overheads. The successful implementation of remote working during the pandemic makes it likely that it will continue to feature, at least in part, in the operations of most companies. In as much as, there are many benefits of remote work, it brings along ongoing threats to businesses in the form of monetary and data losses originating from cyberattacks, internal fraud, control weaknesses, and workflow inefficiencies.

19.7.2 Vulnerabilities in a remote workplace

Remote workers often access corporate accounts on unprotected public Wi-Fi, conduct business on personal computers rather than an employer-issued PC, and transfer files between work and personal devices. Without an IT professional, to regularly update software with security patches designed to stay one step ahead of cyber criminals, employees are exposed to cyber attacks.

Once employees are working in a different environment, such as in a living room or bedroom, they may feel more comfortable and less professional, which can lead to an opportunity for cyber thieves.

Hackers prey on emotional vulnerabilities, too. By clicking ignorantly on links over the internet, they unknowingly give criminals access to their personal data and their employers', exposing valuable corporate information like usernames and passwords, as well as other corporate information. These breaches can have dire financial consequences for individuals and organisations, with the potential to erode customers' trust and loyalty.

19.7.3 Opportunities for fraud in a remote environment

(a) **Lack of supervision of employees:** Inadequate supervision of employees creates access and opportunity to commit certain types of fraud that are more difficult in a physical office environment. Examples

include: data theft, time theft, payroll fraud, workers' compensation fraud, among others.

- (b) **Cyber security risks:** Employees with weak home network security which if not addressed, could create fraud risks for an organisation. As opposed to the office environment, where IT managers can effectively control the security of the company's networks, employees' home networks may use weaker protocols and default passwords. This allows cyber thieves easier access to the network's traffic.
- (c) **Unsupervised and unlimited access:** Unsupervised access to systems and information in a remote environment creates opportunities for employees to easily steal company or customer data and use them for personal gain. Unlimited employees' access to systems and information, more than they need to perform their job functions and also creates fraud opportunities. Breaches of customer data or proprietary secrets could lead to legal issues and lost funds at best; lost customers and reputation damage at worst.
- (d) **Exposure of data security:** Many remote workers take advantage of their newfound flexibility to work in public places with free Wi-Fi. A compromised public Wi-Fi connection can leave a company susceptible to data breach. One successful phishing attempt could reveal a company's confidential and proprietary information and ruin the company's reputation. Thus, increasing the company's risks to cyber fraud.
- (e) **Limited evaluation of fraud risk potentials in virtual environments:** Ignoring potentially costly vulnerabilities of the data or network security control system in a virtual environment, may lead to fraud. The limited evaluation of fraud risk potentials and preparedness to prevent their occurrence endangers an organisation.
- (f) **Inadequate monitoring:** In a physical environment, adequate monitoring of a company's books and records for signs of fraud can be immediately investigated so as to establish new priorities and policies. Whereas, in a remote work environment, this may not be the case.

19.7.4 Fraud prevention measures

Employees do not exist in a vacuum; they have roommates, family members, and visitors who can pose a risk to sensitive data. The fraud triangle suggests that fraudulent behaviour is more likely to occur at the intersection of pressure, opportunity, and rationalisation. Remote work provides the perceived opportunity, while financial hardship can add to the pressure; the rationalisation can easily follow. Some measures to reduce the incidence of fraud in a remote working environment include:

- (a) Provision of company-issued devices and home office equipment to reduce data theft and ensure safe work environments;
- (b) Allow for flexible work schedules to reduce motive and opportunity for time theft;
- (c) Modernise company's best practices in-line with the changing work environment and educate employees on working more safely from public spaces;
- (d) Use time tracking software to monitor productivity. The company may install productivity monitoring software to ensure that employees are fully engaged and productive while working from home;
- (e) Install advanced anti-virus facilities and firewalls to enhance the security in the home environment;
- (f) Implement right restrictions of sensitive financial and non financial corporate information;
- (g) Install properly configured and secure routers for workers at home;
- (h) Issue company-owned devices to employees and secure the devices with device management solution. Enforce the activation of the "find my device" feature on all devices;
- (i) Implement a company-wide screen timeout of 1 minute of inactivity;
- (j) Develop an effective information system use policy that clearly communicates to employees company's expectations regarding their use of company resources, emails and data;
- (k) Employees should be educated on the inherent risks whenever company data flows through a home network. Employees hold more of company's security in their hands than ever before, so the need for following security best practices and controls is vital;
- (l) Train employees on best practices for accessing your company's virtual private network (VPN) for hosting virtual meetings. Staff are on the frontline in the fight against cybercrimes; therefore knowledge and awareness of what fraud looks like,

how it could affect the business, and their roles and responsibilities in preventing them;

- (m) Authorisation & authentication: Levels of authorisation can continue to operate remotely, which can leverage email audit trails and electronic signatures as proof of authorisation at the appropriate management levels;

19.8 Virtual Accounting Principles And Practice

19.8.1 Introduction

In this competitive world, to ease the stress of managing the accounts of a business and still achieve strategic goals, a businessman needs to decide whether to hire an in-house accountant or to take help of a virtual accountant.

19.8.2 Virtual accounting

Virtual accounting is a flexible system in which a qualified professional provides accounting services remotely, rather than physically working at the client's office. Virtual accounting offers all of the same benefits of hiring an accountant for a business, but because the accountant telecommutes and is a contractor, the cost is often less.

Virtual accounting offers an opportunity for qualified accountants to offer their services remotely. It is an efficient, flexible, and cost-effective accounting option that allows businesses to focus on achieving their goals by concentrating on their core competences.

19.8.3 Services offered by virtual accountants

Services offered in practice include:

- (a) Bookkeeping;
- (b) Payable and receivable accounts;
- (c) Banks, credit and loan accounts reconciliation;
- (d) Payroll processing;
- (e) Tax preparation;
- (f) Financial statements preparation;
- (g) Management reporting;
- (h) Financial analysis; and
- (i) Any other tasks which can be handled by an in-house accountant.

19.8.4 Benefits of virtual accounting

- (a) **Flexibility:** Virtual accounting services are great options for both small and large companies who have an accounting department, but need extra assistance. No matter the industry- real estate, hospitality, manufacturing, healthcare, retail, technology, telecoms, wholesale foods, among others, virtual accounting professionals can easily integrate into the existing department and provide assistance, as long as they are needed. This offers a unique blended solution for those businesses which need extra help, but cannot afford to hire additional accounting staff.
- (b) **Efficiency:** Accounting tasks like tax and payroll services can be efficiently and cheaply achieved without hiring a full-time accountant or consultant.
- (c) **Cost saving:** Virtual accounting helps cut costs by ensuring that small businesses only pay for needed and essential accounting work, especially when they cannot afford a full-time employee. It helps in cutting the costs in terms of unutilised time salary, benefits, utilities, supplies and other overheads for an in-house staff member.

Professional expertise: Virtual accountants work effectively in improving their skills, qualifications, and services so that the accounting work is handled by a skilled, experienced, knowledgeable and reliable professional. A person or a company providing virtual accounting services has great expertise in handling the accounting needs of businesses from varied industries.

- (d) **Convenience:** A virtual accounting department works at a client's pace and need. When a client has a question, they get back to you quickly because they understand the value of timely information.
- (e) **Multiple avenues of communication:** Most of the communication with virtual accountants will take place via email. When necessary, they will answer quick questions via instant messenger, and, when the situation warrants, a phone call can always take place. Thus, removing the constraints of physical meeting and delays in reporting.
- (f) **Virtual accounting services are delivered on the client's timeline**
Reports needed on daily, weekly or monthly basis can be provided using virtual accounting services. With the aid of a service level agreement (SLA), this contract binds the virtual accounting professional providing the services and stipulates the terms of operation with the business.
- (g) **Cloud computing:** In addition to receiving financial statements via email on a pre-set schedule, businesses have access to their financial documents at any time, from any device with secure internet access. The financial data is stored securely in data centres, which are protected from fire, flood and other damage. All data on the servers are encrypted for protection, and could be backed up frequently.

- (h) Virtual accounting adds value to the business even beyond the accounting services provided.

19.8.5 Challenges of virtual accounting

The impact of the coronavirus pandemic has changed the business landscape significantly. Many firms which did not embrace the idea of working from home or remote locations, have realised the benefits of having a virtual workforce. But virtual accounting can also create challenges, such as:

- (a) Difficulty in communicating with and managing remote employees;
 - (b) Cost implications for setting up necessary technology for the implementation of virtual accounting;
 - (c) Establishing and enforcing processes and policies for a virtual working environment may prove challenging for small or medium-sized businesses;
 - (d) Other challenges include, lack of motivation; how to deal with distractions often from children, noisy neighbours; and cohabitating with family, all day, every day; and
 - (e) Data security: Every business owner is concerned about data security. Every business wants its financial data to be secure. It is not easy to trust anyone with such financial information. It becomes a major point of concern when considering the use of virtual accounting professionals, who will handle the business accounts remotely.
-
- (n) Increase awareness of social engineering scams: The concern is that the opportunities for fraud are not necessarily happening by exploiting existing authority levels and segregations of duties. The most commonly used route still appears to be social engineering and cybercrime. Combined with a greater reliance on the telephone and electronic interactions, staff who cannot just turn to a colleague and talk through an issue with them, could find themselves inadvertently persuaded to allow a transaction to take place that turns out to be fraudulent; and
 - (o) Make sure employees stay connected: Employees need to feel that they are still connected to the firm, and that the contributions they make on a day-to-day basis are valued. Regular firm-wide communications and updates will help to reduce the extent to which employees feel vulnerable about working from a remote location, thus helping to achieve higher rates of co-operation.

19.9 Chapter review

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

- (a) explain computerised accounting;
- (b) explain the meaning of digitisation and its impact on businesses;
- (c) describe the key differences between digitisation and digitalisation;
- (d) describe data structures and their uses;
- (e) explain the importance of block chain technology in accounting;
- (f) explain the role of artificial intelligence (AI) in financial accounting;
- (g) explain the purpose of virtual accounting and its impact on the accounting profession;
- (h) explain some of the fraud opportunities in a remote environment; and
- (i) describe some of the measures to prevent fraud and other cyber crimes in a remote environment.

19.10 End of chapter questions and suggested solutions

Question 1

Omega Ltd recently transitioned from a manual system to Sage accounting software. Six months later, the financial controller observed a significant drop in processing errors but also noted staff complaints about difficulties in adapting to the new system.

Required:

- a) Identify and explain the benefits Omega Ltd gained from the transition.
- b) Suggest ways to overcome the staff adaptation challenges

Suggested solutions

a) Benefits gained

- Improved accuracy – Reduction in manual errors.
- Efficiency – Faster processing of transactions and reports.
- Data security – Reduced risk of data loss and enhanced backups.
- Real-time reporting – Quick access to financial data for decision-making.

b) Solutions to staff challenges:

- Training workshops – Regular sessions to build user confidence.
- User manuals and guides – Provide step-by-step help.
- Helpdesk support – On-demand IT support.
- Phased implementation – Gradual change rather than abrupt shifts.
- Feedback system – Engage staff in improvement discussions.

Question 2

- (a) Define digitisation and explain how it differs from digitalisation, giving appropriate examples.
- (b) Explain the impact of digitisation on modern businesses, focusing on efficiency, data management, and customer engagement.

Suggested solution

(a) Definition of Digitisation

Digitisation is the process of converting information from a physical or analog format into a digital (computer-readable) format. It involves scanning or encoding data so that it can be stored, processed, and transmitted electronically.

Example: Scanning a paper invoice and saving it as a PDF file on a computer.

Definition of Digitalisation

Digitalisation refers to the use of digital technologies and digitised data to improve business processes, enhance services, and create new value-producing opportunities. It leverages digitised information to transform operations, communication, and service delivery.

Example: Uploading scanned invoices (digitised files) to a cloud-based accounting system that automatically reads, stores, and processes the data for payment and auditing purposes.

Key Differences between Digitisation and Digitalisation

Feature	Digitisation	Digitalisation
Meaning	Conversion of analog to digital	Use of digital technologies to improve business processes
Function	Changes format of data	Transforms workflows and business models
Technology Use	Basic (e.g. scanner, PDF)	Advanced (e.g. cloud, AI, ERP systems)
Example	Scanning receipts into digital format	Automating payroll using cloud-based accounting software
Outcome	Data becomes readable by machines	Business becomes more efficient and customer-centric

- (b) The impact of digitisation on modern businesses)
Efficiency
Digitisation enhances operational efficiency by automating repetitive tasks and reducing the time spent on manual data entry and retrieval.

- Example: Digitised employee records can be accessed instantly without sifting through paper files.
- This leads to quicker decision-making and faster service delivery.

ii) Data Management

Digitisation improves the storage, retrieval, and analysis of business data.

- Businesses can store vast amounts of data in structured formats using databases and digital tools.
- Searching, filtering, and analyzing information becomes more efficient, reducing errors and improving accuracy.

- Example: Accounting software can automatically generate financial reports using digitised data.
- iii) **Customer Engagement**
Digitisation allows businesses to gather and analyse customer data to provide personalised experiences.
 - Businesses can track customer preferences and purchase history, leading to targeted marketing and better service.
 - Example: E-commerce platforms use digitised customer data to recommend products, improving customer satisfaction and retention.
- iv) **Cost Savings and Scalability**
Digitisation reduces the cost associated with physical storage, printing, and manual labour. It also allows businesses to scale easily, especially when using cloud services.
 - Example: A digital inventory system can scale as a business grows without major additional cost.
- v) **Enhanced Collaboration and Remote Access**
Digitised systems support real-time collaboration across departments and geographies.
 - Employees can work remotely, access data securely, and collaborate using shared digital platforms.

Challenges

- High initial costs of implementing digital systems.
- Risk of cyber threats and data breaches if proper security measures are not in place.
- Need for continuous employee training to keep up with technological advancements.

Question 3

You are the Head of IT and Finance in a medium-sized retail company planning to switch to **virtual accounting** and adopt more **digitised** operations.

- (a) Identify and explain three ways **virtual accounting** can benefit your organisation.
- (b) Outline four **key uses of data structures** in managing financial and customer data efficiently.
- (c) Explain three likely **challenges or limitations** of virtual accounting that the company must prepare for.

Suggested solution

(a) Ways virtual accounting can benefit an organisation

i) **Cost Efficiency**

- Virtual accounting eliminates the need to hire full-time in-house accountants, reducing salary expenses, office space, and other overhead costs.
- The organisation pays only for specific accounting services required, leading to significant savings.

ii) **Flexibility and Scalability**

- Services can be scaled up or down based on business needs without the complexities of hiring or retraining.
- Virtual accountants can support seasonal or expansion periods without long-term commitments.

iii) **Access to Professional Expertise**

- Virtual accounting firms or professionals often possess specialised knowledge in various industries.
- This ensures that the company benefits from up-to-date financial practices, tax regulations, and compliance strategies.

(b) Key uses of data structures in managing financial and customer data efficiently

i) **Efficient Data Storage and Retrieval**

- Structures like **arrays and hash tables** allow for quick storage and lookup of customer and transaction records, improving data access speed.

ii) **Organisation and Sorting of Transactions**

- **Linked lists and trees** are used to maintain chronological records, such as sales or payment history, enabling better tracking and auditing.

iii) **Data Analysis and Reporting**

- **Graphs and queues** help in processing and analysing patterns in customer purchasing behaviour, enabling targeted marketing and inventory decisions.

iv) **Memory Management**

- Data structures ensure optimal use of memory space, especially when handling large datasets such as financial ledgers, invoices, and payroll databases.

(c) Challenges or limitations of virtual accounting that the company must prepare for

i. **Data Security Concerns**

- Financial and customer data stored online or shared through cloud services may be vulnerable to cyber threats if not adequately secured.

ii. **Dependence on Internet Connectivity and Technology**

- Virtual accounting requires stable internet access and reliable digital platforms. Any downtime or technical failure can disrupt operations.

iii. **Limited Personal Interaction**

- Communication between staff and virtual accountants may be less responsive or slower than in-person support, potentially delaying urgent decisions or clarifications.

2.3.4

Preparation of financial statements: Approach 2

Step 1: Draft pro-forma financial statements including all of the accounts that you have identified from reading the question. Leave spaces in case you have missed an account that you might need to insert later.

Step 2: Copy the numbers from the trial balance into the pro-forma statements. If you

know that a number is not to be adjusted then you can copy it straight to its destination.

Otherwise set up bracketed workings next to the narrative in the pro-forma. After step 2

your answer might look like this:

Example: ABC – Statement of financial position

	₤	₤
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000)		
Current assets		
Inventories		
Trade receivables (51,000)		
Allowance for doubtful debts (4,000)		
Prepayments		
Cash	6,200	
Total assets		
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year		
Drawings	(22,000)	
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)		
Total equity and liabilities		

Example: ABC – Statement of profit or loss

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory		
Gross profit		
Expenses:		
Wages and salaries	64,000	
Depreciation		
Rent (14,000		
Heating an lighting (5,000		
Bad and doubtful debts		

Step 3: Perform double entry on the face of your answer.

Step 4: Complete the bracketed workings and copy totals into their final destinations.

Step 5: Calculate profit for the year.

Step 6: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:

Example: ABC – Statement of financial position

	₤	₤
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
		68,700
Total assets		168,100
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
		125,700
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
		42,400
Total equity and liabilities		168,100

Example: ABC – Statement of profit or loss

	₤	₤
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	319,400	
Closing inventory	(16,500)	
		(302,900)
Gross profit		
		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation (W1)	14,600	
Rent (14,000 – 700)	13,300	
Heating and lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
		(99,000)
		26,100

Workings

W1 – Depreciation: 10% of 146,000 = 14,600



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