ATSWA

ACCOUNTING TECHNICIANS SCHEME WEST AFRICA

STUDY TEXT

FINANCIAL ACCOUNTING

ASSOCIATION OF ACCOUNTANCY BODIES IN WEST AFRICA (ABWA)

ACCOUNTING TECHNICIANS SCHEME WEST AFRICA (ATSWA)

STUDY TEXT FOR

FINANCIAL ACCOUNTING

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DISCLAIMER

This book is published by ABWA; however, the views are entirely those of the writers.

PREFACE

INTRODUCTION

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

AIM OF THE STUDY TEXT

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

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

READERSHIP

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

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

APPROACH

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

FOREWORD

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

The Committee took up the challenge and commenced the task in earnest. To start off the process, the existing syllabus in use by some member Institutes were harmonized and reviewed. Renowned professionals in private and public sectors, the academia, as well as eminent scholars who had previously written books on the relevant subjects and distinguished themselves in the profession, were commissioned to produce Study Texts for the twelve subjects of the examination.

A minimum of two Writers and a Reviewer were tasked with the preparation of Study Text for each subject. Their output was subjected to a comprehensive review by experienced imprimaturs. The Study Texts cover the following subjects:

PART I

1 Basic Accounting
2 Economics
3 Business Law
4 Communication Skills

PART II

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

PART III

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

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

PRESIDENT, ABWA

STRUCTURE OF THE STUDY TEXT

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

The Study Text is organised into chapters. Each chapter deals with a particular area of the subject, starting with learning objective and a summary of sections contained therein.

The introduction also gives specific guidance to the reader based on the contents of the current syllabus and the current trends in examinations. The main body of the chapter is subdivided into sections to make for easy and coherent reading. However, in some chapters, the emphasis is on the principles or applications while others emphasise method and procedures.

At the end of each chapter is found the following:

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

HOW TO USE THE STUDY TEXT

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

ACKNOWLEDGMENTS

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

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

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

- The Institute of Chartered Accountants of Nigeria (ICAN) for the use of the Institute's examination materials;
- International Federation of Accountants (IFAC) for the use of her various publications;
- International Accounting Standards and Board (IASB) for the use of International Accounting Standards and International Financial Reporting Standards;
- Owners of Trademarks and Trade names referred to or mentioned in this Study Text.

We have made every effort to obtain permission for use of intellectual materials in this Study Text from the appropriate sources.

We wish to acknowledge the immense contributions of the writers and reviewers of this manual.

Our sincere appreciation also goes to various imprimaturs and workshop facilitators. Without their input, we would not have had these Study Texts. We salute them.

Chairman
ATSWA Harmonization & Implementation Committee

A new syllabus for the ATSWA Examinations has been approved by ABWA Council and the various PAOs. Following the approval of the new syllabus which becomes effective from the September 2022 diet a team was constituted to undertake a comprehensive review of the Study Texts in line with the syllabus under the supervision of an editorial board.

The Reviewers and Editorial Board members are:

REVIEWERS

This Study text was reviewed by:

- Mr. Lawal J.O	Foremost Consulting Associate, Abeokuta
- Dr. Aroh, Chike	Federal Polytechnic, Oko
- Mr. Ajileye Johnson	Lagos State Polytechnic, Ikorodu

EDITORIAL BOARD

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CHAPTER ONE

FINANCIAL ACCOUNTING CONCEPTS AND FRAMEWORK

Chapter Content

a. Bases and concept of accounting
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d. Status and purpose of conceptual framework
e. Elements of financial statements
f. Capital maintenance concept

1.0 Objective

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

i. Identify and discuss bases of accounting
ii. Explain the roles of bodies which set accounting standards
iii. Discuss the IASB Conceptual Framework for Financial Reporting in relation to
   - Objective of general-purpose financial statements
   - Qualitative characteristics of financial information
   - Financial statements and reporting entities
   - Elements of financial statements; including their recognition, measurement presentation and disclosure

iv. Identify and explain the attributes of different reporting entities.
v. Identify the possible impacts of relevant legislation and regulation governing corporate and non-corporate entities' accounts

1.1 Bases and Concepts of Accounting

1.1.2 Bases of Accounting

There are three bases of accounting and they are:

i. Accrual basis'
ii. Cash basis; and
iii. Break up basis

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

<u>Accrual Basis</u>

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

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

Accrual basis and the application of the matching principle

The accrual basis in effect the application of the matching principle. The accrual basis provides the reason for adjusting for accrued and prepaid expenses when preparing financial statements.

The application of the matching principle leads to the recognition of

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

Cash Basis

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

Thus, revenue from credit sales and other incomes are reported in the period when the cash involved are received and not in the period when the sales were made, or the income earned. Also, all expenses are recognised and reported in the period when payments were made rather than in the period when the expenses were incurred.

Set-back associated with cash basis of accounting includes the following:

i. It does not match cost with revenue hence profits may be distorted.

ii. Unearned income and liability accounts are not reported; hence statement of financial position may not reflect all monies due or owing.

iii. It does not show income that has not been invoiced or received.

iv. It does not allow for tracking the actual sales and purchases.

v. It does not report the effect of non-current assets utilisation made by entities as it ignores depreciation effect on such assets.

<u>Break up basis</u>

The other two bases of accounting (Cash basis and accrual basis) assumed that every business is a going concern. That is, that the business will continue to operate far into the future periods. However, experiences have shown the business do collapse as a result of financial difficulties occasioned by poor management of resources.

The break up basis of accounting is applied to business which has lost their going concern status. In this situation the business assets and liabilities are measured at the amount of cash they can be sold for or settled(a).

1.2 Other Accounting Concepts

i. Going Concern

The going concern is the fundamental assumption of financial reporting. An entity is considered a going concern if the business entity is capable of earning a reasonable net income and there is no intention or threat from any source to curtail significantly its line of business in the near future.• When financial statements are not prepared on a going concern basis, it should disclose the fact together with the basis on which they were prepared and the reason why the entity is not regarded as a going concern.

ii. Consistency of presentation

The concept of consistency holds that when an entity selects an accounting policy, it should continue to use that policy in subsequent periods. The concept ensures that the accounting treatment of like items to be the same, from one accounting period to another, to allow for comparison.

iii. Fair presentation

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

An entity achieves a fair presentation through compliance with applicable IFRSs with additional disclosure when necessary.

iv. Substance over form

This requires that business transactions should be recognised in the financial statements in accordance with their economic realities to the reporting entity, rather than their legal form. If the economic reality is followed, then the financial statements will represent faithfully, the financial transactions that have occurred.

v. Materiality

Information is material if its omission from, or mis-statement in the financial statements could influence the economic decisions of users. Whether an item is material or not depends on the magnitude or its nature or both in the context of specific circumstances of the business.

An entity should present separately each material class of similar items; if a line item is not individually material, it is aggregated with other items in those statements or in the notes.

An item that is not significantly material to warrant separate presentation in those statements may warrant separate presentation in the note.

1.3 Business Transactions

1.3.1 Business

The term business means different things to different persons. It can be used to describe an economic process and to describe entities that participate in that process.

Business can be defined as an economic system where goods and services are exchanged for one another or for money. A business entity is a commercial organization that aims to make a profit from its operations.

Characteristics of Business

The following characteristics are applicable to all businesses

i. Businesses are formed with a profit motive. That is all business exists to make profit.

ii. Business makes profit by supplying goods or rendering services to others called customers.

iii. Businesses might make the goods they supply or buy the goods from other outside parties.

iv. Business takes risk to survive. So profit is the reward for accepting risk.

v. The profit made by a business belongs to its owners. A share of the profit might be paid to the owners periodically as dividend or share of profit.

1.3.2.1 Types of Business Entity

- Ordinarily there are three main types of business entity:
- A sole trader or sole proprietorship
- A partnership business
- A company or limited liability company

1.3.2.2 Sole Trader Or Sole Proprietor

Any business owned and managed by one person is referred to as a sole trader or sole proprietor. Any individual who sets up a business on his own without form a company is a sole trader.

Important features of a sole trading business are as follows:

a. There is no legal distinction between the proprietor and the business. Thus he is personally liable for an unpaid debt and other obligations of the business and also when a sole trader dies the business cease to exist.
b. The profits of the business belong to the sole proprietor.
c. The assets of the business belong to the sole proprietor.
d. The sole trader can extract cash and other asset from the business for personal use and this called drawings when preparing financial reports.
e. The business may be financed by the owners' capital as well as by personal and business loans introduced.
f. A sole proprietorship business can be sold as a going concern by its owner.

1.3.2.3 Partnership

If partnership business is an enterprise in which two or more persons called partners share the ownership of a business. Each partner will be expected to contribute agreed sum of money to set up the business.

A partnership is defined as the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all. Important features of a partnership are as follows:

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

ix. A partnership can be sold as going concern by its owners.

1.3.2.4 Company/Limited Liability Company

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

a) Ownership of the company is represented by ownership of shares. A company might issue any number of shares, depending largely on its size. Large companies usually have large number of shares in issue and consequently large number of shareholders. The number of shares acquired by a shareholder determines his stake or ownership interest in the company

b) Unlike a sole trader or partnership, a company has the status of "legal system" in the eyes of the Law. Thus

- A company can be legal owner of business assets, and can sue and be sued in its own right in the law.
- A company is taxed separately from its owners for hot profits made by the company. This is not so with sole traders and partnership as the business profit is taxed in the hands of the partners or the sole proprietor.
- A company is liable for its on debts and not the shareholders. When the shareholders are not the managers of their company, it becomes essential that information about the position and performance of the company should be reported regularly by the management to the shareholders. This is the main purpose of financial reporting.

1.3.2.5 Not-for-profit Entities

These are entities which are established with the aim of providing social and welfare services and not necessarily for profit motive. Such entities includes: clubs, societies, voluntary associations, benevolent and similar institutions. Some important features of not-for-profit entities are:

- Members pay subscription to maintain their membership
- They sometimes carry out activities which yield profit like running a bar, organising fee paying competitions
- The entities do not prepare statement of profit or loss, rather income and expenditure account is prepared.

1.4 Advantages and disadvantages different types of business entity

The advantages and disadvantages of operating as each type of business entity may be summarized briefly as follows:

	Subject Matter	Sole Trader	Partnership	Company
1.	Ownership	Owned by one person	Several individual working together	Shareholders
2.	Liability for the unpaid debts and other obligations of the business	Personal liability of owners	Personal liability of partners	Limited

3.	Management	Business managed by its owner	Business managed by its owners-the Partners	Larger companies are managed by professional managers
4.	Raising Capital	Capital for business is Provided by its sole owner. Often Limited in Amount	Capital for the business is provided by its owners. Likely to limited in amount	Capital for the business is provided by shareholders. Public companies can raise new capital from investors in the stock market most very large businesses are companies
5.	Financial accounting and auditing	Some financial accounts needed for tax purposes	Financial accounts needed for the benefit of the partners and for tax purposes	Fairly strict regulation of financial reporting by companies. Also legal requirements for audit

1.5 Financial reporting by sole traders and partnerships

The financial statements of a sole trader are private and do not have to be disclosed, except to the tax authorities and possibly also to a lending bank. These must be prepared according to accepted accounting principles and practice, but need not conform to all the requirements of accounting standards.

Similarly, the financial statements of a partnership business are private and do not have to be disclosed.

1.6 Financial reporting by companies

The financial statements of a company are prepared for the shareholders of the company and are usually subject to audit.
Audit is the examination of the financial statements by an independent expert who expresses an opinion as to whether they are fairly presented (show a true and fair view).
Company law requires the financial statements are filed with a government agency, where they can be accessed and read by any member of the general public.

Companies whose shares are traded on a major stock market make their financial statements generally available to the public often on the company's website.
The financial statements of a company are subject to more regulation than those of a sole trader or partnership.

Financial accounting may also be of importance to management of companies. The most important need of financial accounting is that it provides information needs of persons not involved in running the business. That is they provide historical information needs.

1.7 Regulatory Framework for Financial Reporting

The regulatory framework is the most important element in ensuring that financial information is relevant and presented faithfully in order to meet the needs of shareholders, lenders, creditors, tax authorities, government and other users. Regulation would enhance comparability and transparency of financial statements.

1.7.1 Sources of Regulation:

i. The company law
ii. Accounting standards, that is, International Financial Reporting Standards (IFRSs).
iii. Listing rules in the stock market

1.7.2 Accounting standards

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

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

The International Accounting Standards Board (IASB) is responsible for issuing new IFRSs. IASB has published many IFRSs since 2005.

However, at this level of the ATSWA examination, the following International Financial Reporting Standards are relevant hence their requirements and their applications are treated in some details.

(i) IAS 1 - Presentation of Financial Statements
(ii) IAS 2 - Inventories
(iii) IAS 7 - Cash flow statements
(iv) IAS 8 - Accounting policies, changes in Accounting Estimates and Errors
(v) IAS 16 - Property, Plant and Equipment

Scope

Any limitation of the applicability of a specific IFRS is made clear within that standard. IFRSs are not intended to be applied to immaterial items, nor are they retrospective. Each individual IFRS lays out its scope at the beginning of the standard.

1.7.2.1 Advantages of Accounting standards:

- Improve the reliability of financial statements because their reliability of the statements can be tested against the prescriptions of the relevant standards
- Allow for inter-firm and intra-firm comparisons, which allows users of financial statements to check the progress of the firm and its position in the market effective.
- Allow interpretations of financial statements by users

- Ensure uniformity in the preparation of financial statements of entities within the same industry.
- Ensure that financial statements of entities are prepared in consistent manner every year
- Ensure that financial statements are prepared in a transparent manner, based on rules and principles.

1.7.3 IFRS FOUNDATION

International Accounting Standards Committee Foundation (IASC) is the Parent entity of the IASB.

In July 2010; it changed its name to IFRS Foundation. The IFRS Foundation is made up of 22 Trustees. These Trustees governs the IFRS foundation and also reports to the Monitoring Board.

Duties Of The IFRS Foundation

- It is responsible to raise funds needed to finance standard setting.
- It is responsible for the appointment of members to the IASB, IFRS Interpretation committee and the IFRS Advisory council.
- It oversees and supervises the standard-setting work.
- It also oversees and supervises the IFRS structure and strategy.
- It is also responsible for the review of the constitution.
- It is in charge of governance of the standard setting and IFRS strategy.

IFRS Advisory Council (IFRSAC)

The IFRS advisory council is the formal advisory body or unit to the IASB and the Trustees of the IFRS foundation. It consists of a group of organisations√ and individuals with interest and relevant knowledge in international financial reporting. These members are drawn from different geographic locations and have a wide variety of backgrounds and they include the user groups, the preparers of financial statements, financial analysts, academics, auditors, regulators, professional accounting bodies and investor group. The IFRS Advisory Council is a body set up to participate in the standard-setting process and its members are appointed by the Trustees of IFRS Foundation.

The major role of IFRS Advisory Council is to advise the Trustees of the IFRS foundation and IASB on financial reporting issues especially on prioritisation of its work and on the implication of proposed standards for users and preparers of financial statements. At times, the IFRSIC advises the IFRS foundation on specific issues. The IASB is required to consult with the IFRS Advisory Council in advance of any board decisions on major projects that it wishes to add to its agenda.

International Financial Reporting Standards Interpretations Committee (IFRSIC)

The International Financial Reporting Standard Interpretations Committee (IFRSIC) assists the IASB by improving existing Standards. The IFRS Interpretation Committee is a committee that comprises of mostly technical partners in audit firms but also includes preparers of financial statements and the user groups.

The IFRS Interpretations Committee has the following functions and responsibilities:

- To interpret the accounting standards (IFRS$_S$ and the IAS$_S$) issued by the IASB.
- To review on a timely basis, newly identified financial reporting issues not specifically addressed in IFRS$_S$.
- To clarify issues where unsatisfactorily or conflicting interpretations have developed, or likely to have developed.
- To provide timely guidance on the application and interpretation of IFRS$_S$.
- To answer queries from constituencies about how to interpret IFRS$_S$. That is, filling in the cracks between different rules.
- It also liaises with the US Emerging Issues Task Force and similar bodies and standard setters, to try to preserve convergence.
- It establishes working relationship with local or national standards setters who have adopted or converged or about to adopt or converge to IFRS$_S$

1.7. 4 Company laws:

Company laws set out rules for determining profits available for distribution, issuing and redeeming of share capital, the reserves a company must have and the uses to which they can be put. Company law establishes the accounting requirements for financial reporting. It contains the general requirements to prepare financial statements. It places a duty on directors to prepare annual statements each year and prescribes the form and content of financial statements. Company law varies from country to country. The company law in Nigeria is the Companies and Allied Matters Act 2020.

1.7.5 Listing rules:

These rules set out the information which entities must supply when their shares are traded on the stock market. They must comply with these rules in order to maintain their listing. These rules include financial information , which includes financial reports that entities must prepare and provide to the stock market while they are listed.
Further regulations: These are often issued by the banks and other insurance regulators. These rules will apply to relevant entities in the financial service sector.

1.7.6 The IASB Conceptual Framework for Financial Reporting.

1.7.6.1 Status and purpose of the Conceptual Framework.

Status

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

Objectives of the Framework

The objective of the Framework is set out to.

i. Guide standard setters in the development of future standards and reviewing the existing standards, so that there is a rational basis for reducing number of alternatives in existing standards.
ii. Guide preparers in applying standards and in applying principle based rather than rule based to the treatment of matters not covered by the standards.
iii. Assist auditors in satisfying them self that financial statements being audited are in conformity with the framework principle.
iv. To provide stakeholders with the basis for interpreting the information contained in the financial statements**.**

Objective of general-purpose financial statements

The objective of general-purpose financial statements is to provide information about the financial position, performance and changes in financial position of an entity. The primary users of general-purpose financial reporting are present and potential investors, lenders and other creditors. They use the information to make decisions about;

- buying, selling or holding equity or debt instruments,
- providing or settling loans or other forms of credit,
- exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's resource.

Economic Resources and Claims to the Resources

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

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

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

Changes in Economic Resources and Claims

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

Changes in economic resources and claims resulting from financial performance

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

Changes not resulting from financial performance.

The changes in an entity's economic resources and claims not resulting from financial performance is presented in the statement of changes in equity.

Information about changes in an entity's economic resources and claims resulting from events and transactions other than financial performance relates to the issue of equity instruments or distributions of cash or other assets to shareholders.

Financial performance reflected by past cash flows.

This information indicates how the entity obtains and spends cash. The information assists users to assess the entity's ability to generate future net cash inflows and to assess management's stewardship of the entity's economic resources.

The changes in the entity's cash flows are presented in the statement of cash flows.

1.8 Users of Financial Statements And Their Information Needs Under IFRSs

Apart from the primary users of general-purpose of financial statements, the

Framework also identify other users of financial information.

There are various users of financial statements, each with different information needs. Users of financial statements can be categorised into:
- Internal users and
- External users

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

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

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

1.9 Qualitative characteristics as per the Conceptual Framework

i. Fundamental Characteristics
- Relevance, and
- Faithful representation

ii. Enhancing Characteristics
- Comparability,
- Understandability**,**
- Verifiability , and
- Timeliness

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

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

The relevance of information is affected by its materiality. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality may be based on the nature and magnitude of the item or group of items to which the information relates in the context of an entity's financial report, therefore it is not possible for IASB to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

Faithful Representation: To be useful, information must represent faithfully that which it either purports to represent or could reasonably be expected to represent. Information has the quality of faithful representation when it is, neutral, complete, and free from material error and bias. Another key element of faithful representation substance over form.

A perfect faithful representation would have three characteristics

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

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

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

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

Verifiability

When information can be verified, it gives assurance that the information faithfully represents the economic phenomena being represented. For information to be verifiable, it means that different knowledgeable and independent parties could reach consensus (although not necessarily complete agreement) that a particular depiction is a faithful representation. Quantified information of a single point estimate is verifiable. In addition, a range of possible amounts and the related probabilities can also be verified.

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

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

1.10 Elements of Financial Statements

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

Assets:
A present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits. The potential economic benefits need not to be expected' to flow to the entity; they do not need to be certain or most likely .However ,low probability of an inflow economic benefits may indicate that recognition of an item meeting the definition of an asset may not provide relevant

The rights may include the following:

i. Rights to receive cash;
ii. Rights to receive goods and services;
iii. Rights to exchange economic resources in favourable terms;
iv. Right to use intellectual property; and
v. Right to benefit from the use of physical object such as the lease of property, plant and equipment.

The existence of an asset, particularly in terms of control, is not reliant on: physical form.

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

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

Equity
Equity is the residual interest in the assets of the entity after deducting all its liabilities. Equity comprises of those that arise from owners' contribution and those that arises from increase in income. Examples of equity are equity share capital, share premium, revaluation reserves and retained earnings.

It is the residual interest of the owners or shareholders in the business as at the reporting date. It is calculated as total assets less total liabilities or share capital plus all reserves.

Equity interest confers on the holders the right to receive dividends and proceeds from satisfying the equity claims, either in full on liquidation, or in part at other times.
Income
Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

The definition of income encompasses both revenue and gains.

i. **Revenue**
Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

ii. **Gains**
Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. For instance, when non-current assets are sold above their carrying amount, the difference is gain.
Contributions (e. issue of equity shares) from owners in their capacity as owners are not income.

Expenses
Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

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

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

Distributions to owners in their capacity as owners (i.e. dividend distribution to shareholders) expenses.

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

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

Based on these general criteria:

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

1.10.2 Measurements of Elements of Financial statements

Measurement relates to the basis in which elements of financial statements will be included in the financial statements. The selection of a measurement basis should take into account the fundamental characteristics of useful financial information, that is, relevance and faithful representation; and measurement uncertainty and cost constraint. In selecting a measurement basis for an asset or liability, it is more important to consider the nature of the information that the measurement basis will produce in both the statement of financial performance and the statement of financial position.

The following measurement bases are discussed.

i. Historical cost: This is the cost at which transactions and other events are acquired.

ii. Non-financial assets held at historical cost should be adjusted overtime to reflect the usage through depreciation and amortisation; or when the carrying amount of the asset is greater than the recoverable amount, impairment loss should be written off

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

iii. Fair value: This is defined as the price in which items are exchanged in an orderly transaction between market participants.

iv. Current cost: This is the value at which the entity would acquire the asset or transfer the liability at the current market price.

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

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

Historical cost is the commonest basis but the others are often used to modify historical cost. Inventories are carried at the lower of cost and net realisable value; non-current assets are carried at an amount that is not greater than their recoverable amount, investments may be carried at fair value while non-current liabilities may be carried at their present value.

Some inherent limitations in the use of the measurement bases were highlighted by the Framework:

i. Historical cost may not provide relevant information about assets held for long period of time, hence a variation of current value will be used to provide more predictive information to users.
ii. Fair value may not be relevant if items are held solely for use or to collect contractual cash flows.

1.10.3 Presentation and disclosure

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

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

Capital maintenance concepts:

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

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

Financial capital maintenance Concept:

Under this concept a profit is earned only if the financial (or nominal) amount of the net assets at the end of the period exceeds the financial (or nominal) amount of net assets at the beginning of the period, after excluding any distributions to, and contributions from owners during the period. Financial capital maintenance can be measured in either nominal monetary units or units of constant purchasing power.

Physical capital maintenance:

Under this concept a profit is earned only if the physical productive capacity (or operating capacity) of the entity (or the resources or funds needed to achieve that capacity) at the end of the period exceeds the physical productive capacity at the beginning of period. Current value accounting reflects the concept of physical capital maintenance.

In a period of inflation, profits reported using a financial capital maintenance concept will normally be higher than profits reported using a physical concept of capital.

Most entities adopt a financial concept of capital maintenance.

1.11 End of chapter questions

1. Qualitative characteristics of useful financial information under IFRS may be fundamental or enhancing.

   Which TWO of the following qualitative characteristics are fundamental?
   I. Relevance
   II. Verifiability
   III. Understandability
   IV. Faithful representation

   A. I and IV
   B. II and III
   C. II and IV
   D. III and IV
   E. I and III

2. The cash basis of accounting requires the recognition of revenue only when they are
   A. Due
   B. Earned
   C. Paid
   D. Received D
   E. Budgeted

3. The Conceptual Framework for Financial Reporting deals with the following except
   A. The objective of general-purpose 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
   D. Concepts of revenue and expenditure D
   E. Concepts of capital and capital maintenance

4. Which of the following elements is directly related to the measurement of an entity's financial position?
   A. Performance, income and expenses
   B. Income, expenses and equity
   C. Performance, income and equity
   D. Assets, liabilities and equity D
   E. Assets, liabilities and performance.

5. Which of the following valuation methods should be used when an entity is faced with liquidation?
   A. Fair value
   B. Historical cost
   C. Current cost
   D. Realisable value D
   E. Present value Accounting standards provide guidance on

6. Which of the following is the
   A. Recognition, measurement, presentation and disclosure

B. Recording, measurement, presentation and interpretation
C. Recognition, classification, presentation and interpretation
D. Recording, classifying, aggregating and interpretation
E. Recognition, measurement, interpretation and recording

7. Each component of the financial statements must be properly identified with the following information displayed prominently EXCEPT
A. The name of the entity
B. A description of the nature of the entity's operations and its principal activities B
C. The date of the end of the reporting period covered by the statements
D. The presentation currency
E. The level of rounding used in presenting amounts in the financial statements

8. The process to reduce or eliminate variations in accounting practice and to introduce a degree of uniformity into financial reporting is through
A. Accounting standards
B. Accounting concepts A
C. Accounting manuals
D. Auditing statements
E. Management policies

Use the following information to answer questions 9 and 10
Chiller enterprises entered into a contract on January 22, 2017 with Presser Ventures to supply Presser a machine for an agreed price of N400,000. On February 18, 2017, Chiller purchased the machine from a wholesaler, for N320,000 on credit. Chiller delivered the machine to Presser on March 16, 2017 and payment to Chiller to be made on account.

Presser pays Chiller N400,000 on April 17, 2017. Chiller pays the wholesaler N320,000 on May 12, 2017.

9. Using cash basis of accounting, Chiller Enterprise's expenses and income will be recognised in
A. April and May A
B. March and April
C. February and April
D. January and March
E. March and May

10. Using accrual basis of accounting, Chiller Enterprise's expenses and income will be recognised in
A. January and February
B. February and May
C. February and March C
D. March and April
E. March and May

11. Which of these statements **cannot** be defined as income?
A. Decrease in economic benefits during the accounting period A
B. Increase in economic benefits during the accounting period

C. Decrease in liabilities
D. Gains arising on the disposal of non-current assets
E. Activities that enhance the net assets

12. The objective of general-purpose financial reporting as described in the *Conceptual Framework* is to:
    A. Meet the information need of management
    B. Provide information to regulators
    C. Support the entity's tax return
    D. Meet the information needs of an entity's stakeholders.
    E. Provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity.

1.12 Solution to end of chapter questions

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

1.13 Examination type question

The IASB Conceptual Framework for Financial Reporting provides a conceptual underpinning of IFRS. The objective of general-purpose financial reporting forms the foundation of the conceptual framework.

Required:

a. Explain the objective of general-purpose financial statements and the nature of the information in the statements.

b. Define the following concepts and explain the significance of each on financial reporting.

    i. Materiality
    ii. Consistency
    iii. Offsetting

1.14 Solution to examination type questions

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 for the entity.

General purpose financial statements provide information about the financial position of the entity, statement of profit or loss and other comprehensive income, statement of cash flow and statement of changes in equity, that is, information about the economic resources and the claims against them. Changes in financial position are due to financial performance and other events or transactions.

b. (i) Materiality:

Information is material if its omission from, or misstatement in the financial statements could influence the economic decisions of users. There is no absolute measure of materiality that can be applied to all businesses. Whether an item is material or not depends on the magnitude or its nature or both in the context of specific circumstances of the business.

Items that are being considered as material need to be disclosed in the financial statements. Financial statements could become misleading or confusing if immaterial items are included.

(ii) Consistency:

There is usually more than one way or method by which an item may be treated in the accounts without necessarily violating accounting principles. The concept of consistency holds that when an entity selects a method, it should continue (unless conditions warrant a change) to use that method in subsequent periods so that a comparison of accounting figures over time is meaningful.

The concept ensures that the accounting treatment of like items is consistent, taking one accounting period with another.

(iii) Offsetting:

IAS 1 requires that assets and liabilities, and income and expenses should not be offset against each other. Instead they should be reported separately. Not offsetting would help to compare the amount of assets to liabilities and the income to expenses.

Offsetting is only possible when it is permitted by a standard or it reflects the economic substance of the transaction.

CHAPTER TWO

ACCOUNTING STANDARDS REGULATIONS AND GUIDELINES

Chapter contents

a. Introduction
b. Regulations governing accounting and financial reporting
c. International financial reporting standards IFRS/IASB
d. Presentation of Financial statement IAS1
e. Accounting Policies, changes in accounting estimates and error. IAS8
f. Inventory IAS2
g. statement of cash flows IAS7
h. Property, Plant and Equipment IAS16
i. IFRS for SME(s)

2.0 Objectives

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

(a) Explain the need for regulation in Accounting and financial reporting.
(b) State the importance of IFRS and International Accounting Standard Board (IASB)
(c) Prepare financial statements in accordance with the requirements of accounting standards.
(d) Know the provisions and simple applications of specific accounting standards IAS 1,2,7,8 and16
(e) Know the requirements and simple applications of IFRS for SME(S)

2.1 Introduction

Due to advancement in information technology, the world has become a global village. In order to be able to prepare financial statements that could be acceptable internationally, countries around the world are adopting the International Financial Reporting Standards (IFRS). IASB is responsible for issuance of the standards.

2.2 The regulations governing accounting and financial reporting

Users rely on the financial statements to take investment decisions hence their presentations need to be regulated to ensure credibility and fairness.

For example Banks lend money to companies on the basis of their financial statement also in the event of merger of companies financial statements also form the basis for valuation. While profit reported by a company also forms the basis for charging income tax. In view of these there must be appropriate laws and regulations that would guide against creative accounting as much as possible. Accounting standards provides guidance on common transactions thus ensuring uniformity in the preparation and presentation of financial statements.

The preparation and presentation of financial statement is based on large number of concepts, principle and detailed rules. Some of these are contained in law and others are in financial reporting standard. Many of the most fundamental concepts are not contained in any law or regulations or standards, 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 their legal and regulatory systems are not the same.

However many countries all over the world have now accepted a uniform accounting standards which is known as International Financial Reporting Standards IFRS OR IAS. It is this standards and use of appropriate local GAAP that are applied when preparing and presenting financial statements.

2.3 International financial reporting standards /IASB

2.3.1 International accounting standards board (IASB)

The IASB is the board charged with responsibility for developing international accounting standards. The board is made up of 14 members that are highly skilled in accounting and each member contribute to the issue and publications of the following documents issued by the board:

- an exposure draft of the standard
- a revised International Accounting Standards (IAS)
- an International Financial Reporting Standards(IFRS)
- a final Interpretation of the IFRS interpretation committee(IFRSIC)

The IASB has full responsibility for all technical matters and they have issued IASB – CONCEPTUAL FRAME WORK which set out the concepts that underlie the preparation and presentation of financial statements for users. The details of this has been dealt with in other chapter.

2.3.2 International financial reporting standards (IFRS)

The term IFRS is normally used to refer to the whole body of the standards (i.e IAS and IFRS). The IFRS is made up of the following:

	Published by IASC(up to 2001)	Published by IASB (from 2001)
Accounting Standards	IASs	IFRSs
Interpretations	SICs	IFRSICs

2.3.3 Roles of accounting standard setting bodies

The responsibility for setting Accounting Standards at global level rests with the International Accounting Standards Board (IASB). There are also National Accounting Standards setting bodies in different countries like the Financial Reporting Council of Nigeria (FRCON), which now ensure compliance of entities’ financial statement with the International Financial Reporting Standards (IFRS).

2.3.4 <u>International Accounting Standards Board (IASB)</u>

The fore bearer of the IASB is the International Accounting Standards Committee (IASC) which was established in 1973 to develop international accounting standards with the aim of harmonising accounting procedures worldwide. The first set of International Accounting Standards (IASs) was issued in 1975. The IASC was supported by another body called the Standing Interpretation Committee (SIC) which issued interpretations of rules in standards when practitioners have divergent opinion in treatment of items.

Following the change in the constitution of IASC in 2001, two new bodies were established to replace the IASC and its supporting body, the SIC. The bodies were International Accounting Standards Board (IASB) and the International Financial Reporting Interpretations Committee (IFRSIC). The IASB adopted all the standards (IASs) and Interpretations by SIC that were extant at the time, but pronounced that all new standards written from that time were to be called "International Financial Reporting Standards" (IFRS) and that all interpretations by IFRSIC are to be known as International Financial Reporting Interpretations Committee pronouncements or IFRICS.

Thus, when IFRS is mentioned, it means:

(i) All Accounting Standards (IASs) and Interpretations by SIC published by the IASC up to 2001 (those not yet replaced) and;

(ii) All Accounting Standards (IFRSs) and Interpretations (IFRICs) published by the IABS from 2001.

Since 2001, the IASB has published the following standards using the new nomenclature IFRS:

- IFRS 1 - First time adoption of IFRS
- IFRS 2 - Share-based payment
- IFRS 3 - Business combination
- IFRS 4 - Insurance contracts
- IFRS 5 - Non-current assets held for sale and discontinued operations
- IFRS 6 - Exploration for and evaluation of mineral resources
- IFRS 7 - Financial Instruments: Disclosure
- IFRS 8 - Operating segments
- IFRS 9 - Financial instruments
- IFRS 10 - Consolidated Financial Statements
- IFRS 11 - Joint arrangements
- IFRS 12 - Disclosure of interests in other entities
- IFRS 13 - Fair value measurement
- IFRS 14 - Regulatory deferral accounts
- IFRS 15 - Revenue from contracts with customers
- IFRS 16 - Leases
- IFRS 17 - Insurance contract (replacement for IFRS 4)
- IFRS for SMEs

So far, many IASs and SIC pronouncements have been repealed or amended by IASB since its establishment in 2001.

However, at this level of the ATSWA examination, candidates are required to study properly the following accounting standards:

(vi) IAS 1 - Presentation of Financial Statements

(vii) IAS 2 - Inventories

(viii) IAS 7 - Cash flow statements

(ix) IAS 8 - Accounting policies, changes in Accounting Estimates and Errors

(x) IAS 16 - Property, Plant and Equipment

Candidates should also pay attention to IAS 11 on construction contracts, IAS 17 and IAS 41 on Lease on Agriculture to enable them appreciate and understand the preparations of simple lease accounts, construction contracts accounts and Farmers account examinable in the Principles and Practice of Financial Accounting paper of this examination.

2.3.5 Financial Reporting Council of Nigeria

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

The FRCON was established by the Financial Reporting Council of Nigeria Act, No. 6, 2011 which repealed the Nigerian Accounting Standard Boards Act No. 22 of 2003. The FRCON is an agency (parastal) of the federal government which is directly supervised by the Federal Ministry of Industry, Trade and Investment.

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

(a) To protect investors and other stakeholders interest;

(b) To give guidance on issues relating to financial reporting and corporate governance to professional, institutional and regulatory bodies in Nigeria;

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

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

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

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

(g) To enhance the credibility of financial reporting; and

(h) To improve the quality of accountancy and audit services, actuarial, valuation and corporate governance standards.

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

(i) Directorate of Accounting Standards – Private sectors
(ii) Directorate of Accounting Standards – public sectors
(iii) Directorate of Auditing Practice Standards
(iv) Directorate of Actuarial standards
(v) Directorate of Valuation Standards
(vi) Directorate of Inspection & Monitoring
(vii) Directorate of Corporate Governance

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

(a) To develop accounting and financial reporting standards to be observed in the preparation of financial statements in the private sector and small and medium scale enterprises;
(b) To promote the general acceptance and adoption of such standards by preparers and users of financial statements;
(c) To promote compliance with the accounting standards developed or reviewed by the Directorate;
(d) To review from time to time the accounting standards developed in line with prevalent social, economic and political environment;

(e) To promote compliance with accounting and financial reporting standards adopted by the Council;
(f) To promote in the public interest, accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities; and
(g) To perform such other duties which in the opinion of the Board are necessary or expedient to ensure the efficient performance of the function of the Council.

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

The standards that are examinable at this accounting technician level are as follows:

- IAS 1- Presentation of Financial Statements
- IAS2- Inventories
- IAS 7-Statement of Cashflows
- IAS8- Accounting policies ,Changes in Accounting Estimates and Errors
- IAS 16- Accounting for Property Plant and Equipment
- IFRS for SMEs

2.4 Conceptual framework for financial reporting

2.4.1 Introduction

A conceptual framework is a set of concepts and principles which underpin the preparation of financial statements. It is a framework upon which IFRSs are based and so determined the information contained in financial statements. The International Accounting Standards Committee (IASC), the fore bearer of the IASB issued a document in 1989 called "FRAMEWORK FOR THE PREPARATION AND PRESENTATION OF FINANCIAL STATEMENT". This "Framework" which is not an accounting standard in itself was adopted by the International Accounting Standards Board (IASB) when it came on board in 2001.

The framework comprised of the following sections:

(a) The objective of financial statements
(b) Underlying assumptions of financial statements
(c) The qualitative characteristics that determines the usefulness of information in financial statements
(d) The definition of the elements of financial statements
(e) The recognition of the elements of financial statements
(f) The measurements of the elements of financial statements
(g) Concepts of capital and capital maintenance

The IASB in collaboration with the Financial Accounting Standards Board (FASB), the national standard setters of the United State if American, is currently working to develop a conceptual framework common to each Generally Accepted Accounting Principles (GAAP). The new conceptual framework is being developed on a chapter by chapter basis.

For now, only two chapters have been finalised and released to replace the sections (a) and (c) in the 1989 "Framework" described above. To ensure effective replacement of the two sections and probably avoid possible confusion, the IASB issued a new document called "THE CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING" which is made up of the following chapters:

i) Chapter 1 - The objective of general purpose financial reporting
ii) Chapter 2 - The reporting entity (to be added – yet to be finalised)
iii) Chapter 3 - Quantitative characteristics of useful financial information
iv) Chapter 4 - The Framework (1989): That is the remaining sections of the 1989 document not yet replaced, comprising:

(a) Underlying assumption of financial statements
(b) The elements of financial statements
(c) Recognition of the elements of financial statements
(d) Measurement of the elements of financial statements
(e) Concepts of capital and capital maintenance

However, the changes between the “Framework” 1989 and the “Concept framework” are not fundamental in terms of their impact on IFRS.

Purpose of Conceptual Framework
The need for a formal conceptual framework is recognised by most preparers and users of financial statements as it will enhance uniformity in the treatment and presentation of financial issues and reports. The conceptual framework outlines the concepts which underlie the preparation and presentation of financial statements especially for external users. Thus, the purposes of conceptual framework include:

i. it assist preparers of financial statements in applying IFRSs and in dealing with matters not yet covered by any IFRS.

ii. It assists users when interpreting the information contained in IFRS complaint financial statements.

iii. It assists auditors informing an opinion on whether or not the financial statements adequately complied with IFRSs.

iv. It assists national standard setting bodies when developing their national or local standards.

v. It assists the IASB when developing new IFRSs and in the review of existing ones.

vi. It assists the IASB by providing a basis for the reduction of the number of alternative accounting treatments permitted by IFRSs and therefore promoting harmonisation of regulations and procedure for presentation of financial statements.

vii. It provides information about the approach to the formation of IFRSs to parties interested in the work of the IASB.

It should be noted that where there is a conflict between the conceptual framework and an IFRS, the requirements of the IFRS will prevail over those of the Conceptual Framework in all cases.

2.4.2 <u>Underlying Assumptions of Financial Statements</u>
The Conceptual Framework identified two important assumptions for financial statements and thee are (1) the going concern concept and (3) the accrued basis/concept.

<u>Going Concern Concept</u>

The going concern concept is an assumption in accounting which states that an entity will continue to operate for the foreseeable future and his neither the intention not need to go into liquidation or reduce materially the scale of its operations. The concepts assume that, when preparing the financial statements, the entity will continue to operate in approximately the same manner for at least the next twelve (12) months. The going concern assumption is particularly relevant for the valuation of assets.

Where the going concern assumption is not followed in preparing a financial statements, the fact must be disclosed and in addition the following information:

i) The basis used in preparing the following statements
ii) The reasons why the entity is not treated as a going concern

<u>Accrual Basis/Concept</u>

The accrual basis is an assumption in accounting which states that in preparing the statement of profit or loss and other comprehensive income, that the revenue earned must be matched against expenditure (costs) incurred in earning it. The basis advocates that entities should prepare their financial statements on the basis which transactions are recorded in them, that is as revenue or expenses are earned or incurred in the relevant accounting period due to their concerned and not in the period when the cash is paid or received. The assumption is also referred to as the matching concept.

2.4.3 <u>Users and their Information needs</u>

The main aim of accounting is to provide information which is useful for persons within and outside the organisation users outside the organisation include investors (existing potential), creditors and lenders, government, research scholars and consumers while users within the organisation are management and employees. The information needs of these users differs substantially due to their different roles and interest in the organisation.

Many shareholders and potential investors, lenders and other creditors do not have statutory, power to compel reporting entities to provide information directly to them and thus must rely on general purpose financial statements for much of their financial information need. These group constitute the primary users for whom general purpose financial statements are produced. They should however, not that:

- General purpose financial statements cannot provide all the information needed by them and so will need to consider relevant information from other sources.

- General purpose financial statements only provide information to help users estimate the value of a reporting entity as its absolute value is not revealed in the statements.

- The aim of IFRS complaint financial statement is to provide information that will meet the needs of the maximum number of primary isers and not the need of an individual primary user.

Other categories of users, other than the primary users earlier mentioned, such as government regulators, management, employees and members of the public may also find general purpose financial statements useful but these statements are not primarily directed to them.

An entity's management and employees union are interested in financial information but they do not need to rely on general purpose financial statements.

2.4.4 Objective of general purpose financial statements

The objective of general purpose financial statements, is to provide information about the financial position, performance and cash flows of an entity and this is useful to existing shareholders and potential inventors, lenders and other creditors in making economic decisions. These groups of users make decisions to provide resources to the entity through buying, selling or holding equity and debt instruments and providing or settling loans and other credits. For the purpose of making these decisions, the users need information to help in assessing the prospects for future cash inflows of the entity and thus will need information about the resources of the entity, the claims against such resources and the efficiency and effectiveness of the entity's management in using the entity's resources.

The general purpose financial statements provide information about:

i) The entity's financial position. That is information about economic resources and the claims against them.

ii) Changes in the entity's financial position which could be as a result of:
- financial performance; and /or
- other events or transactions such as share issue

iii) The entity's inflows and outflows of cash and cash equivalents.

The information about the nature and amounts of an entity's economics resources and claims will be helpful to users in assessing the reporting entity's liquidity and solvency and its additional financial needs. It will also help to identify the strength and weaknesses of the reporting entity.

Also the information about the rankings and payment requirements of the entity's existing claims is helpful to users in predicting how future cash flows will be equitably distributed among the reporting entity's claims beneficiaries.

The information about changes in the entity's financial position as a result of performance is revealed through accrual accounting which depicts the effects of transactions, other events and circumstances on the entity's economics resources and claims in the period in which those effects occur and not when the cash is paid or received. Such information is important because it provides a more useful basis of assessing the reporting entity's past and future performance rather them relying or cash receipts and payments for the period.

The information about reporting entity's financial performance assists users to understand the return generated from its economic resources and to appreciate the capacity of the entity to generate net cash inflows through its operations rather than borrowing from outside lenders.

Financial performance is also revealed through management of cash flow. The information about a reporting entity's cash flow for a period helps users to understanding how the entity obtains and spends cash, its borrowing and repayment of debts and settlement of cash dividends and other cash distribution to investors. Also, information on an entity's cash flows helps users in their evaluation of the operations, investing and financing activities of the entity for the reporting period.

2.4.5 Qualitative characteristics of useful financial information

The IASB conceptual framework dealt with the qualitative characteristics of useful financial information. The conceptual framework identified two classes of qualitative characteristics as "Fundamental" and "Enhancing" characteristics.

(a) Fundamental qualitative characteristics – are strong attributes or qualities which make financial information useful. They consist of:
    (i) Relevant; and
    (ii) Faithfull representation

(b) Enhancing qualitative characteristics – are qualitative characteristics which enhance the usefulness of information that is relevant and faithfully represented. They consist of:
    (i) Comparability
    (ii) Verifiability
    (iii) Timeliness; and
    (iv) Understandability

Thus, for financial information to be useful, it has to be relevant and faithfully represent what it ought to represent. All enhancing qualitative characteristics together cannot make financial information useful if that information is irrelevant or not faithfully represented.

Relevant

The conceptual framework stipulates that the information provided in financial statements must be relevant to the decision-making needs of users. Information has the quality of relevance when it is capable of influencing the economic decisions of users by helping them evaluate past, present or future events or confirming or correcting, their past evaluations. Thus, relevant information must predictive and confirmatory values.

Materiality effects the relevant of financial information

Financial information is material if its omission or misstatement could influence decisions that users make on the basis of the financial statements on the reporting entity. Materiality is an entity – specific aspect of relevance based on the nature, size or both of the items to which the information relates in the context of each individual entity's financial statements.

Faithful representation
Financial statements represent a depiction in words and numbers of the economic resources, claims against the reporting entity and the effects of transactions and other events and conditions that change those resources and claims. That is, they represent economic phenomena in depicted in words and numbers.

For financial information to be useful, it must not only represent relevant phenomena but must also faithfully represent the phenomena that it purports to represent. A perfectly faithful representation would have the following attributes;

a) Compete – all the information necessary for users to fully understand and make decision on the phenomena are included.
b) Neutral – the preparation of the financial statements is without bias in the selection and presentation of financial information,
c) errors free – there should be no errors or omissions in the description of the phenomena and in the process of production of the financial statements.

Enhancing qualitative characteristics
This qualitative characteristic helps users to identify and understand the similarities in and the difference among items disclosed in financial statements. The financial information of a reporting entity will be more useful if it can be compared with similar information about other entities in the same industry and or with similar information about the same entity but for different periods or years.

Consistency enhances comparability as it encourages the use f the same methods treatments for similar items over a period of time.

Verifiability
This qualitative characteristic assists users to confirm that financial information fatefully represents the phenomena it purports to represent. Verifiability here implies that different knowledgeable and independent parties could confirm on their own that a particular item, transaction or event is faithfully represented. The verifiability or a financial information may require more than a sign point estimate.

Timeliness
The usefulness of financial information is enhanced if it is timely. That is, making information available to decision-makers in time is capable of influencing their decisions.

Understandability
The information contained in financial statement should be classified and presented in a clear and concise manner so as to make it comprehensible by users who have reasonable knowledge of business and economic activities. However, no relevant information should be omitted on the grounds that it may be very difficult for users to understand.

2.4.6 Components of financial statements
Before the adoption of IFRS in Nigeria in 2012, the preparation of entities financial statements were guided by the companies and Allied Matters Act 2004 and existing local

and international accounting standards. The component of financial statements under that jurisdiction were:

1. Profit and loss account
2. Balance sheet
3. Cash flow statement
4. Value Added Statement
5. Statement of accounting policies
6. Notes to the accounts

With the adoption of IFRS as the financial reporting standards in Nigeria, entities financial statements are now required to comply with the provisions and requirements of applicable IFRSs. A complete set of IFRS financial statements consists of the following components:

a) Statement of profit or loss and other comprehensive income
b) Statement of changes in equity
c) Statement of financial position'
d) Statement of cash flows
e) Notes to the financial statements, comprising a summary of significant accounting policies and other explanatory information

a. <u>Statement of profit or loss and other comprehensive income</u>

This statement presents the financial performance on an entity for a reporting period. It is the IFRS statement which replace the old trading, profit and loss account. In this statement items of income and expenses are classified and present either by nature or by function (cost of sales method) and will require disclosure either in the face of the statement or the notes.

The statement sometimes is prepared in two spate sections as:

i) Statement of profit or loss
ii) Statement of other comprehensive income

b. <u>Statement of changes in equity</u>

This statement is introduced as a new component of an entity's financial statements under IFRS. It replaced the appropriation section of the trading, profit and loss accounts.

The statement shows an entity's profit or loss for a reporting period, items of income and expenses recognised in other comprehensive income for the period, the effects of changes in accounting policies and corrections of errors recognised in the period, and the amounts of investments by, and dividends and other distributions to, entity investors during the period. In summary, it shows the movement in the equity section of the statement of financial position.

c. Statement of financial position

The statement of financial position is the IFRS name for balance sheet. It shows the assets, liabilities and equity of an entity at the end of a reporting period or year. The assets and liabilities are sub-classified into non-current and current in the statement.

d. Statement of cash flows

The statement of cash flow gives information about the changes in cash and cash equivalents of an entity for a reporting period. In the statement, cash flows and outflows are classified according to activities which are operating, investing and financial activities. The statement attempts to reconcile the opening balance of cash and cash equivalents to its closing balance. Cash equivalents are short-term highly liquid investments held to meet short-term cash commitments rather than for investments or other purposes.

e. Notes to the financial statements

Accounting statements permits information to presented either in the face of financial statements or in the notes. The notes may contain significant accounting policies and other explanatory information. Financial statements are better understood when taken together with the accompanying notes.

2.4.7 The elements of financial statements

The elements of financial statements are contained in the statement of financial position and statement of profit or loss and other comprehensive income. The elements are: assets, liabilities and equity for reporting of statement of financial position and income and expenses for statement of profit or loss. These elements are defined in the conceptual framework as follows:

i. Assets

An asset is a present resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity. Something valuable which a business entity owns and can use is an asset. Many assets have a physical form, but this is not an essential requirement for the existence of an asset.

Assets are classified into two main categories as non-current and current assets. Examples of non-current assets include: factories, office building, plant and machinery, motor van, office furniture, computer equipments etc. Current assets includes, inventories, trade and other receivables, cash and bank balances, prepayment etc.

ii. Liabilities

A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. Like assets, liabilities are classified into non-current and current liabilities. Noncurrent liabilities are those obligation due for settlement within period which is more than twelve (12) months after the reporting year end.

Example include long term loans/borrowing, loan notes etc. Current liabilities on the other hand are liabilities die or expected to be settled within an entity's normal operating cycle or within twelve (12) months after the reporting year end. Examples of current liabilities include: trade and other payables, bank overdrafts, accrued expenses, etc. Some liabilities which can be measured only with a substantial amount of estimation are often referred to as provisions.

iii. Equity

Equity is the residual interest in an entity after the value of all its recognised liabilities has been deducted from the value of all its recognised assets. It represents the net assets of the entity value at the carrying amount.

Entity should be sub-classified to show its components in the statement of financial position of corporate entities, such as equity share capital, share premium, retained earnings and other reserves.

iv. Income

Financial performance is measured as the relationship of the income and expenses of an entity during a reporting year, the final result being a profit or loss. Income is defined to include both revenue and gains.

- Revenue is income which arising in the course of the ordinary activities of the entity. It includes sales revenue, royalties income, rental income, fee income, interest and dividend income from investments.

- Gains are other items which can be defined as income but are not revenue. Examples include gains on the disposal or on revaluation of non-current assets.

v. Expenses

The definition of expenses includes losses and other business expenses arising in the normal course of an entity's ordinary activities.

- Expenses are outflows of economic resources of an entity arising in the normal course of business activities, such as the cost of sales, wages, rent, electricity, office expenses, depreciation of non-current assets and other operating expenses.

- Losses are other items which meet the definition of expenses but may or may not arise in the normal course of business activities. Examples include trading losses, loss on the disposal of a non-current assets, losses arising from damages of assets due to fire and flooring disaster.

Recognition of Elements of Financial Statements

For IFRS, recognition is the process of incorporating in the financial statement an item that meets the definition of an asset, liability, income or expense and satisfies the underlisted criteria:

1) It must be probable that the future economic benefits associated with the item will flow to or from the entity, and
2) The item has a cost or value that can be measured reliably.

Probability of future economic benefit flowing in or out

The concept of probability mentioned in the first criterion relates to the degree of certainty or uncertainty that the future economic benefits associated with the item will flow into or out of the entity. The assessments of the degree of certainty or uncertainty should be based on the evidence available at the time the financial statements are prepared. Assessments should made individually for each of the items.

This trade receivables with high degree of certainty of collections would be treated as assets in the statement of financial position while those with high degree of failure of collection should be expended as bad debts in the statement of profit or loss and other comprehensive income.

Reliability of measurement

The reliability criterion requires that only items whose cost or value can be measured with reliability should be recognised in the financial statements. Sometime, the cost or value of an item may not be known and therefore, will need to be estimated. The use of reasonable estimates is an essential part of preparing financial statements and provided the estimates are reasonably, they are appropriate for recognising items in the financial statements. When it is not possible to make a reasonable estimate, the item should not be recognised either in the state of financial position or in the statement of profit or loss and other comprehensive income. Items which fail recognition at certain point in time, may be recognised in future period when the cost or value can be reasonably measured

Recognition of assets

An assets is recognised in the statement of financial position of an entity when there is high degree of certainty that the future economic benefits will flow to the entity and the asset has a cost or value which can be reliably measured. An asset is not recognised in the statement of financial position when expenditure has been incurred but it is unlikely that any future economic benefits will flow to the entity. In this case, the item should be recognised as an expense in statement of profit or loss.

Recognition of liabilities

An entity should recognise a liability in the statement of financial position when is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount of the obligation can be reliably measured.

<u>Recognition of Income</u>
Income is recognised in the statement of profit or loss of an entity when an increase in future economic benefit is as a result of an increase in an asset or a reduction in a liability and this can be reliably measured.

<u>Recognition of Expenses</u>
An entity should recognise expenses in the statement of profit or loss when a decrease in future economic benefit is as a result of a decrease in an asset or an increase in a liability which can be reliably measured.

<u>Measurement of Element of financial Statements</u>
Measurement as described in IFRS is the process of determining the monetary amounts at which an entity measures assets, liabilities, income and expense in its financial statements. The IASB conceptual Framework described several measurement bases used for measuring elements of financial statements. The bases are:

a) **Historical cost** – entities measure assets at the amount of cash paid or at the fair value of the consideration given to buy them while liabilities are measured at the amount of cash that will be paid or spent to satisfy the liability.

b) **Current cost or current value** – here assets and liabilities are measured at their current values. That is, assets are measured at the amount that would be paid to purchase the same or a similar asset at current time. Also liabilities are measured at the amount which would be required to settle such liabilities at the current time.

c) **Realisable value** – this measurement basis is very relevant when an entity is no longer or going concern or is undergoing a liquidation. An entity's assets are measured at the amount that could be obtained by selling them in the open market. Liabilities are measured at the amount that would be required to settle them at the prevailing time.

d) **Present value** – this basis of measures reckons that the assets of an entity can be measured at the discounted value of the future net cash inflows which the asset is expected to generate.

Also the entity's liabilities may be measured at the discounted present value of the expected cash out flows that will be made to settle those liabilities.

The most commonly used basis of measurement in practice is the historical basis

2.5 Presentation of financial statements – IAS1

IAS1 on presentation of financial statement should be applied when entities are preparing Financial statements for publication. In view of this the standard prescribe provisions that should be followed when preparing published general purpose financial statements The objectives general purpose financial statements is to provide information on financial position, financial performance, cash flows to the various users of the financial statements when taking business decisions.

2.5.1 A complete set of general purpose financial statements

A complete set of general purpose financial statement according to IAS1 is made up of the Following:

(a) Statement of Financial Position at the end of the period
(b) Statement of Profit or loss and Other Comprehensive Income for the period
(c) Statement of Changes in Equity for the period
(d) Statement of Cashflows
(e) Notes to the Financial statements including summary of Significant Accounting Policies and Other explanatory notes
(f) A Statement Financial Position at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively.

2.5.2 Additional requirements of ias1 on presentation of financial statements

a. IAS1 require fair presentation of the financial position, financial performance and cash flow of an entity.
b. If an entity has complied with IFRS in the presentation of its financial statement, it should state it explicitly.
c. The going concern basis must not be used when management is of the view that the entity would cease trade.
d. The accrual basis must be applied in preparing financial statement except in the case of statement of cash flows.
e. Each class of item that is material must be presented separately
f. An entity is required to present comparative information in respect of previous periods
g. When there are changes in the presentation and classification of items in the financial statements, the entity shall reclassify comparative amount.
h. An entity is required to present a complete set of financial statements at least once a year.
i. The line items that are required to be presented on the face of the statements of financial position are assets, liabilities, equity, and asset and liabilities held for sale.
j. Each component of the financial statements must be properly identified with the following information displayed prominently
   - Name of the reporting entity
   - Date of the end of the reporting entity or the period covered by the financial statements (whichever is appropriate)
   - Currency of figures reported e.g whether in naira or cedis
   - Level of rounding up of the figures used in the financial statements e.g. N'000 or N'm.

2.5.3 Contents of financial statements

IAS 1, prescribed the structure and contents of the following financial statements:

(i) statement of financial position current and non- current assets

Current and non –current assets should normally be disclosed separately on the face of statement of financial position. Current assets are deemed to be assets that can easily be realised within 12 months from the year end of the financial statement, IAS 1 further states that an asset should be classified as current if it satisfies the following criteria:

- The asset is held for trading purpose
- The entity expects to realise the assets, or sell the assets or consume it in the normal operating business cycle
- The entity expects to realise the assets within 12 months after the reporting period
- It is cash or cash equivalent unless the assets is restricted from being used for at least 12 months after the reporting date of the entity.

  Examples of current assets include cash and bank balances, trade receivables, inventories etc.

Non- current assets include property plant and equipment which would be discussed under IAS 16. They are assets with the following characteristics:

- They are expected to be used for more than one year or 12 months period
- They are held for use in the production or supply of goods or services or for administrative purpose.

Examples of non- current assets include, plant and machinery, motor vehicles investments, intangible assets etc

Current and non- current liabilities

IAS 1 also states that **current and non- current liabilities** should be disclosed separately on the face of the statements of financial position

An item should be classified as current liability if it satisfy any of the following criteria:

- It is due to be settled within 12 months after the end of the reporting period of an entity.
- The entity expects to settle the liability in its normal business operating cycle.
- The liability is held primarily for the purpose of trading. This means that all trade payables are current liabilities even when they are settled after more than 12 months.
- The entity does not have the unconditional right to defer settlement of the liability for at least 12 months after the end of the reporting period.

Example of current liabilities include trade and other payables, short term borrowings (overdraft), current portion of long term borrowings, accruals etc.

All other liabilities that do not meet the above criteria should be classified as **non-current liabilities.**

Examples of non- current liabilities are long - term borrowings, loan notes, etc.

2.5.4 Information to be presented on the face of statement of financial position

IAS 1 states the items which as a minimum must be disclosed as a line item on face of the statement of financial position. This includes the following:

ASSETS:
Property plant and equipment
Investment property
Intangible assets
Long term financial assets
Other investments
Biological assets
Inventories
Trade other receivables
Cash and cash equivalents
Total assets classified as held for sale

LIABILITIES
Trade and other payables
Provisions
Financial liabilities
Current income tax
Deferred tax liabilities
Long term liabilities

EQUITY
Issued share capital
Retained earnings attributable to owners

Tutorials:
Information disclosed on the face of the statement of financial position could be sub divided to give more details and better sub classification. While other information that can be disclosed on the face of the statement should be shown in note forms to the financial statements.

Find below a typical statement of financial position presented in accordance with the requirements of IAS 1.

STATEMENT OF FINANCIAL POSITION FORMAT

ASSETS	N	N
NON-CURRENT ASSETS		
Property plant and equipment	X	
Intangible assets	X	
Financial assets	X	
Investment	X	
Total non- current assets	------	X
CURRENT ASSETS		
Inventories	X	
Trade receivables	X	
Other current assets	X	
Cash and cash equivalent	X	
Total current assets	-------	X
Total assets		XX
EQUITY AND LIABILITIES		
EQUITY		
Share capital	X	
Share premium	X	
Retained earnings	X	
Other components of equity	X	
Total equity		X
NON-CURRENT LIABILITIES		
Loan notes	X	
Long-term borrowings	X	
Deferred tax	X	
Total non- current liabilities		X
CURRENT LIABILITIES		
Trade and other payables	X	
Short term borrowings	X	
Current portion of long term borrowings	X	

Current tax payable	X	
Provisions	X	
Total current liabilities		X
TOTAL EQUITY AND LIABILITIES		XX

2.5.5 Presentation of statement of profit or loss and other comprehensive income

IAS 1 Stipulates that statement of profit or loss can be prepared using the following methods:

- Single statement method : that is where the profit or loss part in merged with the other comprehensive income section
- Two statement method: where the profit or loss part is prepared as a separate part and the other comprehensive income part is also prepared separately

The statement of profit or loss part is made up of income and expenses which would finally result in a profit or loss for the year while other comprehensive income part list other gains or losses that arisen in the period.

Content of statement of profit or loss

The statement of profit normally begin with revenue and ends with profit or loss for the year.

The expenses are deducted from revenue and other income to arrive at the profit or loss for the year. IAS1, however permits the classification of expenses in the statement of profit or loss using **two** methods:

1. **Analysis of expenses by functions**: when expenses are analysed according to their function, the functions are usually
   - Cost of sales
   - Distribution cost
   - Administrative expenses
   - Other expenses

   These methods of classifying expenses is more common with most entities

2. **Analysis of expenses by their nature:** when expenses are analysed according to their nature the categories of expenses will vary according to the nature of the business. for example for manufacturing business expenses will be classified as follows:
   - Raw materials and consumables used
   - Staff/ personnel cost
   - Depreciation
   - Other expenses

Information to be presented on the face of the statement of profit or loss and other comprehensive income

IAS 1 Require as a minimum that the following information should be disclosed on the face of the statement of profit or loss and other comprehensive income during each financial period:

- Revenue
- Finance cost (e.g. interest expense)
- Tax expense
- Profit or loss for the year
- Other comprehensive income
- Total comprehensive income.

Readers should note that additional line times can still be disclosed on the statement provided that they are relevant to better understanding of the entities financial performance.

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME FORMAT (using single format and analysis of expenses by functions)

Statement of profit or loss and other comprehensive income

	₦	₦
Revenue	X	
Cost of sales	(X)	
Gross profit		X
Other income		X
Administrative expenses	(X)	
Distribution cost	(X)	
Finance costs	(X)	
Other expenses	(X)	
Total expense		(X)
Profit before tax		X
Taxation		(X)
Profit for the year		XX
OTHER COMPREHENSIVE INCOME		
Gains on property revaluation		X

Other comprehensive income		XX
TOTAL COMPREHENSIVE INCOME		XXX

2.5.6 Statement of changes in equity

IAS 1 states that a set of financial statement must include statement of changes in equity. A statement of changes in equity shows the components of equity at the beginning of the period, changes during the period, and its amount at the end of the period.

Contents of statements of changes in equity

Share capital
Share premium
Retained earnings
Revaluation reserve
Prior period adjustments.
Other gains and losses.

For each of the items above the statements of changes in equity would show changes resulting from profit or loss, each item of other comprehensive income (gains or losses) and transaction with owners of business.

Transaction with owners of business may arise through the following:

- Issue of new share capital
- Payment of dividend

STATEMENT OF CHANGES IN EQUITY FORMAT

	SHARE CAPITAL	REVALUATION RESERVE	RETAINED EARNINGS	TOTAL
	N	N	N	N
Opening balance	X	X	X	XX
Profit or loss			X	XX
Other comprehensive income		X		XX
TRANSACTION WITH OWNER OF BUSINESS:				
Increase in share Capital	X			XX
Payment of Dividend			(X)	(XX)
CLOSING BAL,	X	X	X	XXX

2.5.7 Notes to the financial statements

IAS 1. Also indicates that information that cannot be disclosed on the face of the financial statements should be disclosed by way of notes to the financial statements. Similarly information that are on the face of the financial statement of the financial statement should be further explained in the notes.

The following explanatory notes should be disclosed in the notes to the financial statements:

- Basis of preparation of the financial statements.
- Significant accounting policies adopted in the preparation and presentation of the financial statements.
- Information required to be disclosed specifically by IFRS/ IAS e.g that the financial statement complied with provision of IFRS.
- Supporting/ detailed information for significant items presented on the face of each of the financial statements.
- Key measurement assumptions made in preparing and presentation of the financial statements.
- Dividend proposed or declared during the year.

- Other disclosures such as description of the nature of the entity's operations and its principal activities, the domicile and legal for of the entity.

Illustration 2.1
BUTAINE Nig limited extracted the following trial balance from its ledgers as 31 December 2021.

	DEBIT(N'000)	**CREDIT(N'000)**
Cash at bank	25,000	
Inventory at 1jan. 2021	600,000	
Administrative expenses	551,500	
Distribution cost	162,500	
Non-current assets at cost:		
Building	2,500,000	
Plant and equipment	350,000	
Motor vehicles	80,000	
Suspense		375,000
Accumulated depreciation		
Buildings		1,000,000

Plant and machinery		120,000
Motor vehicles		30,000
Retained earnings		140,000
Trade receivables	219,000	
Purchases	1,050,000	
Dividend paid	50,000	
Revenue		2,938,000
Tax payable		347,500
Trade payables		262,500
Share premium		125,000
Ordinary share at N1 each		250,000
	5,588,000	5,588,000

The following additional information is relevant:

(i) Inventory as at 31 December 2021 was valued at N400,000000. While carrying out the inventory taking exercise, an error in the previous year inventory count was discovered. The inventory brought forward at beginning of the year has been N550m and not N600m as above.

(ii) No dividend is being proposed

(iii) 250 million ordinary shares were issued at N1.50 on 1 December 2016. The proceeds have been left in suspense account.

(iv) Income tax for the year is N162,500,000.

You are required to prepare:

(a) Statement of profit or loss and other comprehensive income for the year ended 31 December 2021

(b) Statement of changes in equity for the year ended 31 December 2021.

(c) Statement of financial position as at that date

Note: your solution must be in line with the provisions of IAS 1.

Solution to illustration 5.1

(a) BUTAINE Nig limited statement of profit or loss and other comprehensive income for the year ended 31 December 2021

	N'000	N'000
Revenue		2,938,000
Cost of sales		**(w1)** (1,250,000)
Gross profit		1,688,000
EXPENSES:		
Administrative expenses	551,5000	
Distribution expenses	162,500	
Total expenses		(714,000)
Net profit before tax		974,000
Income tax		(162,500)
Net profit for the year		811,500
OTHER COMPREHENSIVE INCOME:		
Other comprehensive income		Nil
TOTAL COMPREHENSIVE INCOME		811,500.

WORKINGS:

(W1) COST OF SALES:

	₦'000
Opening inventory	600,000
Purchases Less:	1,050,000
Closing inventory	(400,000)
Cost of sales	1,250,000

(b) **Statement of changes in equity for the year ended 31 December 2021.**

	Share capital	Share Premium	Retained earnings	Total
	N'000	N'000	N'000	N'000
Bal. at I Jan. 2021	250,000	125,000	140,000	515,000
Prior period adjustment	----------	-----------	(W2) (50,000)	(50,000)
Restated balance 1 Jan. 2021	250,000	125,000	90,000	465,000
Profit for the year	-	-	811,500	811,500

Dividend paid	-	-	(50,000)	(50,000)
Share issued	250,000	(w3) 125,000	-----------	375,000
Bal. 31 Dec. 2016	500,000	250,000	851,500	1,601,500

WORKINGS:

(W2) INVENTORY ADJUSTMENTS

Wrong balance b/d N600m - N550m

= N50m

(W3) SHARE PREMIUM

N250m x 1.5 = N375m

Hence share premium = N375m – N250m = N125m

(C). Butaine Nigeria limited statement of financial position as at 31 December 2021.

	₦'000	₦'000
NON CURRENT ASSETS		
Buildings	2,500,000	
Accm depreciation	(1,000,000)	
Carrying amount	--------------	1,500,000
Plant and machinery	350,000	
Accm depreciation	(120,000)	
Carrying amount		230,000
Motor vehicle	80,000	
Accm depreciation	(30,000)	
Carrying amount	------------	50,000
TOTAL NON- CURRENT ASSETS		1,780,000
CURRENT ASSETS		
Inventories(400- 50)	350,000	
Trade receivables	219,000	
Cash at bank	25,000	
Total current assets	-------------	594,000
TOTAL ASSETS		**2,374,000**
EQUITY AND LIABILITIES		
Share capital		500,000
Share premium		250,000
Retained earnings		851,500
Equity		1,601,500
CURRENT LIABILITIES		
Tax payable(347500+162500)	510,000	
Trade payables	262,500	
Total current liabilities		772,500
EQUITY AND LIABILITIES		**2,374,000.**

2.6 Inventories IAS2

IAS 2 prescribes the basis for determining and accounting for inventories as an asset until the related revenues are recognized. Inventories are described as assets that are held for sale in the ordinary course or consumed in the production process or in rendering of services. Examples are finished goods, raw materials and work-in-progress and stores, spare parts and consumables.

2.6.1 Basis of valuation

Inventories are required to be valued at lower of cost and net realizable value.

(a) Cost includes the purchase cost and all other costs incurred in bringing the inventories to their present location and condition such as import duties, transport and handling charges.

(b) Cost of finished goods will also include the cost of converting (conversion cost) the raw materials to finished goods. Conversion costs include the cost of direct labour and systematic allocation of overhead cost.

(c) Inventory cost do not include:

- (i) General and administration cost, selling and distribution cost, abnormal cost and storage cost that are not related to production.
- (ii) Interest and other borrowing costs
- (iii) Foreign exchange fluctuation on inventories purchased with foreign currency
- (iv) The difference between the cost of purchase and the normal credit terms.

2.6.2 <u>COST MEASUREMENT</u>

a. Cost is measured using either the specific identification method, the first-in-first-out method and the weighted average cost method.

b. Specific identification is used when the inventories are not interchangeable and are segregated for specific project.

c. In all other cases an entity can use either the FIFO or weighted average method to measure cost of inventories

(i) FIFO Method

The FIFO method assumes that inventories purchased or produced first are sold first such that remaining inventories are those that have been most recently purchased or produced.

(ii) Weighted Average Method

The cost of each item is determined from the weighted average of the cost of similar items existing at the beginning of a period and the cost of those items purchased or produced during the period.

(iii) Net Realisable Value

Net realizable value (NRV) refers to estimated selling price in the ordinary course of business, less the estimated cost to completion and estimated that are necessary to achieve sale. The estimation of the NRV should be made at the statement of financial position date.

(iv) Measurement of Net Realisable Value

The Net Realisable Value of the materials and other supplies held for use in production of finished goods is less than the cost of the finished product in which the raw materials are used is sold at less than the cost. When the NRV is lower than the cost, the difference should be recognized as expense in the statement of profit or loss.

2.6.3 Disclosure requirements for inventories under IAS2

a. The accounting policies that are adopted for measuring inventories including the cost measurement employed.
b. The total carrying amount of inventories along with their appropriate classification e.g finished goods, work in progress raw materials e.t.c
c. The amount of inventory recognized as expense during the period
d. The amount of write-down recognized as expense during the period
e. The amount of any reversal of any previous write-down of inventory
f. The carrying amount of inventories pledged as security for liabilities

2.6.4 Methods of recording inventories

There are two methods of recording inventories. These are:

- Periodic inventory method
- Perpetual inventory system.

2.6.5 Periodic inventory method

This is system is based on the use of ledger accounts:
Purchase account which is used to record all purchases during the year;
Inventory account which is used to record the value of inventory at the beginning /end of the financial year.

It should be noted that in a periodic inventory system, the double entry applied are between the inventory account and statement of profit or loss. i.e the cost of the opening inventory is included in the cost of sales. This is because it is an expense and an expense is a debit entry. It debited to the statement of profit or loss (and credited to the inventory account) with cost of the opening inventory

One the other hand the cost of the closing inventory is included in the statements of financial position as an asset, so there must be a debit balance of the closing inventory. i.e debit inventory account (and credit statement of profit or loss) with the valuation of the closing inventory.

Closing inventory double entry is :

	DR	CR
INVENTORY (Statement of financial position)	X	
COST OF SALES (statement of profit or loss)		X

2.6.6. PERPETUAL INVENTORY METHOD

Under the perpetual inventory method a single account is used to record inventory movements. The account is used to record purchases in the period and the inventory is brought down on the account at the end of each year. The account is also used to record all issues out of the inventory and this constitute the cost of sale

When a perpetual inventory method is used, a record is kept of all receipt of items into the inventory (at cost) and all issue of inventory to cost of sales. Usually a bin card is maintain manually for this record.

Under this method it means that the purchase account becomes unnecessary because all purchase are recorded in the inventory account. Therefore all transactions involving receipts 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.

ILLUSTRATION 2.2

(a) The accounting policies of MAMA LTD state that inventories are valued at lower of cost and net realisable value. The company engages a perpetual method for recording its inventories. A recent inventory taking exercise establishes that the amount of inventory currently held at cost are as follows

TYPE OF INVENTORY	COST	SALES PRICE	SELLING EXPENSES
	₦	₦	₦
Inventory AA	200,000	195,000	12,500
Inventory XY	350,000	450,000	5,000
Inventory JO	400,000	425,000	5,000
Inventory BA	150,000	1,875,000	3750

Required:

Determine the value of the inventory that will be included in the statement of financial position of MAMA Ltd at the end of the year.

(b) On I Jan. 2021 MAMA Ltd. had an opening balance of inventory of 200 units which cost N50 each.
During the month the company made the following purchase 2 Jan. 600 units at N60 each 15 Jan. 1000 units at N70 each.

During the month it sold 1,200 units as follows:
5 Jan, 400 units
17 Jan. 400 units
26 Jan. 400 units

You are required to calculate the value of the closing inventory using FIFO method at end of the month of January.

SOLUTION TO ILLUSTRATION 5.2

(a)	**INVENTORIES**	**LOWER OF:**	**₦**
	AA	200,000 OR(195,000-12,500)	182,500
	XX	350,000 OR(450,000-5,000)	350,000
	JO	400,000 OR (425,000-5,000)	400,000
	BA	150,000 0R (187,500- 3750)	150,000
INVENTORY VALUE			1,082,500

(b) VALUE OF INVENTORY USING FIFO AT END OF JANUARY

RECEIPT				ISSUE			BALANCE		
Date.	Qty.	pr.	₦	Qty.	pr.	N	Qty.	pr.	₦
1 Jan.	200	50	10,000				200	50	10,000
2 Jan.	600.	60	36,000				800	50/60	46,000
5 Jan.				200	50	10,000			
				200	60	12,000	400	60	24,000
15 Jan.	1,000	70	70,000				1,400	60/70	94,000
17 Jan.				400	60	24,000	1,000	70	70,000
26 Jan.				400	70	28,000	600	70	42,000

2.7 Statement of cash flows

IAS 1 States that a complete set of financial statements should include a STATEMENT OF CASH FLOWS. While IAS 7 which is on cash flows set out detailed requirements for the format and content of the statement. A statement of cash flows provides information about where the business obtain its cash during the financial period and how it made use of the cash.

A statement of cashflows categories in flows and out flows of cash, under three main headings namely:

- Cash flows from operating activities
- Cash used in or obtained from investing activities
- Cash paid or received in financing activities.

Statement of cash flows can be prepared using two methods, these are:

- Indirect method
- Direct method

The details relating to preparation and presentation of statement of cash flows in accordance with IAS 7 provisions are dealt with in detail in other chapter.

2.8 Accounting policies, changes in accounting estimates and errors –IAS 8

2.8.1 Introduction

(a) IAS8 deals with the selection and changes in policies and disclosure thereof

(b) It also sets out the requirements and disclosure for changes in accounting estimates and correction of errors.

The objectives of the standard are:

(i) To enhance relevance and reliability of financial statements.

(ii) To ensure comparability of the financial statements of an entity over time as well as with financial statements of other entities.

2.8.2 Selection of accounting policies

An entity is required to apply the standard that applies to a transaction, item or event. If no standards exist presently for the item management shall develop and apply a policy that is reliable and relevant to the decision making needs of the user. The policy shall be considered reliable if it:

(a) Represents faithfully the financial position, the performance and cash flows

(b) Reflects the economic substance of transactions, other events and conditions

(c) Is neutral

(d) Is prudent

(e) Is complete in all material respects

In applying the judgments, management is required to consider two things in order of importance.

(i) The requirements and guidance in the standards and interpretation dealing with similar and related losses.

(ii) The definition and recognition criteria and measurement concept of assets, liabilities, income and expenses in the framework of the IASB.

The entity may also consider the most recent pronouncement of other similar standards, accounting literature and accepted industry performance.

2.8.3 Consistency of accounting policies

Entities are required to apply the accounting policies selected consistently for similar transactions, events and conditions.

If a standard permits categorization of items, an accounting policy shall be selected and used consistently.

Once an accounting policy is selected it may be changed only if the change is required by the standard or it results in providing more reliable or relevant information in the financial statements.

2.8.4 Changes in accounting policy

An example of changes in accounting policy is when an entity changes its method of inventory valuation. When an entity changes an accounting policy voluntarily it must account for it retrospectively (i.e as if the policy has always been applied) unless there is a transitional provision when the policy shall be applied according to the provision.

The impact of the new policy on the retained earnings prior to the earliest period should be adjusted against the opening balance of retained earnings.

If it is impracticable to determine the effects of the change, the entity shall apply the change prospectively from the start of the earliest period. The change and the reason for the change must be disclosed.

Items that are not considered as changes in accounting policies

(1) The application of an accounting policy for transactions, other events or conditions which substance differ in form from those that occur previously.

(2) The application of new accounting policy for the transactions, other events or condition that did not occur previously or immaterial.

Disclosure of accounting policies

a) If the change in accounting policy is due to the initial application of standard, the entity must disclose the change when it has an effect on current and prior periods or it would have an effect in future periods. If it is impracticable to determine the impact, the entity must disclose the title of the standard and the nature of the change.

b) When the change is voluntary and the entity would be unable to determine the future or past impact, the entity shall also disclose the nature of the change and the reason for the new policy providing reliable and more relevant information.

CHANGES IN ACCOUNTING ESTIMATES

Accounting estimates may change as a result of business environment. Such change in estimate does not require restating the financial statements of a prior period, because they do not amount to correction of errors.

Examples are:

a) Estimating allowances for doubtful debts
b) inventory obsolescence
c) Estimating the useful lives of PPE
d) Determining the fair values of financial assets and financial liabilities
e) Estimating the amount of warranty obligations

The effect of a change in accounting estimate shall be recognized prospectively by including it in the profit or loss in the period of the change only or if it affects future periods in both the period and future periods.

The effect of the change (if any) on assets, liability and equity shall be adjusted on their carrying amount in the period of change.

Disclosure of accounting estimates

The active and financial effect of the change in accounting estimate of current and future periods.

Errors

When the financial statements contain errors that are material, the entity shall correct errors retrospectively in the financial statements authorized for issue when the error is discovered.

(a) The entity shall restate the comparative amounts for the period(s) presented for which the error occurred.
(b) If the error occurred before earliest period presented, the entity shall restate the opening balances of assets, liabilities and equity of the earliest period presented.

Disclosure requirement of prior period errors

(i) The nature of the error
(ii) The amount of the error and the line item affected in a financial statement
(iii) Basic and diluted earnings per share
(iv) The amount of the correction at the beginning of the earliest period presented

Illustration 2.3

The financial Accountant of BOURNVILLA Ltd encountered the following during the process of preparing the financial statement of the company.

(i) In preparing the financial statement for year 31 December 2014 the Accountant discovers an error affecting the 31 December 2013 financial statement.
(ii) During the year 31 December 2015 the company changes its accounting policies

Required:

State how the Accountant should treat the situation above while complying with the provisions of IAS 8 on Accounting policies, changes in accounting estimates and correction of errors.

Solution to illustration 2.3

(i) The error should be corrected in the 31 December 2014 financial statement by restating the comparative figures for 31 December 2013 at their correct amount.

(ii) Since there is a change in accounting policy the company must also present a statement of financial position as 1 January 2014 the beginning of the earliest comparative period.

This means that the change should be applied to the balance as at 1 January 2014 as if the new policy had always been applied.

2.9 Property, plant and equipment- IAS 16

2.9.1 Introduction

IAS16 sets out the requirements for the recognition and measurement of property, plant and equipment (PPE) and prescribes the disclosure requirements.

Characteristics of Property, Plant and Equipment (PPE)

Property, plant and equipment are tangible items that are held for use in the production or supply of goods or services or for rentals to others, or for administrative purposes and are expected to be used for more than one period:

a. They are non-current assets
b. They have useful life of more than one year
c. They are used for production of goods or services or for rental
d. Benefits from its use flow to the organization
e. The entity has control over the use of the asset.

2.9.2 Recognition of property, plant and equipment

Two criteria are used to determine the recognition of Property, plant and Equipment

(a) It is probable that the future economic benefit associated with the item will flow to the entity.

(b) The cost of the item can be measured reliably.

(i) If the value of an item is insignificant individually, an entity can aggregate the value of such similar items so that they can be material and qualify for recognition (e.g. moulds and dies).

However, each unit of the items must be expensed if they cannot be aggregated with similar items

(ii) The amount of major overhaul or inspection components of an asset can be recognised as an item of PPE if the original cost can be separately identified and separately depreciated (overhaul and replacements for ships and aircraft).

2.9.3 Measurement and recognition

An item of PPE should be recognised initially at its cost.

<u>Element of Cost</u>

(a) Purchase price, including import duties and any other none refundable purchase taxes, less trade discounts and rebates granted by the supplier.

(b) Cost that are directly attributable to bringing the asset to the location and condition for its intended use.

Examples are:

(i) Cost of transportation of the asset to the site
(ii) Cost of preparing the site
(iii) Installation and assembly cost
(iv) Remuneration paid to employees who set up the asset
(v) Borrowing costs that can be capitalized (IAS23)

(c) Cost that are not directly attributable like advertising costs, promotion costs and training costs should be expensed in the period they are incurred.

(d) The same principle for measuring costs apply to both acquired and constructed assets. If the entity construct similar item for sale, the profit element should be removed.

2.9.4 Measuring of cost

a) The cost of an asset is measured at cash price at the date of acquisition

b) If payment for an item of property planning and equipments is deferred beyond normal credit items (e.g finance lease and hire purchase), the difference between the cash price and the total price is recognized as a finance cost.

c) If an asset is acquired in exchange for another asset, the asset acquired is measured at its fair value.

d) If the fair value of the asset acquired cannot be determined, the item is measured at the carrying amount of the asset given up.

Illustration 2.4

SKY POWER PLC. Purchased a sky oriented machine to be used at a project site

The following cost were incurred:	N’000
Purchase price of the machine	4,000
Delivery cost	400
Installation cost	500
Trade discount given	200
Cost of site preparation	800
Architect’s fees	60
Administration expenses	600
Test run cost	300

The test run was to ensure that the asset was installed and working correctly without causing any sky pollution items of inventories were produced during the test run. This has a value of N40,000. The Standards organization of Nigeria (SON) have granted the company a license to operate the asset on the condition that the company will remove the asset at end of the project and return the site to its former condition . The company has recognised a liability of N1,000,000 in respect of expected clearance cost.

Require:
Calculate the cost of machine in accordance with the provisions of IAS 16 on property plant and equipment.

Solution to illustration 2.4

Cost of sky power machine

	₦'000
Purchase price (4,000-200)	3,800
Delivery cost	400
Installation cost	500
Cost of site preparation	800
Architect's fees	60
Decommissioning cost	1,000
Test run cost (300- 40)	260
Cost of machine	6,820

2.9.5 Measurement after recognition
After recognition an item of property, plant and equipment should be measured using their cost model or revaluation model. Any model selected must be applied consistently.

2.9.6 Cost model
The cost model requires an asset after initial recognition, to be carried at cost less accumulated depreciation and impairment losses.

Depreciation is the systematic allocation of the depreciable amount of an asset over its expected useful life. An entity is required to apply depreciation to an item PPE on systematic basis over its expected useful life.

Depreciable value is the cost of the asset less its residual value.

Expected useful life is the period used, not the assets economic life which could be appreciably longer.
The residual value of the asset shall be deducted when considering depreciation.

Residual value is the estimated disposal costs at the end of its useful life. The depreciation charged for each period shall be recognized in the income statement.

Depreciation method: An entity is permitted a choice of depreciation method. It can use the straight line method or the reducing balance method or units of production method. The depreciation shall be reviewed annually and shall be changed to reflect the change in expected pattern of consumption in future. The change shall be accounted for as change in accounting estimates.

2.9.7 Revaluation model

(a) An item of property plant and machinery whose fair value can be measured reliably, may be carried at a revalued amount.

(b) The revaluation amount would then be subject to depreciation and impaired losses for the remaining useful life of the asset which would now represent the fair value of the asset.

(c) When an asset is revalued, the entire class of the PPE to which the asset belongs must be revalued.

(d) The increase in the carrying amount of property, plant and equipment is credited to comprehensive income statement and transferred to statement of changes in equity under revaluation surplus. If the increase in carrying amount reverses a previous decrease, then, the increase in carrying amount is recognized in income statement to the extent it offset the previous decrease.

2.9.8 Derecognition of property, plant and equipment

a. When an asset is disposed or it cannot provide any more future economic benefits, it is derecognised

b. Profit or loss on the disposal of the property, plant and equipment in the statement of profit or loss but is treated as income or loss.

c. When an item property plant and equipment are held for sales, the carrying amount is transferred to inventory. The proceed from the sale of such property, plant and equipment should be recognized in revenue.

Illustration 2.5

(a) An item of property plant and equipment which cost N750m is expected to have a useful life of five years and an expected residual value of N5m. using straight line method of depreciation. What is the annual depreciation charge? And what will be the carrying amount of the assets after four years?

(b) A non-current asset cost N100m it is depreciated using a reducing balance method at rate of 20percent each year. What is the annual depreciation charged in years 1 to 4.

(c) An office equipment which originally cost N75m with accumulated depreciation of N51m was sold for N18m and the cost of disposal was N5m.

What is the gain or loss on disposal of the office equipment?

Solution to illustration 2.5

(a) Depreciation charged for the year = $\dfrac{\text{cost of asset less residual value}}{\text{Expected useful life (years)}}$

$\dfrac{\text{₦750m less ₦5m}}{\text{5years}}$

Annual depreciation = ₦149m

Carrying amount at end of year 4. Cost of asset	₦750m Less
Accumulated Depreciation (₦149mx 4)	(₦596m)
Carrying Amount	₦154m

(b)

YEAR	COST/CARRYING AMOUNT(N'000)	ANNUAL DEPRECIATION AT 20% (N'000)	CARRYING AMOUNT (N'000)
1	100,000	20,000	80,000
2	80,000	16,000	64,000
3	64,000	12,800	51,200
4	51, 200	10,240	40,960

(c) GAIN OR LOSS ON DISPOSAL OF OFFICE EQUIPMENT

	N'm	N'm
Sales proceed on disposal		18
Less: disposal costs		(5)
		13
Less: Asset cost	75	
Accum depreciation	(51)	
Carrying amount at date of disposal		(24)
Loss on disposal		11

2.9.9 Disclosure requirements of IAS 16

IAS 16 requires the following disclosures in the note to the financial statements for each class of property plant and equipment.

(a) Measurement bases (cost or revaluation model)

(b) Depreciation methods

(c) Useful lives or depreciation rates used

(d) Gross carrying amount and accumulated depreciation at the beginning and end of the period

(e) Assets classified as held for sale

(f) Additions during the year

(g) Increase or decrease arising from revaluation and from impaired losses and reversal thereof.

(h) Assets pledged as security for liabilities

(i) Assets in the course of construction. For asset that are revalued the following need to be disclosed:

- The effective date for valuation
- Whether an independent valuer was involved
- Methods and significant assumption used in assessing the fair value
- For each class of asset revalued, the carrying amount that would have been recognized if the class had not been revalued.

- The revaluation surplus, stating the change for the period and any restriction in distribution to shareholders.

(j) A reconciliation between the opening and closing values for gross carrying amount and accumulated depreciation, showing:

- Additions during the year
- Disposal during the year
- Depreciation charged for the year
- Assets classified as held for sale in accordance with IFRS 5.
- Acquisition of assets through business combinations
- Impairment losses
- Effect of revaluation.

The following table below is an example of a simple statement of non- current assets which are normally presented in the notes to the financial statements of entities.

	Buildings	**Machine**	**Plant and Equipt**	**Total**
Cost :	Nm	N'm	N'm	N'm
At start of the Year	X	X	X	XX
Additions	X	X	X	XX
Disposal	(X)	(X)	(X)	(XX)

At end of the Year	X X	XX	XX	XX
Accumulated depreciation:				
At start of the Year	X	X	X	XX
Charged for the Year	X	X	X	XX
At year end	X	X	X	XX
Carrying amount:				
At start of the Year	X X	XX	XX	XX
At end of the previous year	XX	XX	XX	XX

Illustration 5.6

The following information were contained in the non-current assets register of Abiodun Ltd on December 31, 2020:

Cost at 31/12/2020

Freehold buildings
Motor Vehicle
Plant and equipment
Construction in progress

Accumulated Depreciation at 31/12/2020

Freehold buildings
Motor vehicles
Plant and equipment

Additional information figures in millions:

(i) During the year the company acquired a warehouse for N50,000 on April on April30,2021.

(ii) The sum of N25,000 was incurred on the construction in progress and this resulted in the resulted in the completion of a plant costing N94,000 put into use by the company on June 30,2021.

(iii) A delivery van which as purchased at a cost of N32,000 was the disposed on March 15^{th}, 2021. The carrying amount of the van on Jan. 1, 2021 was N20,600.

(iv) Freehold buildings are to be depreciated over 50years while motor vehicles and plant and equipment at the rate of 20% and 15% on cost per annum respectively. Full year depreciation is to be granted in the year of acquisition will no depreciation charge in the year of disposal.

(v)

<u>**Required:**</u>

Prepare the non-current assets schedule for the year ended December 31, 2021.

Solution to illustration 2.6

Abiodun Ltd

Non-current Assets Schedule for the year ended December 31, 2021

Particulars	**Freehold building**	**Motor vehicle**	**Plant & equipment**	**Construction in progress**	**Total**
	N'm	N'm	N'm	N'm	N'm
Cost at 31/12/2020	680,000	96,500	122,800	209,600	1,108,900
Cost of addition	50,000	------	------	25,000	75,000
Reclassification	-----	-------	94,000	(94,000)	-------
Cost of Disposal	----	(32,000)	----	----	(32,000)
Cost at 31/12/2020	730,000	64,500	216,800	140,600	1,151,900
Accumulated Depreciation 31/12/2020	54,000	38,600	55,260	------	148,260
Charge for the year	13,600	12,900	32,520	------	59,020
Accumulated Depreciation on Disposal	----	(11,400)	----	----	(11,400)
	68,000	40,100	87,780	-----	195,880
Carrying amount 31/12/2021	662,000	24,400	129,020	-----	956,020
Carrying amount 1/1/2021	625,600	57,900	125,440	209,600	1,108,900

Calculation of Depreciation

1) Freehold building = $^{N680,000}/_{50years}$ = N13,600
2) Motor vehicles = N64,500 x 20% = N12,900
3) Plant & Equipment = N216,800 = N32,520

2.10 IFRS FOR smes

The IASB also develop s and publishes a separate standards intended to apply the General purpose financial statements of and other financial reporting entities that in many countries are referred to by variety of terms, including **small and medium entities (SMEs**), private entities, non- publicly accountable entities etc. this standard is referred to as **international financial reporting standards for small and medium-sized entities (IFRS for SMEs).**

2.10.1 Description of small and medium - sized entities

Small and medium – sized entities are entities that:

(a) Do not have public accountability

(b) Publish general purposes financial statements for external users. Examples of the external users include the owner of the business and potential creditors and credit rating agencies.

(c) The objectives of the financial statement of a small and medium sized entity is to provide information about the financial position, performance and cash flows of the entity that is useful for economic decision making by board range of users who are in the position to demand reports tailored to meet their particular information needs.

2.10.2 COMPLETE SET OF FINANCIAL STATEMENT FOR smes.

A complete set of financial statement of an SMEs shall include all of the following:

- A statement of financial position as at the reporting date
- (i) a single statement of comprehensive income for the reporting period displaying all items of income and expenses recognized during the period including those items recognized in determining profit or loss and items of other comprehensive income. Or (ii) a separate statement of profit or loss and a separate statement of comprehensive income. The separate statement of comprehensive income will begin with profit or loss and displayed the items of other comprehensive income
- A statement of changes in equity for the period
- A statement of cash flows for the period
- Notes, comprising a summary of significant accounting policies and other explanatory information.

If the only changes to equity during the period for which the financial statement are presented arises from profit or loss payment of dividend, correction of prior period errors, and changes in accounting policies the entity equity may **present a single statement of income and retained earnings in place of comprehensive income and statement of changes in equity.**

Also if the entity has no item of comprehensive income in the period in which a financial statement is presented it may present only a statement of profit or loss which ends with profit for the year.

2.11 Chapter summary

The adoption of International Financial Reporting Standards (FIRS) is now universal; hence most Countries around the world are now adopting it in the preparation and presentation of Financial Statements.

The presentation and disclosure requirements in the Financial Statements in accordance with International Accounting Standards (IAS) 1,2,7,8,16 were fully discussed. Also there was brief discussion of IFRS for SMEs.

2.12 End of chapter questions

1. Which of the following is not a component of financial statements under IASI?
   (A) A statement of financial position
   (B) A statement of comprehensive income
   (C) A statement of change in equity
   (D) A statement of Affairs
   (E) A statement of Cash flows

2. Which of the following disclosure is NOT required under IASI?
   (A) A description of the entity's operation and its" principal activities
   (B) The level of rounding used in presenting the financial statements
   (C) Name of the reporting entity
   (D) Name of major shareholders of the entity
   (E) The measurement basis used in preparing financial statement

3. Which of the following NOT a qualitative characteristic of financial statement according to IASB framework?
   (A) Understability
   (B) Relevance
   (C) Reliability
   (D) Comparability
   (E) Materiality

4. Which of the following should NOT be included in cost of inventory?
   (A) Normal amount of wasted material
   (B) Administrative overhead
   (C) Purchase price
   (D) Import duties
   (E) Variable production overhead

5. Which of the following should NOT be included in the cost of an item of plant?
   (A) Cost of delivery and handling cost
   (B) Cost of site preparation
   (C) Cost of plant per suppliers invoice
   (D) Estimated discounting cost to be incurred after 5 days
   (E) Interest charges paid to supplier of plant for deferred credit.

6. Inventories are required to be valued at lower of ……………… and ……………..
7. Which of the qualitative characteristics is closely related to materiality?
8. Subsequent to its acquisition, two models are specified for measurement of an item of property plant and equipment state them.
9. Assets held for sale in the ordinary course of business are………………….
10. Depreciable amount is the cost of an asset less its…………………..

2.13 Solutions to end of chapter questions

1. D
2. D
3. E
4. B
5. E
6. Cost, net realizable value
7. Relevance
8. Cost model, revaluation model
9. Inventories
10. Residual value

CHAPTER THREE

INCOMPLETE RECORD AND SINGLE ENTRY

Chapter contents

a. Introduction

b. Accounting for incomplete records

c. Preparation of financial statements from incomplete records.

3.0 Objectives

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

a) Use accounting equations to calculate profit where only opening and closing net assets figures are available.

b) Convert single entry and incomplete records into double entry

c) Prepare financial statement from records maintained on double entry basis

d) Determine the figures for purchases and revenue from purchases control account and revenue control accounts

e) Derive expenses and revenue earned from incomplete records.

3.1 Introduction

The term single entry "is applied to any system, which does not provide for the two fold aspect of transactions; while the alternative term, incomplete records" is often applied to books of account kept on such a single entry or incomplete double entry system.

"Single entry" recognises only the personal aspect of transactions, with receivables and payables. In practice, however, a cashbook is invariably kept, but, with this exception, the impersonal aspect of transactions is usually left entirely unrecorded.

In this chapter you will learn the procedure involved in preparing the Statement of Profit or Loss and Statement of Financial Position for an enterprise that has only opening and closing net assets and perhaps capital as the only known figures. You will also understand and learn how to ascertain the proprietor's drawings and any additional capital contribution during an accounting period from scanty information provided by a cashbook summary.

Questions on incomplete records and single entry are popular for examiners because they enable them to test techniques, which are also relevant for other topics such as ledger control accounts. It also provides the basic information necessary to prepare financial statement but without the examiner presenting it in the form of a Trial Balance.

3.2 The ascertainment of profit from incomplete records

Generally speaking, profits (or losses) are ascertained, under the single entry system, by a comparison of the values of the net assets at two specified dates, after taking into account additions to, or withdrawals from, capital during the period. The difference between these two values represents the profit or loss, according to whether there is an increase or decrease in the figures.

The accounting equation states that:

Business Assets = Owner's Capital+ Business Liabilities

The equation above can be restated as:

Owner's Capital = Business Net Assets – Business Liabilities

During an accounting period, the business realised an excess of income over expenditure, the additional cash or assets generated belong to the owner(s), thus increasing the capital. The accounting equation will now become:

Opening capital +profit = opening net assets + increase in net assets.

The introduction or withdrawal of resources by the owner will also increase or decrease the owner`s capital. As a result profit can be calculated using the format below:

	¢
Closing capital	XXX
Less opening capital	XXX
Increase in net assets	XXX
Owners' Drawings	XXX
Additional Capital	(XXX)
Net profit for the year	XXX

Illustration 3.1

Calculate the net profit for the year ended December 31 2021 from the following information:

	31/12/2020	31/12/2021
	GH¢	GH¢
Property	200,000	200,000
Equipment	60,000	90,000
Trade receivables	40,000	80,000
Cash	10,000	15,000
Overdraft	60,000	90,000
Trade payables	50,000	30,000

Drawings during the year were GH¢45,000 and additional capital introduced during the year was GH¢50,000.

Solution 3.1

	31/12/2020 GH¢	31/12/2021 GH¢
Total Assets	310,000	385,000
Total Liabilities	(110,000)	(120,000)
Net Assets	**200,000**	**265,000**
		¢
Closing capital		265,000
Less opening capital		200,000
Increase in net assets		65,000
Owners' Drawings		45,000
Additional Capital		(50,000)
Net profit for the year		60,000

3.3 Preparation of detailed financial statement from incomplete records

It is understandably certain that calculating the profit of an enterprise using the method Presented above is not satisfactory. It is important for you to note that the accountant does not only prepare the final accounts of an enterprise but also communicates accounting and financial information to stakeholders. It is therefore much more informative when a Statement of Income is drawn. It is important for the accountant to convert these scanty and incomplete records into the acceptable double entry form.

For one to be able to prepare a Statement of Profit or loss and Statement of Financial Position from single entry and incomplete records, the procedures detailed below are recommended:

3.3.1 Preparation of statement of affairs

One must first construct a statement of financial position at the beginning of the accounting year. This means that the assets and liabilities of the business must be as curtained and calculated. The statement prepared to show the financial position of the business at the beginning of the year is technically called **statement of affairs**`.

In most practical situations the owner of the business will provide lists of values of non-current assets that he uses in the business together with the dates of acquisition. It should therefore be easy for one to calculate the accumulated provision for depreciation of the noncurrent assets from the date of their purchase to the date of reporting. Values of such items as inventories in trade, receivables and liabilities may have to be estimated with the help of the owner.

From the above information a journal should be opened and accounting entries with the aim of achieving the dual purpose of recording accounting transactions should be effected. This means that appropriate debit entries must be posted into assets account and credit entries entered into capital or liabilities accounts.

The difference between the assets and liabilities, which usually ends up with the assets exceeding the liabilities may be assumed to be the initial amount that the owner used in starting the business and therefore will be recorded as the capital of the business. It is possible that the owner may be able to mention the initial amount he used in commencing the business. Where this is the case then, any difference between such capital and the net assets estimated may be recorded as the balance on the Statement of profit or loss retained in the business.

3.3.2 Preparation of cash and bank summary

Ascertain the Cash position of the business. This is usually done by carefully examining any available bank statement, any pay-in-slip and the cheque counter foil. The bank statement together with the cheque counterfoil could reveal information concerning purchases, payment of rent, bank charges, wages, insurance, interest earned, the acquisition of non-current assets, and any personal withdrawals. Information extracted from the pay-in-slip and credit alert received will help determine the amount of money paid in by customers to whom goods that were sold on credit and also direct sales by cheque instead of cash. The above information may be used to prepare a cash summary or a receipt and payment account for the business.

3.3.3 Analysis of unbanked cash sales

One must at this stage determine the amount of cash sales which have not been banked by the owner, but which might have been used by the owner to pay for business expenses, cash purchases, and personal drawings. It is possible that the owner might have made use of some of the physical inventory in trade for his or her personal use. In such a situation conducting an informal interview with the owner could confirm the existence on such occurrences and so will help the book keeper make an appropriate estimate for inventory drawings. Physical inventory taking by counting of items in inventory at the close of business will give us the actual closing inventory figures and therefore may not need to be estimated.

(a) Posting from the cash and bank summary

After the analysis above have been made, one can now carry out the following postings into the ledger. Note that in step one opening entries were made through the ledger, and therefore some of these entries will be made into existing ledger accounts irrespective of how inaccurate they may be.

From the analysis of the debit side of the cash and bank summary and information obtained from the pay-in-slips:

a) All cash sales or takings should be credited to the Trade receivables account in the sales ledger;

b) Any proceeds from the sale of non-current assets should be credited to the respective asset account;

c) Any interest or income from investment must also be credited to the appropriate revenue account;

d) Any other item should be posted to the credit of the relevant account;

From the analysis of the credit side of the cash and bank summary and information obtained from the cheque counterfoils:

a) All payments for goods purchased should be debited to the trade payables account in the purchase ledger account;

b) Payment of expenses should be debited to the relevant nominal account;

c) All purchases in connection with non- current assets should be debited to the appropriate asset accounts;

d) Any charges should be posted to debit of the bank charges account;

e) Any other item should be posted to the debit of the relevant account;

Where any difference exists on the cash book summary entries should be posted to make it balance. If the difference is on the credit side then the cash book should be credited and the proprietor`s drawings account debited. If the difference is on the debit side then one can safely presume that the owner of the business has introduced additional capital. This difference should be debited to the cash and credited to the capital account of the business.

(b) Preparation of trade receivables and trade payables

At a Stage, one will have to determine year-end adjustment and balances. A schedule will have to be compiled detailing all customers who are owing the business, as a result of goods sold to them on-credit. The total of the schedule of Trade receivables therefore represent debts owed to the business and as such must be carried forward to the credit of the total sales ledger control account. There is likely to be a missing figure in the debit side of the total Trade receivable account, which represent total sales on credit for the period and should be transferred to the credit of the Statement of profit or loss as sales or revenue.

Another schedule that must be prepared is a list of amount owing by the business to suppliers for goods purchased on credit. The total of this schedule represent total liabilities by way of trade payables outstanding at the end of the period and should therefore be carried forward to the debit of the purchases ledger control account. The total purchases for the period will be derived from the credit side of the purchases ledger control account as a balancing figure and should be transferred to the debit side of the statement of profit or loss.

(c) Extraction of trial balance

This is the final stages as all the transactions would have been recorded and the entry will now have been completed and for that matter the business will be able to extract a trial balance which will form the basis for the preparation of the Statement of profit or loss and Statement of Financial Position.

Illustration3.2

Boakye, a sole proprietor, trading as KKB Enterprise requested Oko & Associates, a firm Chartered Accountants, where you are employed as a trainee Accountant, to prepare the accounts of his business for the year ended December 31, 2021.

Your audit Manager assigned this work to you. Your interview with Boakye revealed the following:

(i) He did not maintain double entry book-keeping system.

(ii) All sales were on credit basis. During the year Boakye received GH¢9,025,000, GH¢475,000 in cheques and cash respectively from his customers.

(iii) Suppliers of goods during the year were paid GH¢6,840,000 by cheque.

(iv) Boakye rented 2 premises at Danso man and High Street for residential and business purposes respectively. In July 2020, he paid GH¢480,000 as one year rent in advance for his residence. In July 2021, he again paid a cheque of GH¢600,000 to cover year advance for his residence. The rent for the premises at High Street was GH¢60,000 per month in 2021. Boakye always paid all his rent by cheque.

(v) General business expenses paid by cheque amounted to ¢106,200

(vi) He took cash of GH¢38,000 every month for his private use.

Boakye provided you with the following additional information.

	31/12/2021	31/12/2020
	GH¢	GH¢
Trade Receivables	1,254,000	1,045,000
Trade Payables	617,500	380,000
Rent Owing	60,000	120,000
Bank Balance	3,000,000	1,073,500
Cash in Hand	60,000	76,000
Inventories	1,700,500	1,510,500
Furniture &Fittings	--	920,000

(vii) Depreciation is provided annually at the rate of 20% on Furniture and Fittings.

(viii) Boakye agreed to pay GH¢100,000 as Accountancy fees.

(ix) Differences in cash and bank balances at the end of 2021 represents additional drawings/ capital respectively.

Required:

(a) Compute the profit of Boakye.

(b) Prepare cash and bank Summary for year 2021

(c) Prepare statement of profit or loss for the year ended 31 December 2021

Solution to 3.2

(a) **Calculate opening net assets to arrive at opening capital**

We need the opening capital to enable us calculate the closing balance in the statement of financial position. All that is required is to pick up all opening balances not forgetting the balancing figures. The information is presented clearly, with the inclusion of bank and cash balances in the tabulation of the assets and liabilities figures.

Statement of affairs

	31/12/2021	31/12/2020
	GH¢	GH¢
Furnitures & fittings (w5)	736,000	920,000
Trade receivables	1,254,000	1,045,000
Inventories	1,700,500	1,510,500
Bank	3,000,000	1,073,500
Cash in hand	60.000	76,000
Trade payables	(617,500)	(380,000)
Rent owing	(60,000)	(120,000)
Accountancy fees	(100,000)	--
Net worth	5,973,000	4,125,000

Increase in net worth GH¢5973,000 less GH¢4125,000= GH¢1,848,000

Computation of profit

	GH¢
Increase in net worth	1,848,000

Add Drawings (456,000+600,000+35,000)	1,091,000
	2,939,000
Less Additional Capital (b)	1,227,700
Net Profit	1,711,300

(b) CASH BOOK SUMMARY

	Cash	**Bank**		**Cash**	**Bank**
	GH¢	GH¢		GH¢	GH¢
Bal b/d	76,000	1.073,500	Suppliers	-	6,840,000
Received from customers	475,000	9,025,000	Drawings	456,000	-
Capital (missing figure)	-	1,227,700	Rent	-	600,000
			Gen. Bus. Exp.		106,200
			Rent (w3)	-	780,000
			Drawings (missing fig)	35,000	
			Balance	60,000	3,000,000
	551,000	11,326,200		551,000	11,326,200
Bal b/d	60,000	3,000,000			

(c) Statement of profit or loss.

	GH¢	GH¢
Revenue (w1)		9,709,000
Cost of sales (w4)		(6,887,500
Gross profit		2,821,500
Less Expenses:		
Depreciation (w5)	184,000	
Rent	720,000	
General business expenses	106,200	
Consultancy fees	100,000	
		1,110,200
Net profit		1,711,300

Workings

(W1) Prepare sale and purchases ledger control accounts

In a double entry-system, control accounts are used to confirm the arithmetical account of the sales and purchases ledger system. This technique will be used to calculate and purchases as a missing figure.

Sales Ledger Control Account

	GH¢		GH¢
Balance b/d	1,045,000	Cash	475,000
Sales (missing fig.)	9,709,000	Bank	9,025,000
Balance c/d	1,254,000	10,754,000	10,754,000
Bal. b/d	1,254,000		

Purchases Ledger Control Account

	GH¢		GH¢
Bank	6,840,000	Bal. B/d	380,000
		Purchases (missing figure)	7,077,500
Bal. C/d	617,500		
	7,457,500		7.457,500
		Bal. b/d	617,500

(W2) Derive the accruals and prepayments

In addition to these four techniques it will be necessary to calculate figures for the Statement of profit or loss by adjusting cash paid for expenses for opening and closing accruals and prepayment.

(W3) Rent expense control

	¢		¢
Bank (missing figure)	780,000	Bal.B/d	120,000
		P or L (12@60,000)	720,000
Bal. C/d	60,000		
	840,000		840,000
		Bal. b/d	60,000

(W4) Computation of cost of goods sold

		¢
Opening stock (1/1/21)		1,510,500
Purchases (w1)		7,077,500
	8,588,000	
Less closing stock (31/12/21)	1,700,500	
Cost of goods sold	6,887,500	

(W5) Computation of Depreciation

	¢
Fixtures and fittings at cost (1/1/21)	920,000
Less Depreciation (20% @ ¢920,000)	184,000
Net book value (31/12/21)	**736,000**

Illustration 1.3

Damask is a retailer who deals in spare parts at Kokompe. He pays in to his bank account the amount of his cash takings, after retaining GH**¢10,000** per week for personal use and after payment of wages and expenses, which for the accounting period of 31 December 2021, were as follows:

¢

Staff wages	1,200,000
Goods	220,000
Cleaning	75,000
Carriage	35,000
Others	20,000

The transactions in his Bank Account during the period were:

	¢
Balance as at 1 January 2021	2,000,000
Lodgements:	
From takings (cash)	30,100,000
Bulk sales account (cheques)	4,800,000
Interest on treasury bills	30,000
	36,930,000

Payments	**¢**
To suppliers	30,830,000
Rates	400,000
Furniture & fittings	600,000
Telephone & electricity	150,000
Rent	400,000
Consultancy	70,000
Repairs	150,000
Others	70,000
Air condition expenses	220,000
Fire insurance	60,000
Income tax	900,000
Drawings	180,000
Balance c/d	2,900,000
	36,930,000

You are re

The following information were also provided:

	31/12/2020	**31/12/2021**
	¢	¢
Receivables –Bulk sales	490,000	430,000
Payables– Goods purchased	2,900,000	3,195,000
- Rent	80,000	30,000
- Electricity	25,000	65,000
- Telephone	45,000	-
- Consultancy fees	40,000	40,000
Inventories in trade	2,050,000	1,875,000
Furnitures and fittings	-	540,000

Rates and Air condition expenses included ¢55,000 and ¢20,000 relating to his private residence. You are required to prepare a Statement of profit or loss for the year ended 31 December 2021 and a statement of financial position as at that date.

Solution 1.3

(i) Calculate opening net assets to arrive at opening capital

You have to calculate the capital of the business by using the information on asset and liabilities at the opening and closing dates. This is done by preparing a statement of the business by picking up all opening balances and calculating the net asset business as at 31 December 2016. The information on the bank and cash balances in the presentation of the liabilities.

The statement of affairs of Damask as at 31 December 2021 is as follows:

STATEMENT OF AFFAIRS

		31/12/20	**31/12/21**
Assets:		**¢**	**¢**
Furniture & Fittings		-	540,000
Trade Receivables		490,000	430,000
Inventories		2,050,000	1,875,000
Cash in the bank		2,000,000	2,900,000
		4,540,000	5,745,000
Liabilities:			
Trade Payables	2,900,000		3,195,000
Rent Owing	80,000		30,000
Electricity Owing	25,000		65,000
Telephone owing	45,000		
Consultancy Fees		40,000	40,000
		3,090,000	
			3,330,000
Capital		1,450,000	2,415,000

(ii) Prepare sale and purchases ledger control accounts

In a double entry-system, control accounts are used to confirm the arithmetical accuracy of the sales and purchases ledger system. This technique will be used to calculate sales and purchases by way of missing figure. This calculation will explore the horizontal format of determining the sales and purchases figures as missing figures instead of the usual T'account that you are familiar with.

The sales figure will be determined as follows:

	¢	¢
Lodgements:		
Shop takings		30,100,000
Add Proprietor's drawings		520,000
Expenses paid	1,550,000	
Cash sales	32,170,000	
Bulk sales account	4,800,000	
Add closing balance of Trade Receivables	430,000	
Less opening balance of Trade Receivables	(490,000)	
Credit sales	4,740,000	
Total sales	36,910,000	

The amount for Purchase is determined as follows:

	¢	¢
Payments for goods supplied		30,830,000
Add closing balance of Trade Payables		3,195,000
		34,025,000
Less opening balance of Trade Payables		2,900,000
Credit purchases		31,125,000
Add cash payments		220,000
Total purchases		31,345,000

Statement of Profit or Loss for the year ended 31/12/2021

	¢	¢	¢
Sales/Revenue			36,910,000
Less cost of sales:			
Opening inventories		2,050,000	
Purchases	31,345,000		
Carriage inwards	35,000	31,380,000	
		33,430,000	
Less closing inventories	1,875,000	31,555,000	
Gross profit		5,355,000	
Interest on treasury bills		30,000	
		5,385,000	
Less Expenses:			
Staff wages	1,200,000		
Rates	345,000		
Rent	350,000		
Telephone & Electricity	145,000		
Consultancy fees	70,000		
Repairs	150,000		
Air conditioner	200,000		
Fire insurance	60,000		
Cleaning	75,000		
Other expenses (70,000+20,000)	90,000		
Depreciation	60,000	2,745,000	
Net profit before tax		2,640,000	
Income tax		900,000	
Net Profit for the year		1,740,000	

Statement of Financial Position as at 31/12/2021

	¢	¢	¢
Non-current assets			
Furniture and fittings			600,000
Less depreciation provision			60,000
540,000			
Current Assets			
Inventories		1,875,000	
Trade Receivables		430,000	
Bank		2,900,000	
5,205,000			
Current Liabilities			
Trade Payables	3,195,000		
Rent owing (W1)	30,000		
Electric it owing (W2)	65,000		
Accountancy fee owing (W3)	40,000		
		3,330,000	
			1,875,000
			2,415,000
Financed by			
Capital at 1/1/21			1,450,000
Net profit			1,740,000
3,190,000			
Less drawings (W4)			775,000
			2,415,000

(iii) Calculation of accruals and prepayments

Addition to the above techniques it will be necessary to construct figures for the profit and loss account by adjusting cash paid for expenses for opening and closing accruals and payment.

WORKINGS

(W1)

Rent expense Control

	¢		¢
Bank	400,000	Bal b/d	80,000
		P& La/c	350,000
Bal. c/d	30,000		
	430,000		430,000
		Bal. b/d	30,000

(W2) **Telephone & Electricity**

	¢		¢
Bank	150,000	Bal. b/d	70,000
		P& La/c	145,000
Bal. c/d	65,000		
	215,000		215,000
		Bal. b/d	65,000

(W3) **Consultancy fees**

	¢		¢
Bank	70,000	Bal b/d	40,000
		P& La/c	70,000
Bal. c/d	40,000		
	110,000		110,000
Bal. b/d			40,000

(W4) **Drawings**

	¢		¢
Bank 180,000		Bal. c/d	775,000
Cash	520,000		
Rates	55,000		

Air-condition exp	20,000		
	775,000		775,000
Bal. b/d	775,000		

3.4 Chapter summary

In this chapter, we have explained the difference between a double entry accounting system and single entry system. We have also learned how to use the closing and opening capital figures to calculate the net profit of a trader that is not keeping his books of accounts on the double entry system.

We have learnt how to convert from a single entry system to a double entry which also aids the preparation of Statement of Profit or loss and Statement of Financial Position from records that were kept on single entry basis. We mentioned that figures such as sales and purchases could be calculated as missing figures from the sales ledger control account and purchases ledger control account respectively.

It is imperative for readers to note that as with all accounting topics, frequent practice of incomplete records questions is essential for skill and confidence required.

3.5 End of chapter questions

1. In which ledgers can data relating to discount be found?
   - A. Nominal ledger
   - B. Cash Book
   - C. Sales ledger
   - D. Private ledger
   - E. Public Ledger

Use the data below to answer Questions 2 to 5

	31/12/20	**31/12/21**
	¢	**¢**
Non-Current assets (cost)	320,000	286,000
Current assets	750,000	920,000
Current liabilities	150,000	130,000
Provision for depreciation	70,000	74,000

During 2021, a Non-Current asset costing ¢54,000 with a book value of ¢20,000 was sold for ¢15,000

2. What was the capital of the business as at 31 December 2020?

A. ¢920,000
B. ¢865,000
C. ¢860,000
D. ¢850,000

E. ¢840,000

3. What is the capital of the business as at 31 December 2021

A. ¢1,076,00
B. ¢1,002,000
C. ¢865,000
D. ¢860,000
E. ¢850,000

4. What was the value of the net profit or loss for the year ended 31 December, 2021?

A. ¢152,000 loss
B. ¢152,000 profit
C. ¢147,000 profit
D. ¢120,000 loss
E. ¢120,000Profit

5. What was the depreciation charge for 2021?

A. ¢74,000
B. ¢70,000
C. ¢34,000
D. ¢4,000
E ¢1,000

6. A "statement of affair" is similar to

A. Statement of Income
B. Income and expenditure account
C. Statement of Financial Position
D. Trial Balance
E. Ledger Account

7. A Statement of Affairs may include only

A. Accrued expenses, assets, liabilities and outstanding revenues
B. Expenses, assets, accrued revenues and liabilities
C. Assets, liabilities and expenses
D. Expenses, profits, assets and liabilities
E. Net Income, Expanses and Assets

8. Koki started business on 1 January 2021 with ¢200,000. At the end of the year his total assets valued ¢500,000. He did not owe anybody. Throughout the year Koki took ¢70,000 out of the business to maintain his family. In June 2021, he won lotto of ¢150,000 and added the prize to the business capital. Calculate Koki`s profit for 2021.

A. ¢370,000
B. ¢300,000
C. ¢280,000
D. ¢220,000
E. ¢120,000

9. If cost price is ¢240,000 and selling price is ¢300,000 then

A. Mark-up is $33^1/_3$%
B. Margin is $33^1/_3$%
C. Margin is 20%
D. Mark-up is 20%
E. Make-up is 8%

10. What is the cost of goods sold, given the sales figure as ¢800,000 with a mark-up of 25%?

A. ¢640,000
B. ¢604,000
C. ¢540,000
D. ¢504,000
E ¢160,000

EXAMINATION TYPE QUESTIONS

1. Victorosky who does not keep proper books of account has presented the following information for the year ended 31 December 2020.

	2020(¢)	**2019(¢)**
Inventories	200,000	185,000
Cash at Bank	98,500	56,000
Trade Receivables	376,000	490,000
Office Equipment	450,000	400,000

Cash in hand	25,000	29,000
Trade Payables	160,000	158,500
Motor vehicle	740,000	755,000

You are required to calculate the profit or loss of Victorosky for the year ended 31 December 2020, after taking into consideration the following:

a) Victorosky makes monthly withdrawal of cash and goods valued at ¢20,000 and ¢3,000 respectively.
b) Customer with an outstanding bill to the tune of ¢5,400 was declared bankrupt by a court in Accra.
c) Rent prepaid and electricity owing amounted to ¢16,000 and ¢18,500 respectively.
d) Additional capital introduced during the year was 75,000.

2. Babariga is a trader who does not keep proper books of account. He has however provided you with the following information:

a. He paid ¢10,000 in bank account as his initial capital

b. He banked all sales after withdrawing cash for the following: Personal use ¢350,000 per week
Staff Salaries and wages ¢500,000 monthly

General expenses ¢11,140,000

c. Cash sales awaiting lodgement ¢8,102,000.
Lodgements made into the Bank amounted to ¢450,000,000

Withdrawals from the bank were:	¢
Rent	13,000,000
Insurance	10,000,000
Transport expenses	6,750,000
Payment to suppliers	245,000,000
Purchase of motorcar	63,500,000
Purchase of computers	18,000,000
Telephone expenses	8,698,000

The following balance was also available as at 30 September 2021

Trade Payables	¢134,000,000
Inventories	¢42,000,000

Bad debts	¢4,420,000
Trade receivables	¢25,000,000
Rent prepaid	¢2,800,000
Payables for insurance	¢2,150,000

Depreciation is to be provided on the cost of all non-current assets at the rate of 20%.

You are required to prepare the Statement of profit or loss for the year ended 30 September 2021 and a Statement of Financial position as at that date.

3. Richardosky has kept the following summary of accounts:

Statement of Financial Position as at 1 January 2020

	¢		¢
Sundry creditors	105,000	Office equipment	250,000
Rent and Rates	6,000	Fixtures and Fittings	50,000
		Stocks	120,000
Loan	250,000	Sundry Debtors	235,000
Surplus	404,000	Bank	110,000

Analysis of Trade Payables

	¢	¢
Balance 1/1/20		105,000
Purchases		548,000
Cash paid	415,000	
Discounts	7,000	
Returns	4,000	
Balance 31/12/20	227,000	
	653,000	653,000

Analysis of Receivables

	¢	¢
Balance 1/1/20	235,000	
Sales	980,000	
Cash received	820,000	
Discounts	42,500	
Bad debts	35,000	
Returns	29,500	
Balance 31/12/20		288,000
	~~1,215,000~~	~~1,215,000~~

Analysis of Balances as at 31/12/2020

	¢
Inventories	235,000
Rent prepaid	8,000
Rates owing	4,000
General expenses owing	28,000
Office equipments	366,000
Fixtures & Fittings	45,000

Analysis of Cash Book

	Dr.	Cr.
	¢	¢
Balance as at 1/1/20	110,000	
Trade Receivables	820,000	
Creditors		415,000
Cash Sales	95,000	
Office equipment		150,000
Wages and Salaries	150,000	
General expenses	32,000	
Rent and Rates	42,500	
Cash Purchases	48,000	
Selling expenses	45,000	
Balance as at 31/12/20	95,000	

You are required to prepare Richardosky's Statement of Financial Position as at 31 December 2020, together with statement of profit or loss for the year ended on that date.

3.8 Solution to examination type questions

Solution 1

Victorosky

Statement of Affairs

	31/12/19		31/12/20
Assets:	¢		¢
Office equipment	400,000		450,000
Motor vehicles	755,000		740,000
Trade Receivables	490,000		376,000
Inventories		185,000	200,000
Prepayments		-	16,000

Cash at bank		56,000	98,500
Cash in hand		29,000	25,000
		1,915,000	1,905,500
Liabilities:			
Trade Payables		158,500	160,000
Accruals		-	18,500
	158,500	178,500	
Capital	1,756,500	1,727,000	

The calculation of profit or loss could be based on the formula below:

Opening Capital + Net Profit (or – Net loss) + Additional Capital – Drawings= Closing Capital
¢1,756,500 + Net Profit + ¢75,000 - ¢276,000 = ¢1,727,000

Solving for Net Profit

Net Profit=¢1,727,000-¢1,756,500 - ¢75,000 +¢276,000

Net Profit=¢171,5000

Solution 2

Babariga Statement of profit or loss for the year ended 30 September 2021

	¢	¢
Sales		487,522,000
Less Cost of sales		
Purchases	379,000,000	
Less closing inventories	42,000,000	337,000,000
Gross profit		150,522,000
Less Expenses:		
Rent (13m – 2.8m)	10,200,000	
General expenses	11,140,000	
Staff salaries & wages	6,000,000	
Telephone	8,698,000	
Depreciation– Motor car	12,700,000	
Depreciation– computers	3,600,000	
Insurance (10m + 2.15m)	12,150,000	
Transport	6,750,000	
Bad debts	4,420,000	
		75,658,000
Net Profit for the year		74,864,000

STATEMENT OF FINANCIAL POSITION AS AT 30 SEPTEMBER 2021

	¢	¢	¢
NON-CURRENT ASSETS	Cost	Dep.	NETBOOK VALUE
Motorcar	63,500,000	12,700,000	50,800,000
Computers	18,000,000	3,600,000	14,400,000
	81,500,000	16,300,000	65,200,000
Current Assets:			
Inventories		42,000,000	
Receivables (Wii)		25,000,000	
Prepayment		2,800,000	
Bank (Wi)		67,814,000	

		137,614,000	
Current Liabilities:			
Trade Payables (WIII)	134,000,000		
Accruals	2,150,000		
		(136,150,000)	
			1,464,000
			66,664,000
Financed by			
Capital			10,000,000
Add Profit for the year			74,864,000
			84,864,000
Less Drawings			18,200,000
			66,664,000

Workings:

(i) Cash book summary

	¢		¢
Capital	10,000,000	Rent	13,000,000
Lodgements	450,000,000	Insurance	10,000,000
Cash sales	8,102,000	Transport	6,750,000
		Payment to suppliers	245,000,000
		Purchases of motorcar	63,500,000
		Purchases of computers	18,000,000
		Telephone expenses	8,698,000
		Cash payments:	
		Drawings	18,200,000
		Staff salaries & Wages	6,000,000
		General expenses	11,140,000
		Balance c/d	67,814,000
	468,102,000		468,102,000
Balance b/d	67,814,000		

(ii) Sales Ledger Control Account

	¢		¢
Credit sales (missing figure)	479,420,000	Bank	450,000,000
		Bad debts	4,420,000
		Bal. c/d	25,000,000
	479,420,000		479,420,000
Bal. b/d	25,000,000		

Total sales = ¢479,420,000 +¢8,102,000 = ¢487,522,000.

(iii) Purchases Ledger Control Account

¢

¢

Bank 245,000,000 Purchases (missing figure)
379,000,000

Bal. c/d

134,000,000

379,000,000
379,000,000

Bal, b/d
134,000,000

Solution 3

Richardosky Statement of Income for the year ended 31 December 2020

	¢	¢	¢
Revenue (95 +980)			1,075,000
Less returns			29,500
			104,500
Less Cost of sales: Opening stocks		120,000	
Purchases (548+48)	596,000		
Less returns	4,000	592,000	
		712,000	
Less closing stock		235,000	477,000
Gross profit			568,500
Discount received			7,.000
			575,500
Less Expenses:			
Rent (42.5 – 6 – 8 +4)		32,500	
General expenses (32 + 28)		60,000	
Salaries &Wages		150,000	
Bad debts		35,000	
Discount allowed		42,500	
Depreciation– Plant & Machinery		34,000	
Depreciation– Fixtures &Fittings		5,000	
Selling expenses		45,000	404,000
Net Profit			171,500

Richardosky Statement of Financial Position as at 31 December 2020

	¢	**¢**	**¢ Non-**
Current Assets:	**Cost**	**Dep.**	**Net**
Office equipment	400,000	34,000	366,000
Fixtures &Fittings	50,000	5,000	45,000
	450,000	39,000	411,000
Current Assets:			
Inventories		235,000	
Trade Receivables		288,000	
Prepayment		8,000	
Bank		95,000	
		626,000	
Current Liabilities:			
Trade Payable	227,000		
Accruals (4 +28)	32,000		
		(259,000)	367,000
			778,000
Less loans			250,000
			528,000
Financed by:			
Capital			404,000
Add Profit for the year			171,500
			575,500
Less Drawings			47,500
			528,000

CHAPTER FOUR

ACCOUNTING FOR NOT-FOR PROFIT ORGANISATIONS

Chapter contents

a. Introduction

b. Receipt and Payment Account

c. Income and Expenditure Account

d. Membership subscription

e. Bar Trading Account

f. Life Membership

g. Accumulated Fund/Equity Reserve Fund

4.0 Objectives

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

(a) Explain what a not- for- profit organization is

(b) State the difference between a receipts and payments account and an income and expenditure account;

(c) Explain the difference between the final accounts of not-for profit organizations as those of sole traders and partnerships;

(d) Prepare receipts and payments account;

(e) Prepare income and expenditure account;

(f) Prepare subscription account making the necessary adjusting entries with respect to amount in arrears and payments in advance; and

(g) Prepare the accumulated fund or Equity Reserve of a not-for profit organization

4.1 Introduction

There are many types of not-for profit organizations. They include government owned hospitals and voluntary health and welfare organizations. In Ghana and Nigeria and other west African countries, citizens depend heavily on such entities for religious, educational, social and recreation needs. Examples of other not-for profit organizations include the following:

4.1.1 Private and community foundations

4.1.2 Professionals

4.1.3 Research and scientific organizations

4.1.4 Social and country clubs

4.1.5 Trade associations

4.1.6 Labour organizations

4.1.7 Political parties

It is not only profit making organizations that need accounts. Organisations set up for purposes other than profit, also need to tell their stakeholders how they have dealt with the funds they have contributed.

The legal status of such entities is usually spelt out in club rules or regulations. Students must however remember that external financial information provided by such organizations must be inconformity to generally accepted accounting principles.

The accounts of clubs, societies and charitable organizations may consist of the following:

(i) Receipts and payments account

(ii) Income and expenditure account and

(iii) Statement of financial position.

4.2 Receipts and Payments Account

This is a statement of cash actually received and paid during a given period. Receipts being debited and payments credited. It is, in effect, a summary of the cash book, and therefore shows the opening and closing balances of cash in hand, and receipts and payments of any kind and on any account made during the period.

An example of a receipts and payments account is shown in below:

Receipts	¢"000	Payments	¢"000
Bank balance 1/6/2011	118,000	Printing & stationery	228,000
Sponsored walk	23,000	Management expenses	109,000
Subscription	580,000	Caterer for president ball	113,250
Sundry income	57,000	Electricity and water	78,500
Sale of clubs manual	230,000	Bar Payables	278,500
Sale of equipment	254,000	Bank balance 31/5/20	454,750
	1,262,000		1,262,000

FEATURES OF RECEIPTS AND PAYMENTS ACCOUNTS

- It is a summary of all cash receipts and payments whether it is capital or revenue in nature.
- It shows the opening and closing cash and bank balances
- It does not distinguish between capital and revenue items as in the case of income and expenditure accounts

- It is easy to prepare as it does not require the complex application of double entry principle or accounting conventions.

4.3 Income and Expenditure Account

Income and expenditure account is the equivalent of Statement of profit or loss account of a non-trading concern. It contains only revenue items, being debited with all expenditure, and credited with all income of a period, whether or not it has actually been paid or received within that period. The final balance of an income and expenditure account represents the excess of income over expenditure (surplus) or the excess of expenditure over income (deficit), as the case may be, for the period. This balance is similar to the net profit or loss of a trading concern.

Readers must note that an income and expenditure account differs from the receipts and payments account. The latter records only cash movements, the former takes into consideration non-cash adjustments for amounts owing and owed at the period end and for depreciation. It also recognizes the accounting distinction between revenue and capital expenditure. The important point that readers must note is that the income and expenditure account is prepared on an accrual basis.

4.4 Membership Subscription

A club or society receives payments from members for benefits, which members have enjoyed. Annual membership subscriptions of clubs and societies are usually payable one year in advance. Such payments in advance by members is shown as liability in the Statement of financial position. This is because the year's membership has still to run as at the year end. A large number of club subscriptions in arrears may never be received and the financial position of the club or association could be distorted, since such amounts are usually shown as assets in the Statement of financial position.

Illustration 2.1

Receipts and payments account for the year ended 31 May 2021

Receipts	¢	**Payments**	¢
Bank balance 1/6/2020	118,000	Printing & stationery	228,000
Sponsored walk	23,000	Management expenses	109,000
Subscription	580,000	Caterer for President's ball	113,250
Sundry income	57,000	Electricity and water	78,500
Sale of club's manual	230,000	Bar creditors	278,500
Sale of equipment	254,000	Bank balance 31/5/2021	454,750
	1,262,000		1,262,000
Bank balance 1/6/2021	454,750		

Extracts from the membership subscription book revealed that subscriptions due from members amounted to ¢80,000 on 31 December 2020 and ¢120,000 on 31 December 2021. The accounts clerk recorded subscription of ¢21,500 and ¢109,000 in respect of subscriptions that have been paid by members in advance for 2021 and 2022 respectively. The subscription account will be prepared as follows:

Subscription Account for the year ended 31 Dec. 2021

	¢'000		¢'000
Balance b/f	80,000	Bal b/f	21,500
Income and Expenditure a/c	532,500	Receipts & Payment a/c	580,000
Balance c/f	109,000	Balance c/f	120,000
	721,500		721,500
Balance b/f	120,000	Balance b/f	109,000

By carrying forward subscription in advance, the accountant is applying the matching concept. This is because the payment of ¢109,000 in 2021 represents income meant for 2022 accounting year. This must therefore be removed from the current year's income and expenditure account, hence the debit balance carry forward.

From the above solution subscription in arrears have been treated as an asset. This will hold true as a result of the accrual concept since the subscription in arrears are income that have been earned for the accounting year of 2021 but for which cash has not been received.

In practice however, subscriptions in arrears are often excluded from the Statement of Financial Position on grounds of the prudence concepts. This is due to the fact that subscriptions that are owed by members for a long time end up not being paid eventually.

In examination situations, however, readers are reminded to follow the policy of the club or society as provided by the examiner.

4.5 Bar Trading Account

It is not uncommon for clubs/ associations to engage in other income generating activities to raise additional revenue for the effective running of the club.

These other activities are done with the sole aim of making profit. For instance the aim of a local trade union is not to make profit but the union may operate a bar.

A long side its activities with the object of making profit. The profit will not be distributed among the members but rather used for the purpose of the union.

If a club has a bar, a separate Statement of profit or loss account will be prepared for its trading activities. The net profit from the bar activities is then included as income in the income and expenditure account of the club or association. Any loss on the bar activities will be shown in the expenditure side of the income and expenditure account.

4.6 Life Membership

Subscriptions are often received from life members who paid at once and for subscription which entitles them to membership facilities for the rest of their lives. The once and-for-all payments from life members are not income relating to the year in which they are received by the club, because the payment is for the life if the member's subscriptions are small, they are credited to income as received but if they are significant in amount, then they should be credited in equal proportion over the estimated active club membership of such members.

4.7 Accumulated Fund OR Equity reserve fund.

This represents the opening capital of a not-for profit making organization. It has the same meaning ascribed to the capital accounts of a sole trader and partnership and is calculated as the difference between total assets and liabilities. It is usually common to see most not-for profit organizations keeping accounts on single entry basis. For this reason the procedure for preparing the accumulated fund of a not-for profit organization is the same as that of statement of affairs as obtained under incomplete records and single entry discussed in other chapter.

Illustration 2.2

The following is the Receipts and Payments Account for the Victorosky Fun Club for the year ended 31 October 2021.

RECEIPTS	¢"000	**PAYMENTS**	¢"000
Subscription	1,643,560	Printing & Stationery	59,160
Sponsored walk	478,802	Bar steward's salary	69,600
President's Ball connections	408,000	Caterers for President's ball	250,000
Sundry income	75,000	Light, cleaning etc	32,640
Bar takings	510,000	Petty cash	65,000
Sale of equipment	7,923	Bar payables	280,000
Raffle	183,030	Investment in ABC limited	450,000
		Donation	50,000
		Sundry President's ball exp.	5,275
		Prizes of raffle	21,600
		Building project (materials)	839,000

Rent	360,000
Secretary’s salary	120,000
Sundry bar expenses	3,360
Insurance	18,000
New equipment	67,800
8	36,000
Hiring of hall for Pres. Ball	20,000

the following additional information has been given:

1. Current Assets and Liabilities were:

		2020 ¢''000	2021 ¢''000
Bar Inventories	27,000		36,000
Bar Payables	18,000		33,000
Subscriptions in arrears	240,000		360,000
Subscriptions in advance	150,000		210,000
Light and cleaning owing	4,200		6,800
Insurance prepaid	4,200		5,200
Petty cash float		3,000	1,000
Cash in hand		15,565	14,340
Bank balance	246,500		281,105

2. The petty cash float is used exclusively for telephone and postages

3. The club started constructing its club House during the year. The project will take four years to complete. Amount owed for building materials supplied at 31 October 2021 was ¢511,500,000. Wages owed for October 2021 was ¢175,000,000. Inventory of materials at the end was ¢220,500,000.

4. Tickets for the President's Ball were sold at ¢300,000 each. The club engaged the services of a caterer who agreed to charge on the number of plates served under the following conditions:

   - Below 1,500 plates, amount to be charged per plate was ¢250,000.
   - From 1,501 to 2,000 plates, amount to be charged per plate was ¢220,000.
   - Above 2,000 plates, amount to be charged per plate was ¢200,000. Of the 2,400 tickets sold, 90% attended the function and were served.

5. Depreciation of equipment is to be calculated at 10% per annum on written down value. The Club's equipment which was disposed of during the year had a carrying value of ¢9,905,000 on 1 November 2020.

6. Subscriptions in arrears for more than one year are to be written off.

7. An amount of ¢1,000,000,000 is to be transferred from accumulated fund to building fund.

8. Investment in ABC limited is expected to be held for at least five years.

9. Included in subscription is an amount of ¢192,000,000 in respect of 2020.

10. Rent paid represents one and half years to 30 April, 2023

Required:

(a) Accounts showing the profit or loss on Bar operation and president's Ball

(b) The accumulated fund as at 1 November 2014.

(c) The income and expenditure account of Victorosky Fun Club for the year ended 31 October 2015 and statement of financial position as at that dat

Solution to illustration 2.2

Victorosky Fun Club

(i) President ball Income statement Account for the year ended 31 December 2021

	¢‟000	¢‟000
Sale of tickets (2,400@¢300,000)		720,000
Less: Cost of meals served [2,400 x 90%@¢200,000]		432,000
		288,000
Less Expenses:		
Hiring of Hall	20,000	
Sundry Expenses	5,275	25,275
Profit to I & E a/c		262,725

(ii) Bar Trading Account for the year Ended 31 October, 2021

	¢‟000	¢‟000
Takings		510,000
Opening Inventory	27,000	
Add purchases (w1)	295,500	
	322,500	
Less closing Inventory	36,000	286,500
		223,500
Less Expenses:		
Stewards salary	69,600	
Sundry expenses	3,360	72,960
		150,540

Accumulated fund as at 1 November, 2020

	¢‟000	¢‟000
Equipment		9,905
Cash in hand		15,565
Bank		246,500
Inventory		27,000
Subscriptions		240,000
Prepaid insurance		4,200
Petty cash		3,000
		546,170
Bar Payables	18,000	
Light and cleaning owing	4,200	
Subscriptions	150,000	172,200
ACCUMULATED FUND/ EQUITY RESERVE FUND		373,970

Victorosky funclub

Income and expenditure account
For the year ended 31 October 2021

INCOME:	¢‟000	¢‟000
Subscription (W2)		1,751,560
Sponsored walk		478,802
Sundry income		75,000
Raffle (¢183,030-¢21,600)		161,430
Profit on Bar Trading		150,540
Profit on president Ball		262,725
		2,880,057
Expenditure:		
Bank charges	36,000	
Insurance (¢4,200 + ¢18,000 - ¢5,200)	17,000	
Printing & Stationery	59,160	

Light & cleaning (6,800 + 32,640 - 4,200)	35,240	
Telephone & Postage W3	67,000	
Depreciation (10% @ ¢67,800)	6,780	
Donation	50,000	
Secretary's Salary	120,000	
Rent [12/18 @ ¢360,000]	240,000	
Bad debt (W1)	48,000	
Loss on sale of equipment (¢7,923-¢9,905)	1,982	681,162
Surplus of income over expenditure		2,198,895

Victorosky fun club

Statement of financial position as at 31 October, 2021

ASSETS EMPLOYED	¢‘‘000		¢‘‘000
NON- CURRENT ASSETS:			
Equipment at cost	67,800		
Less depreciation	6,780		61,020
Construction in progress			1,830,000
			1,891,020
Investment in ABC Shares			450,000
			2,341,020
Current Assets:			
Inventory (¢220,500+¢36,000)		256,500	
Receivables-President’s ball (w4)		312,000	
Subscription in arrears		360,000	
Insurance prepaid		5,200	
Rent prepaid		120,000	
Bank balance		281,105	
Cash (¢14,340+1,000)		15,340	
		1,350,145	
Current Liabilities:			
Creditors: Building project	511,500		
Bar	33,000		
Caterer (¢432,000-250,000)	182,000		
Subscription in advance	210,000		
Light & cleaning owing	6,800		
Wages outstanding	175,000		
		1,118,300	
Net current Assets			231,845
Net Assets			**2,572,865**

EQUITY RESERVE FUND:	
Accumulated fund (W6)	1,572,865
Building fund	1,000,000
	2,572,865

WORKINGS

(W1) Bar Purchases:	¢'‘000
Payables 2021	33,000
Receipts & Payment a/c	280,500
	313,500
Less Payables 2020	18,000
	295,500

(W2). Subscription Account

	¢'‘000		¢'‘000
Balance b/f	240,000	Balance b/f	150,000
Income & Expenditure a/c	1,751,560	Receipts & Payment a/c	1,643,560
		Bad debt (240-192)	48,000
Balance c/f	210,000	Balance c/f	360,000
	2,201,560		2,201,560

(W3)	Telephone & Postages	¢'‘000
	Petty cash 2020	3,000
	Receipts &Payment	65,000
		68,000
	Petty cash 2021	1,000
	Income &Expenditure a/c	**67,000**

(W4)	Receivables on President's Ball:	¢'‘000
	Tickets sold	720,000
	Less Amount Paid	408,000
	Amount to be collected	312,000

(W5)	**Work in progress-Club House**	¢'000	¢'000
	Payment for materials		839,000
	Add Amount owed (2021)		511,500
			1,350,500
	Less closing stock		220,500
	Materials used on project		1,130,000
	Wages paid	525,000	
	Add amount owed (2021)	175,000	700,000
	Cost to date		1,830,000

	Accumulated Fund		¢'000
(W6)	Balance as at 1/11/2020		373,970
	Transfer from I & Ea/c	2,198,895	
		2,572,865	
	Amount transferred to building fund	1,000,000	
		1,572,865	

4.8 Chapter Summary

The chapter explained the difference between a receipt and payment account and an income and expenditure account and that the receipts and payments account does not show the true financial position of an organization.

The profit or loss account of a not-for profit organization is called income and expenditure account from which any surplus (profit) or deficit (loss) is calculated and also the accumulated fund is similar to the equity account of a trader.

We also learned that where the club or society engaged in any activity with the aim of earning income for the attainment of the objectives of the organization, a separate profit or loss account should be prepared and the resulting profit or loss transferred to the income and expenditure account.

The treatment of subscription owing should be seen as part of the earnings or in accordance with accounting policy of the organization.

Similarly, life membership and entrance fees should be accounted for bearing in mind the accounting policy of the organization.

3.8 Solution to examination type questions

Use the data below to answer Questions 1– 4

Receipts and Payments Account for the year ended 31 December, 2021

		¢'000			¢'000
Balance b/f		8,000	General expenses		7,800
Subscriptions	50,000		Equipment	9,000	
Bar Sales	36,000		Clubhouse furniture	27,000	
			Bar purchases	30,000	
			Bar keeper's wages	4,000	

The treasurer also stated that on 1 January 2021, the club had ¢24,000 worth of equipment and owed ¢500 for electricity. Bar Inventory on 1 January and 31 December are valued at ¢10,000 and ¢13,000 respectively. Non-current assets are depreciated at 10% per annum.

1. Bar operation's surplus for the year was
   a. ¢36,000
   b. ¢6,000
   c. ¢5,000
   d. ¢3,000
2. The accumulated fund at the beginning of the year was
   a. ¢42,500
   b. ¢41,500
   c. ¢42,000
   d. ¢32,000
3. The net value of the club's non-current assets as at 31 December, 2021 was
   a. ¢60,000
   b. ¢36,000
   c. ¢54,000
   d. ¢32,400

4. The cash balance at the end of the year was
   a. ¢16,200
   b. ¢18,200
   c. ¢16,000
   d. ¢16,700
5. In the final accounts of non-profit making organization, capital expenditures are recorded in
   a. Income and expenditure account
   b. Subscription account
   c. Statement of financial position
   d. Profit or loss account
6. Revenue receipts of a not-for profit making organization are recorded in the
   a. Profit or loss account
   b. Income and expenditure Account
   c. Statement of Affairs
   d. Bar Purchases Account
7. Which of the following statements is NOT true about the accounts of clubs and societies?
   a. A deficit of income and expenditure account reduces accumulated fund.
   b. Income and expenditure account does not contain capital receipts and expenditure.
   c. The excess of total assets over liabilities represents accumulated fund
   d. The closing balance of receipt and payments account is transferred to income and expenditure account.
8. With regard to a not-for-profit organization, a debit balance on the subscription account is reported on
   a. Income and Expenditure Account
   b. Statement of Financial Position (SFP)
   c. Accumulated Fund
   d. Receipts and Payments Account

Details of subscription account of "Big Men Keep Fit Club" are as follows:

¢"000

Subscription owing	1/1/21	30,000

Subscription received 2021 320,000

Subscription received in 2021 included ¢40,000 in respect of 2022 financial year.

9. What is the subscription to be transferred to income and expenditure account for 2021?
   a. ¢390,000
   b. ¢330,000
   c. ¢310,000
   d. ¢250,000

10. A club received the following life membership fees in each of its first two years:

    Year 1¢300,000
    Year
2¢160,000

    The club's policy is to take credit for life membership fees in equal amounts over 10 years. Determine the amount to be transferred to income and expenditure account in year 2.
    a. ¢16,000
    b. ¢43,000
    c. ¢46,000
    d. ¢32,000

4.10 Solution to end of chapter questions

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

4.9 EXAMINATION TYPE QUESTIONS

1. The information below relates to the Madonna Youth Club for the accounting period of 2020.

		¢''000
Cash in hand 1/7/19		1,800
Subscription received:		
	2020	2,000
	2021	18,000

Receipts for renting of park	1,000
Receipts refreshing guest	6,000
Sundry receipts	12,500
Payments:	
Repairs	1,200
Salaries and wages	10,000
Printing and Stationary	3,000
Caretakers wages	6,800
Refreshment materials	8,500
Electricity expenses	4,500
Vehicle running expenses	5,000
Payables for repair	800
Payables for vehicle running expenses	400
Payables for refreshment materials	2,200
Subscription owing for 2020	3,000

You are required to prepare:

a) Receipts and payments accounts

b) Income and expenditure account for the year ended 30 June 2020.

2) The Financial Treasurer of Ayoyo Fun Club has presented the following summary of receipts and payments account for the year ended 31 December 2021.

Receipts and Payments Account for the year ended 31 December 2021

	¢‘‘000		¢‘‘000
Balance b/f	4,900	Rent and rates	804
Membership Subscription	5,760	Social activities expenses	3,000
Membership admission	840	Bar purchases	3,580
Bar receipts	7,500	Bar wages	1,104
Other receipts	3,800	General wages	2,560
		Equipment	5,720
		Electricity expenses	208
		Postage &Telephone	352
		Bank charges	116
		Insurance	604
		Balance c/f	4,752
	22,800		22,800

The following additional information is available:

	31/12/20	31/12/21
Premises	60,000	60,000
Furniture and fittings	4,400	2,840
Bar Inventory	1,040	1,420
Subscription in arrears	80	120
General wages owing	180	-
Subscriptions in advance	400	-
Insurance prepaid	136	180

Depreciation of 20% is to be written off equipment.

You are required to prepare:

a) Bar Profit or loss Accounts

b) Income and expenditure account for the year ended 31 December 2021.

c) Statement of financial position as at 31 December 2021

CHAPTER FIVE

ADJUSTMENT TO ACCOUNTING RECORDS

Chapter contents

a. Introduction

b. Bases and Concept of Accounting

c. Business transactions

d. Accounting System

e. Double Entry System

f. Ledger Accounts

g. Accounting Cycle

h. Trial Balance

i. Adjusting Process

j. Extended Trial Balance

k. Correction of Errors

l. Simple Financial Statement

5.0 OBJECTIVES

At the end of this chapter, readers should:

a) Know the role of source documents and the needs for books of prime entry

b) Understand the double entry book keeping system

c) Know how to prepare initial trial balance make necessary accounting adjustments and prepare the final trial balance.

d) Be able to prepare simple financial statements of sole proprietorship or trader.

5.1 INTRODUCTION

Accounting is typically of two types, these are Financial Accounting and Management Accounting. However, financial accounting is a method of reporting financial performance and financial position of an entity. An entity is any type of business organisation such as sole trader, partnership, limited liability company etc.

5.2 Bases and Concepts of Accounting

5.2.1 Bases of Accounting

There are three bases of accounting and they are:

i) Accrual basis’
ii) Cash basis; and
iii) Break up basis

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

Accrual Basis

The accrual basis of accounting also referred to as accrual concept and accrual accounting, recognize transactions, other events and conditions in the accounting period. They occur and not when the associated cash is received or paid.

Hence, revenue from sales and other incomes are reported in the period when the income arises and not in the period when the cash is received. Also an expense should be charged in the period to which it relates and not the period when the payment is effected or made.

The accrual basis provides the reason for making adjustments for accrued and prepaid expenses when preparing financial statements.

Cash Basis

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

Thus, revenue from credit sales and other incomes are reported in the period when the cash involved are received and not in the period when the cash involved are received and not In the period when the sales were made or the income earned. Also all expenses are recognised and reported in the period when payment s were made rather than in the period when the expenses were incurred.

Break up basis

The other two bases of accounting (Cash basis and accrual basis) assumed that every business is a going concern. That is, that the business will continue to operate far into the future periods. However experiences have shown the business do collapse as a result of financial difficulties occasioned by poor management of resources.

The break up basis of accounting is applied to business which has lost their going concern status. In this situation the business assets and liabilities are measured at the amount of cash they can be sold for or settled.

Accounting Concepts

Accounting concepts are basic assumption, postulations or ideas adopted and used in accounting practice for the preparation of financial statements. They include the following:

i. Entity Concept
ii. Dual Aspect concept
iii. Matching concept
iv. Accrual concept
v. Money measurement concept
vi. Realisation concept
vii. Historical cost concept
viii. Going concern concept
ix. Substance over form

Entity Concept

The entity concept is also known as legal entity or business entity concept. Under this concept, the business is treated for the purpose of financial reporting as an institution separate and distinct from the legal owners. For this reason, transactions and to the events are recorded from the point of view of the business and the presence or existence of its owners is reflected only in the capital account.

The essence of the entity concept is to distinguish the income and expenses of the business from the private income and expenses of the owner or his drawings from the business. The application of this concept is important in sole traders and partnership businesses where the owner/partners actively participate in the business affairs. For a limited liability company, the legal entity is established by law.

Dual Aspect Concept

The dual aspect concept states that there are two aspects to every business financial transaction. One is the giving of value, while the other is the receiving of the same value. The receiving of value gives rise to assets while the giving of value gives rise to capital and liabilities. Under this concept the two aspects are always equal to each other. This gave rise to the accounting equation.

Capital + liabilities = Assets

The dual aspect concept is the basis of the double-entry book keeping in modern accounting.

Matching Concept

The matching concept holds that in determining profit or loss for an accounting period. The income earned in the period should be matched with the expenses or cost incurred in the same period to earn the income. Where income is deferred from one period to another, all elements of cost or expenses relating to the deferred income will be carried forward. The concept is important because any error in the matching of the income and expenses will result in the financial statement being misleading and unreliable.

Accrual Concept

This concept is closely related to the matching concept. The accrual concept states that income should be recognized and accounted for when they are earned and not when they are received.

Similarly, expenses should be recorded and accounted for when they are incurred and not when they are paid. It is the application of this concept that gives rise to prepayments and accrued expenses (accruals) normally adjusted for when preparing financial statements

Money Measurement Concept

The money measurement concepts demands that only financial transactions and other events which can be measured in monetary terms should be recorded and accounted for . This means that accounting does not provide complete information about an entity since qualitative useful information bordering on the continuous operations or otherwise of an entity are not recorded.

The limitation of this concept is that sometimes the value of money is not stable like in inflationary periods and also the issue of time value of money will affect measurement.

Realization Concept

The realization concept is concerned with ascertaining when revenue or income is earned. The concept advocates that revenue and incomes should not be recognized until they have been realized or earned. It also hold s that revenue should be recognized at the time goods are sold and services are rendered, that is, at the pint the customer has accepted liabilities for the goods. Rent income is realized with passage of time and not when the rent is received.

Historical Cost Concept

This concept holds that all assets acquired by an entity should be recorded in the accounting books at their historical or original costs paid to acquire them. The justification for the historical cost concept is its objectivity, that is the cost can be verified or traced to the source documents and that other measure of value would be subjective and questionable. A known criticism against this concept is that with passage of time, cost would no longer represent the fair value of an asset especially in inflationary period. The historical cost is the basis for calculating annual depreciation charge on assets.

Going concern concept

The going concern concept is an assumption in accounting that a business entity will continue to operate indefinitely. That is, the entity has neither the intention nor the necessity of liquidation or refund significantly the scale of its operation. When circumstances detect the need for liquidation of a business entity, the going concern concept will cease to apply.

Under going concern status, assets and liabilities are valued on historical cost basis but when the going concern is in doubt, assets are valued on break-up value basis. Going concern concept helps investors and to the stakeholders in making economic decisions about the entity.

Periodicity Concept

Periodicity concept requires that the assessment of the operations and performance of a business entity should be based on a specified period usually referred to as the accounting or reporting period. It could be weekly, monthly but should not exceed one year. Periodicity concept is justified based on the fact that the actual net return from operations of an entity cannot be fully determined until the end of the life of the entrepreneur when its assets are realized and liabilities paid off. The periodic review would help to assess management efficiency and the planning and control of future operations.

Substance over form

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 their legal form.

Examples are found in sales and re-purchase agreements, lease contracts and consignments

5.3 Business Transactions

5.3.1 Business

The term business means different things to different persons. It can be used to describe an economic process and to describe entities that participate in that process.

Business can be defined as an economic system where goods and services are exchanged for one another or for money. A business entity is a commercial organization that aims to make a profit from its operations.

Characteristics of business

The following characteristics are applicable to all businesses

(i Businesses are formed with a profit motive. That is all business exists to make profit.

(ii) Business makes profit by supplying goods or rendering services to others called customers.

(iii) Businesses might make the goods they supply or buy the goods from other outside parties.

(iv) Business takes risk to survive. So profit is the reward for accepting risk.

(v) The profit made by a business belongs to its owners. A share of the profit might be paid to the owners periodically as dividend or share of profit.

Types of business entity

Ordinarily there are three main types of business entity:

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

5.3.2 <u>Sole trader or sole proprietor</u>

Any business owned and managed by one person is referred to as a sole trader or sole proprietor. Any individual who sets up a business on his own without form a company is a sole trader.

Important features of a sole trading business are as follows:

a. There is no legal distinction between the proprietor and the business. Thus he is personally liable for an unpaid debt and other obligations of the business and also when a sole trader dies the business cease to exist.

b. The profits of the business belong to the sole proprietor.

c. The assets of the business belong to the sole proprietor.

d. The sole trader can extract cash and other asset from the business for personal use and this called drawings when preparing financial reports.

e. The business may be financed by the owners' capital as well as by personal and business loans introduced.

f. A sole proprietorship business can be sold as a going concern by its owner.

5.3.3 <u>Partnership</u>

If partnership business is an enterprise in which two or more persons called partners share the ownership of a business. Each partner will be expected to contribute agreed sum of money to set up the business.

A partnership is defined as the relationship between persons who have agreed to share the profit of a business carried on by all or any of them acting for all. Important features of a partnership are as follows:

(i) It must be an association of two or more persons to carry on a business

(ii) The partners are the owners of the business are personally liable as individuals for the unpaid debts and other obligations of the business.

(iii) When a partner dies the partnership comes to an end and is dissolved. That is there is no perpetual succession.

(iv) The profits of the business belong to the partners in an agreed ratio.

(v) The assets of the business belong to the partners in agreed ratio.

(vi) The partners, if allowed by the partnership deed, can extract cash and other assets from the business as drawings.

(vii) The business may be financed by both the partners capital and loans

(viii) A partnership can be sold as going concern by its owners.

5.3.4 Company/limited liability company

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

a) Ownership of the company is represented by ownership of shares. A company might issue any number of shares, depending largely on its size. Large companies usually have large number of shares in issue and consequently large number of shareholders. The number of shares acquired by a shareholder determines his stake or ownership interest in the company

b) Unlike a sole trader or partnership, a company has the status of “legal system” in the eyes of the Law. Thus

   i. A company can be legal owner of business assets, and can sue and be sued in its own right in the law.

   ii. A company is taxed separately from its owners for ht profits made by the company. This is not so with sole traders and partnership as the business profit is taxed in the hands of the partners or the sole proprietor.

   iii. A company is liable for its on debts and not the shareholders. When the shareholders are not the managers of their company, it becomes essential that information about the position and performance of the company should be reported regularly by the management to the shareholders. This is the main purpose of financial reporting.

5.3.5 Not-for-profit entries

These are entities which are established with the aim of providing social and welfare services and not necessarily for profit motive. Such entities includes: clubs, societies, voluntary associations, benevolent and similar institutions. Some important features of not-for-profit entities are:

(i) Members pay subscription to maintain their membership.

(ii) They sometimes carry out activities which yield profit like running a bar, organizing fee pay competitions.

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

Advantages and disadvantages different types of business entity

The advantages and disadvantages of operating as each type of business entity may be summarized briefly as follows:

	Subject Matter	**Sole Trader**	**Partnership**	**Company**
	Ownership	Owned by one person	Several individual working together	Shareholders
2.	Liability for the unpaid debts and other obligations of the Business	Personal liability of owners	Personal liability of partners	Limited
3.	Management	Business managed by its owner	Business managed by its owners-the Partners	Larger companies are managed by professional Managers
4.	Raising Capital	Capital for business is provided by its sole owner. Often Limited in Amount	Capital for the business is provided by its owners. Likely to limited in amount	Capital for the business is provided by shareholders. Public companies can raise new capital from investors in the stock market most very large businesses are Companies
5.	Financial accounting and Auditing	Some financial accounts needed for tax purposes	Financial accounts needed for the benefit of the partners and for tax purposes	Fairly strict regulation of financial reporting by companies. Also legal requirements for Audit

5.4 <u>Financial reporting by sole traders and partnerships</u>

The financial statements of a sole trader are private and do not have to be disclosed, except to the tax authorities and possibly also to a lending bank. These must be prepared according to accepted accounting principles and practice, but need not conform to all the requirements of accounting standards.

Similarly, the financial statements of a partnership business are private and do not have to be disclosed.

5.5 Financial reporting by companies

The financial statements of a company are prepared for the shareholders of the company and are usually subject to audit.

Audit is the examination of the financial statements by an independent expert who expresses an opinion as to whether they are fairly presented (show a true and fair view).

Company law requires the financial statements are filed with a government agency, where they can be accessed and read by any member of the general public.

Companies whose shares are traded on a major stock market make their financial statements generally available to the public often on the company's website.

The financial statements of a company are subject to more regulation than those of a sole trader or partnership.

Financial accounting may also be of importance to management of companies. The most important need of financial accounting is that it provides information needs of persons not involved in running the business. That is they provide historical information needs.

5.6 Accounting system

Business entities operates system to record business transactions in accounting records. This system is called book keeping system. All companies small or large have book keeping system for recording financial details of the business on regular basis
The book keeping records of a business are often referred to as the accounts of the business. The content of financial statement might vary depending on whether the business is a sole trader, partnership or limited liability company.

The basic process used to record transaction is however similar for all types of entities. The technique used is called DOUBLE ENTRY BOOK KEEPING, this will explained later in this chapter.

Source documents of financial transactions

When a business transaction takes place they are usually recorded using source documents. These source documents are the source of all financial information recorded by a business.

The documents used to record business transactions in the books of accounts of a business include:

Receipts: This document confirms that payments have been received. This is usually in respect of cash sales

Payment Vouchers: This is document that is used for recording payments made to third parties such as suppliers, customers etc.
Remittance Advice: A document sent to suppliers with a payment details. A remittance advice allows the suppliers to update the customers' records to show which invoice has been paid and which ones are still outstanding.

Debit Notes: It is a formal request for suppliers to issue a credit note. It is a document sent by a customer to a supplier in respect of goods return or overpayment made.

Credit Notes: It is a document sent by supplier to customer in respect of goods retuned. It is also referred to as a NEGATIVE INVOICE.

Invoice: An invoice is a document that establishes indebtedness to the effect that money has not being paid or received for goods or services bought or sold. An invoice therefore evidences credit transactions which consist of credit sales and credit purchases

Sales Order: This is a document in which a customer places order for goods or services. We also have purchases order.

Statements: This is a document sent out by a supplier to a customer listing the transactions on the customer's account. The statement is useful as it allows customers to reconcile the amount that they believe they owe the suppliers to the amount that the supplier believes they are owed. Any difference noted can then be investigated and resolved.

Goods Received Notes: this is the document that serves as evidence that goods were received into the warehouse. Even where goods received notes are not issued on regular basis, the details of the consignment from suppliers which arrives without an advice note must always be recorded.

Books 0f prime entry

Business transactions are usually recorded in source documents as earlier explained above. The recordings in the sources documents are then entered in to the books of prime entry in other to further process the business transactions before the financial statement can be prepared.

Therefore books of prime entry are the books in which we first record the business transactions, before they are further processed in order to produce the financial statement.

The main books of prime entry are as follows:

- Sales day book
- Purchases day book
- Sales return book
- Purchases return book
- General journal
- Cash book
- Petty cash book.

Sales and purchases day books

Sales day book: this is a record that relates to transaction relating to goods sold on credit. The sales day book is used to keep the list of all invoices sent to customers each day. A typical sales day book will contain the following information:

DATE	INVOICE	CUSTOMERS	AMOUNT INVOICED (₦)
20 Jan 2017	340	Jare dada	250,000
23 Jan 2017	341	Taiwo Kehinde	155,000
25 Jan 2017	342	Janet Paul	140,000
2 Feb. 2017	343	Samson Ajayi	165,000
TOTAL			710,000

Purchases day book

This is a record that relates to all transactions relating to goods that are purchased on credit. A business keeps a record in a purchase day book of all invoices received. A typical purchase day book is shown below:

DATE	SUPPLIERS	AMOUNT (₦)
30 Jan 2017	Kofi & co	50,000
31 Jan 2017	Ahamed Nig. Ltd	175,000
4 Feb 2017	Maxi Ltd	155,000
5 Feb 2017	Wike & co	205,000

It should be noted that there is no invoice number column in the purchase day book above because the day book records other peoples invoices which would have all sorts of different numbers

Sales and purchases return day book

A business may maintain a separate sales return day book or purchases return day book. Alternatively any return in respect of sales or purchase may be treated as a reversal entry in the respective sales and purchase day books earlier explained above. This is because the returned items are not usually much.

General journal

The General Journal is also a book of prime entry that is used to record transactions that are not in any other book of original entry. It is also used to record complex transactions that would require explanations. The journal might also be used to provide explanation for simple transactions.

Some of the uses of journal include the following:

- Postings from books of prime entry
- Financial year- end adjustments
- Corrections of errors and omissions
- Any other adjustments

Example of a general journal is shown below:
DEBIT(DR) CREDIT (CR)

Name of account to be debited X

Name of account to be credited

X

Cash book and petty cash book

Cash book: is a special journal that is used for recording all cash receipts and cash payments. If a cash book is maintained there is no need for preparing a cash account in a general ledger except if It is required for the purpose of control. The cash book is also a book of original entry where transactions are recorded for the first time from the source document. A cash book serves the dual role of a journal and a ledger.

Petty cash book: Majority of small and large business maintain petty cash book for recording small and frequent transactions of the business. Most petty cash books are operated under the **imprest system**.

Under the imprest system a petty cash is kept at an agreed sum, such that each topping up of the agreed balance is equal to the amount paid out in the period.

The petty cash is meant to receive and pay small amount of cash on regular basis.

Main features of cash book

- It performs both the functions of journal and the ledger at the same time.
- Only cash transactions are recorded in the cash book
- All cash receipt are recorded on the debit side while cash payments are recorded on the credit side

Forms of cash book

A cash book can be in several forms

- Single column cash book – recording cash transactions only
- Double column cash book- for recording cash and bank transactions.

- Triple column cash book – for recording cash and bank transactions involving gain or loss on account of discount.
- Petty cash book- for recording petty cash expenses.

Single column cash book

This single column cash book has one column for amount on each side. All cash receipt are recorded on the left side (debit side) and all cash payment are recorded on the right side (credit side). It is strictly a cash account. There may be no need to open a cash account in the ledger except for control purposes. An example of the format of a single column cash account is shown below:

DATE	PARTICULARS	REF.	AMOUNT	DATE	PARTICULARS	REF.	AMOUNT

The debit side or the left side which is the receipt could consist of cash proceeds from sales , capital, trade receivables, loan received etc. while the right side or the payment side could consist of cash purchases, purchase of property plant and equipment., drawings, payment for trade payables, and other cash withdrawals.

Double column cash book

This cash book has two amount columns i.e one for cash and the other for bank on each side. Cash and cheques received are recorded on the debit side while cash and cheques used in payment are recorded on the credit side. The format for double column cashbook is shown below:

DATE	PARTICULARS	REF	CASH	BANK	DATE	PARTICULARS	REF	CASH	

Triple column cash book

This cash book has two amount columns i.e. one for cash, bank and the other for discount on each side. It is normal for business to allow discount when payment is received from customers promptly and before due date. It is equally so when payments is made in respect of trade payables accounts before the due dates All cash receipts and discount allowed will appear on the debit side and all cash payments and discount received will be shown on the credit side of the cash book. The format of a double column cash book is shown below:

DATE	PARTICULARS	REF	CASH	BANK	DISCOUNT ALLOWED	DATE	PARTICULARS	REF	CASH	BANK	DISCOUNT RECEIVED

5.7 Double entry system

This is a technique of recording transactions which recognizes two sides of each transactions i.e. DOUBLE ENTRY SYSTEM.

Double Entry System employs the concept of DEBIT (DR) and CREDIT (CR). The receiving of value requires a debit entry to be made in the account of the person receiving the value (if an individual) or of the thing receiving if an object (e.g. Land, Furniture, cash) or to nominal account in respect of which value is received (e.g. rent and rates, postages, salaries and wages).

A corresponding credit of an equal amount will at the same time be made in the account of the giver of the benefit.

Thus every transaction triggers off two entries, one a DEBIT and the other a CREDIT, of EQUAL AMOUNTS.

For Example:

If Uche purchased goods worth ₦20,000,000 from Adamu on credit it means that purchases accounts will be debited by ₦20,000,0000. While Adamu's account will be credited by ₦20,000,000. However, if Uche purchased goods worth ₦20,000,000 from Adamu on cash basis the double entry would be:-

Purchases account will be DEBITED Cash account will be CREDITED
If Uche is recording the Entries.

However, if it is Adamu that is recording the transactions the credit transaction would be recorded as;
CREDIT SALES ACCOUNT with ₦20,000,000.
DEBIT UCHE ACCOUNT with ₦20,000,000.
While cash transaction would be
DEBIT CASH ACCOUNT CREDIT

Credit sales account

As a form of practice, students should endeavour to determine the double entry of the following transactions as a way of reviewing the principle of Double Entry.

(a) Purchase of Plant and Equipment at a cost of ₦5,000,000 from XYZ & Co. Ltd. on credit.
(b) Sold goods for cash at ₦800,000
(c) Paid salaries and wages amounting to ₦1,500,000 in cash

5.7.1 The general rule of keeping to the double entry system

A part from the explanation given above, readers will find it helpful to make use of the following general rule.

All that is required is for readers to be able to remember simply that Assets and Expenses are DEBITED, while Liabilities and Income are CREDITED.

This rule can further be expanded as follows:

Debit Items which:	Credit Items which:
- Increase Assets	Increase Liabilities
- Increase Expenses	Increase Income/Capital
- Decrease Liabilities	Decrease Assets
- Decrease Income/Capital	Decrease Expenses

The Skill required in order to be able to apply this rule is the ability to analyse transactions and determine their impact whether they increase or decrease assets expenses, liabilities or income/ capital.

Illustration 3.1

How would each of the following be reflected as a double entry:

i. N1,800,000 cash paid to supplier for amount outstanding
ii. Cash sales of N2,000,000 to customers
iii. Purchase of goods from supplier worth N2,500,000 issuing cheque
iv. Telephone bills of N5,000 was paid cash

Solution to illustration 3.1

i. Decrease in Liability (trade payables) DR
N1800,000 Decrease in Assets (cash) CR
N 1,8000,000

ii. Increase in Income (sales) CR
N2,000,000

Increase in Assets (cash) DR
N2,000,000

iii. Increase in Expenses (purchases) DR
N2,500.000 Decrease in Assets (bank) CR
N2,500,000

v. Increase in Expense (telephone bill) DR
N5,000 Decrease in Assets (cash) CR

N5,000.

5.8 Ledger accounts

A typical ledger account is referred to as T account.

A ledger accounts summarises all the individual transactions listed in the books of prime entry The principal accounts are contained in a ledger which could be namely:

Nominal ledger or general ledger

Entries are posted into this ledger accounts based on double entry principles. That is for every debit entry there should be a corresponding credit entry, a typical ledger accounts normally have two sides which represents the debit side and the credit side. Usually the right hand side represent the credit side of the ledger while the left hand side represent the debit.

Illustration of a typical ledger accounts

Accounts name

DEBIT SIDE		CREDIT SIDE	
	₦		₦

5.9 ACCOUNTING CYCLE

The preparation of financial statements (i.e Statement of profit or loss, statement of changes in equity, statement of cash flows and statement of financial position) requires the understanding of all phases of the accounting cycle as an essential foundation.

The following outline summarises the basic phases of the accounting cycle.

a. Transactions should be recorded in books of prime entry and analysed

b. Transactions should be journalized where necessary

c. The journal entries should be posted to the ledger accounts.

d. The ledger accounts are balanced off.

e. Trial balance should be prepared from the ledger accounts. (Initial Trial Balance)

f. Data needed to adjust the Initial Trial bal. should be obtained

g. A works sheet inform of Extended Trial Balance is prepared (to obtain the final T/balance)

h. Financial Statements in form of statement of profit or loss, statement of financial position and other relevant financial statement is then prepared.

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5.10 TRIAL BALANCE

A Trial Balance is simply a listing, divided into Debit and Credit columns of the balances on all the accounts in a double entry system. The objective of a trial balance is to determine or prove the arithmetical accuracy of the double entries.

5.10.1 Objectives of Trial Balance

Under the double entry system, the total debits in the ledger must be equal to the total credits. The Trial Balance, as earlier mentioned, is the recognized method of ascertaining whether this is so or not.

The trial balance being a summary of the ledger is also used for preparing statement of profit or loss and statement of financial position (Final Accounts).

5.10.2 Types of Trial Balance

In practical terms there are two types of Trial Balance.

(i) Initial Trial Balance: This is simply the list of Debit and Credit balances extracted from the General Ledger and it the most common type of Trial Balance.

(ii) Extended Trial Balance: As the name implies, this is simply an extension of the Initial Trial Balance into Final Trial Balance and statement of Profit or Loss and

Statement of Financial Position.

Extended Trial Balance is normally used by the practicing accountants when carrying out Audi t/Accounting assignments as it facilitates the preparation of Audited Statement of Profit or Loss Accounts and Statement of Financial Position.

A typical extended trial balance normally contains the following columns.

S/N	Particulars	Initial Trial Balance		Accounting Adjustments		Final Trial Balance		Profit or Loss A/C		Statement of Financial position	
		DR	**CR**	**DR**	**CR**	**DR**	**CR**	**DR**	**CR**	**DR**	**CR**

5.10.3 Trial Balance As a Means of Detecting Errors

Differences can be encountered on extraction of a Trial Balance (i.e. Debit Side of a Trial Balance may not agree with Credit Side). The reason why totals of a Trial Balance may not agree in the first instance may be due to any of the following errors:-

(a) Errors that are revealed by trial balance

(i) Errors in Extraction of Trial Balance:

- ❖ Debit balance in the General Ledger having been entered in the Credit column of the Trial Balance and vice versa.
- ❖ Balance omitted in extracting list of Debits and Credits

(ii) Errors in computation of the balances of the accounts

(iii) Errors of transposition of figures e.g. N18 or N81 or N7.81 for N1.87.

(iv) Non-correspondence of debit and credit entries by omission of one side, both entries on one side or difference in amount between entries.

(b) Errors that are not revealed by trial balance

These are errors that will not be revealed by the trial balance. That is errors that still exist despite the fact that both credit and debit sides of the trial balance agree with each other.

(i) **Errors of omission:** If there is omission of the same amount on both the debit and credit sides of the trial balance.

(ii) **Compensating errors:** If errors on one side of the Trial Balance have the same effect as errors on the other side. This will not prevent the agreement of the Trial Balance.

(iii) **Errors of Commission:** When the correct amount is entered but in the wrong account; e.g.N1,000 was posted to the credit side of Kofi‟s Account instead of the credit side of Kojo‟s Account.

(iv) **Errors of Principle:** When an item is entered in the wrong class of account e.g if an expense is debited to an Asset Account.

(v) **Errors of Original Entry:** When the errors are made in a book of prime entry and posted wrongly to the ledger.

(vi) **Errors of Complete Reversal of Entries:** When the entries meant to be credited are debited and those meant to be debited are credited for the same transaction. This will not affect the trial balance.

5.10.4 Construction of Trial Balance from List of Balances

List of balances used for the construction of a trial balance is obtained from the closing balances in the general ledger, private ledger and nominal ledger. However, when students are asked to prepare a trial balance from a given list of balances, this means that items have to be sorted into Debits and Credits and the total of both Debit and Credit must agree. The procedure requires students to identify which items would fall into Debit or Credit side of the Trial balance.

The following rules will be found useful.

(i) Assets, Losses and Expenses are debit balances.

(ii) Liabilities, Equity, Gains and Profit are credit balances.

Illustration 3.2

The following is the list of balances extracted from the ledger of CHINEDU & COMPANY, a sole Practitioner that is an Audit Firm as at 31 December, 2021.

	₦
Audit Fee Income	1,000,000
Consultancy Fee Income	2,000,000
Cash in Bank	1,650,000
Sundry Income	300,000
Capital	750,000
Administrative Expenses	600,000
Salaries & Allowances	800,000
Subscriptions	10,000
Retained profit Brought Forward	1,150,000
Professional Licence Renewal Fees	5,000
Rent	150,000
Stationery	250,000
Sundry Receivables	850,000

Transport & Travelling	75,000
Furniture & Fittings (Cost)	300,000
Motor Vehicle (Cost)	550,000
Newspapers & Journals	80,000
Rates	50,000
Provision for Depreciation– (M/V)	110,000
Provision for Depreciation (Furniture & Fittings)	60,000

Provision for Depreciation- (M/V)	110,000
Provision for Depreciation– (Furniture and Fittings)	60,000

You are required to prepare a Trial Balance of the firm as at 31 December, 2021

Suggested solutions to illustration 3.2
Chinedu and company
Trial balance as at 31 December 2021

-classification		**DR**	**CR**
		₦	₦
Audit Fees Income	- income		1,000,000
Consultancy Fee Income	- income		2,000,000
Cash in Bank	- Assets	1,650,000	
Sundry Income	- income		300,000
Capital	- equity		750,000
Administrative Expenses	-Expense	600,000	
Salaries & Allowances	- Expense	800,000	
Subscriptions	-Expense	10,000	
Profit & Loss Account B/Fwd	-Equity		1,150,000
Professional Licence Renewal Fees	-Expense	5,000	
Rent	- Expense	150,000	
Stationery	- Expense	250,000	
Sundry receivables	- Asset	850,000	
Transport &Travelling	- Expense	75,000	
Furniture & Fittings (Cost)	-Asset	300,000	
Motor vehicle (cost)	- Asset	350,000	
Newspaper & Journals	-Expense	80,000	
Rates	-Expense	50,000	
Provision for Depreciation M/V	- liability		110,000

Provision for Depreciation– Furniture & Fittings-liability		60,000
	5,370,000	5,370,000

5.11 Adjusting process

After the extraction of the initial Trial Balance from the ledger of the enterprise or firm, there is the need at the end of the accounting year to record some end of period adjustments in order to ensure that the ledger balances show a true and fair position (e.g. ensuring that revenue is matched with costs).

The adjusting entries are posted into the ledger through the use of Journals or by direct postings into the ledgers. The latter is not recommended.

These adjustments usually follow systematic and fairly consistent procedure. The adjustments are usually made in the following instances.

a) Where benefits have been received by the firm but have not been paid for at the end of the Accounting year or period (ACCRUED EXPENSES OR ACCRUALS)

b) Where payments had been made for certain services which had not yet been received or enjoyed by the end of the accounting period (PREPAID EXPENSES OR PREPAYMENTS).

c) Where the firm has recorded some income which has not yet been earned (RECEIPT IN ADVANCE OR UNEARNED INCOME).

d) Where the firm has rendered some services to other organizations that as at the close of the relevant accounting period have not yet been paid for such services (ACCRUED INCOME)

e) Losses which are anticipated or expected to have occurred by the exact amount of which is not yet known and may remain unknown for sometime in future (e.g. BAD & DOUBTFUL DEBTS, OBSOLETE OR DETERIORATING STOCK etc).

f) Anticipation for diminution in value of Assets as a result of wear and tear and other physical factors (e.g. PROVISION FOR DEPRECIATION AND AMORTISATION OF INVESTMENTS).

5.11.1 Accounting Procedure for the End of the Period Adjustments

Accruing for accrued expenses

These are benefit or services received during the accounting period but which are either not billed or not paid for in that period. An ACCRUED EXPENSE is therefore an expense which has been incurred but not billed or paid for. Accruals are usually noted in connection with Electricity costs, Salaries & Wages and cost of professional services such as Accountancy and Audit Fees, Legal Fees etc, where services are rendered and payment made at a later date.

Illustrations 3.3

Asejere Enterprises Financial year ends on 31 December every year. The firm paid for electricity bill up to 31 July, 2020. The monthly electricity bill rate is N1,500. As the firm did not receive the next bill until 28 February, 2021, no payment was made for the period from August to December, 2020.

Required:

(i) Determine the amount of electricity expenses for the year ended 31 December, 2020.

(ii) The amount of electricity expenses that should be accrued for in the year 2020.

(iii) The Journal entries to be raided to reflect the accruals.

(c) The postings of the entries into necessary ledger accounts

Suggested solution to illustration 3.3

(i) Electricity expenses for the year ended 31 December, 2020

,

	₦
Payment made up to 31 July 2020 (7 x 1,500)	10,500
Amount due not yet paid for:	
1 August 31 December, 2020 (5 x 1,500)	7,500
	18,000

(ii) Amount accrued for in year 2016

This is the amount of services enjoyed but not yet paid for

	₦
1 August 2020 to 31 December, 2020 (5 x 1,500)	7,500

(iii) Journal entries

	DR	**CR**
Electricity Expenses Account	**7,500**	
Accrued Electricity Expenses Account		**7,500**

(Being value of electricity consumed but		
Not yet paid for during the year)		

(d) Electricity expenses account

	₦		₦
31 July 2020 Cash	10,500	31 Dec. 2020 Profit & Loss A/c	18,000
31 Dec. 2020 Accrued			
Electricity Expenses	7,500		
	18,000		18,000

Accrued electricity account

			₦
		31 Dec. 2020 Elec.	7,500

Profit & loss account

	N		
31 Dec. 2020 Exp.	18,000		

5.11.2 Tutorial note

You will observe in our posting to various ledger accounts in question (c) above that the accrued amount of N7,500 increase the Electricity Expenses for the year to N18,000 whilst the credit to the accrual accounts establish the liability for the amount (i.e₦7,500).

Prepayments or pre-paid expenses

Prepayment is just the opposite of accruals. Simply put, prepayment is payment made in advance for services or benefit that has not been received or enjoyed.

Prepaid expenses a rise when at the end of an accounting period it is found that the benefit accruing from some of the operating expenses paid for during the period have not been exhausted. A portion of the benefit that is already paid for but not utilized is carried forward as an ASSET to be enjoyed in future.

Prepayment usually arise in connection with such expenses as Rent, Insurance, Telephone, where payments are sometimes made in advance for a period exceeding one year or for a period covering part of the current and future financial year of an entity.

Illustration 3.4

WAZOBIA VENTURES a Sole Proprietor firm with financial year ending 31 December 2016 carried out the following transactions.

(i) The firm paid for office rent for three (3)years to the land lord at the rate of N25,000p.a. The rent is expected to cover years 2021, 2022 and 2023. The total amount paid was charged into rent account.

(ii) The firm also paid for insurance of its motor vehicle amounting to N144,000 on 2 July 2021. The Insurance premium covered the period 1 July 2021 to 30 June 2022.

Required:

(a) Make necessary adjustments to close the books of WAZOBIA VENTURES for the year ended 31 December 2021.

(b) Determine the amount that should be treated as Rent & Insurance Expenses for the year ended 31 December 2021.

Suggested solution to illustration 3.4 (a)(i)

Rent expenses

Total amount of Rent paid during the year ended 31 December 2021 is

	₦25,000 x 3	=	₦75,000
Rent due in the year 2021	(₦25,000 x 1)	=	₦25,000
Rent paid in advance(for 2022 & 2018)			₦50,000

Journal entries

	DR	CR
Pre-paid Rent Account	50,000	
Rent Account		50,000
Being rent paid in advance for years 2022 & 2023		

LEDGER POSTINGS
Rent Account

	₦		₦
31 Dec.2021 Cash	**75,000**	**Prepaid**Rent	50,000
		Profit&LossA/c	25,000
	75,000		75,000

Prepaid Rent Account

	₦		₦
1 Dec. 2021 Rent	50,000	31st Dec. 2021 C/d	50,000
1 Jan. 2022 B/d	50,000		

Profit & Loss Account

	₦	
31 Dec, 2021 Rent	25,000	

(a)(i) Insurance expenses

Amount paid on 2 July, 2021
₦144,000 Amount due during the year (6/12 x 144,000) (72,000) (1 July 2021 to 31 Dec. 2021)

Amount paid in advance 6/12 x 144,000 72,000 (i.e. 1 Jan. 2022 to 30 June 2022)

JOURNAL ENTRIES

	DR	CR
Prepaid Insurance Account	72,000	
Insurance Account		72,000
Being prepaid insurance for the period		
1 Jan. 2022 to 30 June 2022		

	₦	
31 Dec, 2021 Rent Account	25,000	

(a)(i) INSURANCE EXPENSES

Amount paid on 2 July, 2021	₦144,000
Amount due during the year (6/12x144,000)	(72,000)
(1 July 2021 to 31 Dec. 2021	
Amount paid in advance6/12 x144,000	72,000
(i.e. 1 Jan. 2022 to 30 June 2022)	

JOURNALENTRIES

	DR	CR
Prepaid Insurance Account	72,000	
Insurance Account		72,000
Being prepaid insurance for the period		
1 Jan. 2022 to 30June 2022		

LEDGER POSTINGS INSURANCE ACCOUNT

	N		N
2July 2021 cash	144,000		

31 Dec. 2021 Prepaid Insurance

72,000

31 Dec. 2021 Profit& Loss A/c

72,000

144,000 144,00

PREPAID INSURANCE ACCOUNT

	₦		₦
31st Dec. 2021 Insurance A/c	72,000	31st Dec. 2021 C/d	72,000
1st Jan. 2022	72,000		

PROFIT& LOSS ACCOUNT

31st Dec. 2021 Insurance A/c	72,000		

(b) Amount that should be treated as rent and insurance expenses for the year ended 31 December 2021

Rent expenses:

This is the amount due in the year

Total amount paid for 3 years	=	₦75,000
Amount due for one year(1/3 x 75,000)	=	₦25,000

Insurance expenses:

Total amount paid for Insurance for the year is ₦144,000 covering the period from 1 July 2021 to 30 June 2022. Period relating to year 2021 is 1 July to 31 Dec. 2021 (i.e. 6 months).

Tutorial notes

- ❖ The amount calculated mathematically in part `b" of the question agrees with amount Charged as expenses to the Profit & Loss Account for the year ended 31 December 2021.
- ❖ In financial year 2022 ₦25,000 would be charged as rent for the year out of the balance of N50,000 outstanding as at 31 December 2021 while the remaining ₦25,000 would be carried forward to year 2023.

  Therefore in year 2022 the accounting entries would be.

	DR	CR
	₦	₦
Rent Account	25,000	
Prepaid Rent Account		25,000

(Being prepaid rent transferred to rent account during the year).

This same process would be repeated in year 2023 to completely utilize the balance in the prepaid rent account.

(c) ALLOWANCE FOR BAD & DOUBTFUL DEBTS

In business, goods are sometimes sold on credit. Ownership and possession of the goods is transferred at the time of sale and the vendor is left with debit due from the customer. The vendor hopes that this will be paid for with in a reasonable time.

However, some customers may not pay up when due, nor the others, resulting in what is called a doubtful debt or may not pay up at all which may subsequently lead to what is described as a "Bad debt".

The Prudence concept in accounting requires that debts which are "Doubtful" should be valued at Net realizable value. In view of this, deductions should be made from Receivables so that receivables are shown at the amount that is expected to be received. This deduction is known as the "**ALLOWANCE FOR DOUBTFUL DEBTS".**

At the end of each financial year RECEIVABLE ACCOUNTS should be reviewed and any debt that is definitely uncollectible or Bad should be WRITTEN OFF to Bad Debt Account. However, some debts may not be definitely bad, but may be doubtful. In such cases a provision for Doubtful Debt should be made.
In practice every organisation develops its own policy for categorizing debts. However, the following factors are generally considered

- Age of Debts
- Currency of Receivable Accounts
- Customers current financial standing

The accounting entries relating to Bad Debts would be approached from two points of view. When definitely Bad Debts they are written off and when provisions are made for debts considered being doubtful of recovery.

(i) BAD DEBTS WRITTEN OFF

Where bad debts are written off, the accounting entries are as follows: Debit: Bad Debt Account Credit: Receivable Acct.

This will involve reducing the Receivable balance and treating the amount written off as an expense in the Profit or Loss account.

(ii) ALLOWANCE FOR DOUBTFUL DEBTS

The accounting entries in respect of Doubtful Debts are:

Debit: Doubtful Debts Expenses Account

Credit: Allowance for Doubtful Debts
Unlike the entries for writing off bad debts, this entry only sets up a precautionary amount

which could be subsequently used to offset any specific debt that becomes bad. Therefore it is an additional precautionary measure designed to protect firms against loss of Trade Receivables.

However, the ultimate implication of this provision are deduction of the total Receivable figures in order to determine the value of net good debt that is to be carried forward to the new accounting year. Thus, while Doubtful Debts Expense account is debited to Profit or Loss Account the credit balance in the provision account is deducted from trade Receivables (in statement of financial position).

ILLUSTRATION 3.5

The Trial Balance extract of JOHNBULL as at 31 March 2022 includes the following:	₦
Receivables	431,920,000
Bad debts	6,380,000
Allowance for Doubtful Debts as at 31 March 2022	15,219,000

At the year end JohnBull decided that:

(i) A further N1,520,000 of the Trade receivable are Bad.

(ii) A general allowance of1% was required against the remainder of the debts.

Required:

Show Journal Entries and Ledger entries to reflect these decisions.

SUGGESTED SOLUTION TO ILLUSTRATION 3.5

		DR	CR
		N"000	**N"000**
(i)	Bad Debts Account	1, 520	
	Trade receivable Accounts		1,520
	Being additional Bad Debt written off		
	During the year		
(ii)	Doubtful Debts Account	4,304	
	Allowance for Bad Debt		4,304

Being 1% allowance made for doubtful debts

BAD DEBT ACCOUNT

	₦`000		₦`000
31/3/2022 T.Receival	6,380	31/3/2022 Profit & Loss Account	7,900
31/3/2022 T.Receivable	1,520		
	7,900		7,900

DOUBTFUL DEBTS ACCOUNT

	N"000		N"000
31/3/2022 Provision for Bad Debt	4,304	Profit&Loss A/c	4,304

PROVISION FOR BAD &DOUBTFUL DEBTS

	N"000			N"000
Balance C/d	19,523	31/3/2022 Balance b/d		15,219
		Doubtful Debt A/c	4,304	
	19,523		19,523	

5.12 EXTENDED TRIAL BALANCE

Extended Trial Balance can be drawn with the use of a "WORKSHEET". A Work Sheet Is an analysis sheet in columnar form in corporating on the same page, the following:

a) Trial Balance (Initial)
b) Adjustment
c) Adjusted Trial Balance OR Final Trial Balance
d) Income Statement (Statement of profit or loss)
e) Statement of Financial Position.

Therefore, a worksheet can be said to be an extended draft of the final accounts indicating all the entries which have been made in order to obtain the financial statements.

5.12.1 TYPICAL WORKSHEET OR EXTENDED TRIAL BALANCE

Opening Trial Balance		**Adjustments Balance**		**Final Trial Statement**		**Statement of profit or loss**		**Statement of financial position**	
DR	**CR**	**DR**	**CR**	**DR**	**CR**	**DR**	**CR**	**DR**	**CR**

5.12.2 PROCEDURE FOR SETTING UP A WORKSHEET OR EXTENDED TRIAL BALANCE

Step 1: Extract the opening Trial Balance from the ledger of the firm (these are unadjusted balances).

Step 2: With each adjustment necessary, enter in the appropriate column (Debit Credit entries) against the relevant account affected. This is necessary in order to adjust the balances extracted from the ledger in Step 1 above.

Step 3: Extend for each account the amount in the "Trial Balance" (Opening) and adjustment column into the ADJUSTED TRIAL BALANCE OR FINAL TRIAL BALANCE COLUMN adding together credit or debit balances as the case may be.

Total both the Debit and Credit Sub Columns of the ADJUSTED TRIAL BALANCE OR FINAL TRIAL BALANCE and ensure that both sides agree to confirm arithmetical accuracy of the adjustments and the Double Entry principle.

Step 4: Extend the adjusted trial balance column into the income statement column for items that relate to trading activities, operational income, expenses, into the appropriate Debit and Credit Columns.

Excess of credit over Debit usually indicates Net Profit and the reverse indicates net loss.

The difference should be inserted into the column that is short and extended to the opposite side in STATEMENT OF FINANCIAL POSITION COLUMN. The two sides of income statement column will thus agree.

Step 5: All balances which are still outstanding in the Adjusted Trial Balance or final Trial Balance will therefore be extended in to the STATEMENT OF FINANCIAL POSITION COLUMN.

The two sub columns in the statement of financial position will agree if all the preceding steps have been correctly followed.
The two sub columns in the statement of financial position will agree if all the preceding steps have been correctly followed.
This would thus complete the preparation of the work sheet or the Extended Trial Balance.

CORRECTION OF ERRORS AND SUSPENSE ACCOUNT

Errors can occur at any stage in the recording of financial transactions and preparation of financial statements. These errors can be grouped broadly into two categories as follows:

(a) Errors that are revealed by trial balance.
(b) Errors that are not revealed by trial balance

These two categories of errors have been discussed earlier in this chapter.

Correction of Errors

Errors are normally corrected when identified by the use of journal entries. The journal indicates the account(s) to be debited and the account(s) to be credited. It also contains a narration which describes the errors that are not revealed by trial balance do not pass through the suspense account.

Illustration 5.6

The trial balance of Kwame Ankra Enterprise extracted on 30th April 2022 agreed but the book keeper later discovered the following errors committed during the financial year.

i. Cash purchase of ¢560,000 spent for the purchase of new equipment was debited to the office equipment repairs account.
ii. The sum of ¢198,000 paid for insurance expenses was debited to rent account during posting.

Required:

Make necessary Journal entries to correct the above errors.
Suggested solution to illustration 3.6

Kwame Ankra Enterprise

Journal	Dr	Cr
	¢	¢
i. Purchase Account	6,000,000	
Cash Account/ book		6,000,000
Being the posting of cash purchase of omitted in error	¢	6,000,000
ii. Office Equipment Account	560,000	
Office Equipment Repairs Account		560,000
Being the correction of error of principles committed by debiting office equipment		

Repairs account instead of office equipment account		
iii. Insurance Account	198,000	
Rent account		198,000
Being the correction of the wrong debit of ¢198,000 to rent account instead of the insurance account.		

SUSPENSE ACCOUNT

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

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

Illustration 5.7

The trial balance of Malam Bako Enterprise at December 31, 2021 did not balance and a credit balance of N1,717,000 was entered in the suspense account to agree the trial balance. A detailed check of the books disclosed the following errors.

(a) Purchases return for December 2021, N400,000 posted to the debit of purchase account.

(b) Sales day book for June undercast N40,000.

(c) Discount received in September N480,000 posted to the wrong side of discount acoount.

(d) A sales of N41,000 to B. Adamu was correctly entered in the sales book but was posted to the credit of B. Adamu in the sales ledger as N22,000.

(e) N20,000 paid for repairs to vehicles was not entered in the relevant repairs account.

Required

Show the relevant journal entries to effect the correction and the suspense account after the corrections.

Suggested solution to illustration 3.7
Malam Bako Enterprise

Journal Dr
Cr

N
N

a) i). suspense account 400,000
Purchases account
400,000
Being cancellation of amount of purchases account

ii). Suspense account 400,000
Purchases Return Account
400,000
Being the correct posting of total purchases return for December.

b) Suspense Account 40,000
Sales Account
40,000
Being record of the correction of undercast of sales day book for June.

c) i) Suspense account 480,000
Discount Received Account
480,000
Being cancellation of discount received debited in error to the discount received account.

ii). Suspense account 480,000
Discount Received Account
480,000
Being the correct posting of discount received in September.

d) i). B. Adamu's Account 22,000
Suspense Account
22,000
Being record of the cancellation of incorrect posting to B. Adamu's Account.

ii) B. Adamu's Account 41,000
Suspense Account
41,000
Being the correct posting of the sales to B. Adamu.

e) Vehicle Repairs Account 20,000
Suspense Account
20,000
Being record of repairs expenses previously omitted.

Suspense Account

N	N
Purchases Account 400,000	Balance b/d 1,717,000
Purchases Returns Account 400,000	B. Adamu's Account 22,000
Sales Account 20,000	B. Adamu's Account 41,000
Discount Received Account 960,000	
	Vehicle Repairs Account 20,000
1,800,000	1,800,000

You can see that having corrected all the errors, the suspense account has nil or zero balance.

5.13 FINAL ACCOUNTS OF SOLE TRADERS

The preparation of the final accounts of a sole trader requires knowledge of all the accounting principles that have been discussed so far in this chapter. In addition readers need to have knowledge of the following as this is peculiar to this type of business of organization (Sole Trader).

5.13.1 EQUITY OF SOLE TRADERS

The Equity of a sole Trader in made up of the capital contributed either in the form of cash or in kind at the beginning plus profit earned in the business which has not been withdrawn.

	N
Capital	X
Add Retained Profit	X
Less Drawings	(XX)
Equity	(X)

5.13.2 DRAWINGS

A Sole Trader may decide to earn a regular salary or alternatively he may decide to make periodic drawings i.e. withdrawals in anticipation of profit.

The basic differences between salaries and drawings are as follows:

a) Salaries is a charge against profit while drawings is a withdrawal of income.

b) Salaries reduce the amount of net income while drawings do not affect Net Income but only reduce equity.

c) Salaries may be constant and regular from month to month. Drawings are usually un regulated and they tend to fluctuate from month to month depending on the proprietor's personal commitments.

d) Salaries are subject to tax at source e.g. Pay As You Earn (PAYE) or Personal Income Tax while drawings are not subjected to tax at source.

e) A common feature of drawings is that it may sometimes be taken in kind when the owner takes out some goods from the firm for personal use. Salaries on the other hand is taken in cash.

The Accounting Entries required for reflecting drawings in the Books of the Sole Trade areas follows:

	DR	**CR**
Drawings	X	
Cash (if cash is withdrawn)		X
Purchases (if goods are withdrawn)		X

5.13.3 TAXATION AND SOLE TRADER ACCOUNTS

A business firm that is a separate entity in law normally pays tax on its income as any natural person does. This position is however different in the case of a Sole Trader since the firm is not a legal entity. It is therefore not liable to tax. The income of the Firm is not subjected to Tax since the firm is not a legal entity. It is therefore not liable to tax. The Sole Trader is required to declare such income in his yearly tax return and where practicable he should attach the firm "s financial statements in support of his declaration.

In view of the above, no specific provision is made for Tax in a Sole Trader Account unlike Limited Liability Company Account.

However, where the owner of the business withdraws cash from the firm for the purpose of paying Income Tax Liability, such payment is treated as Drawings from the business.

5.13.4 STATEMENT OF PROFIT OR LOSS/ STATEMENT OF COMPREHENSIVE INCOME

Where a Sole Trader engages in trading activities the firm would be required to prepare Statement of Profit or Loss account

Statement of profit or loss account: This is an account where Revenue is compared with cost of sales with the aim of determining the GROSS PROFIT OR LOSS of the firm. Gross Profit results where there is excess of Revenue over cost of sales and Gross Loss where the reverse is the case.

After obtaining the Gross Profit or Loss in the account other operating expenses and income will be considered before arriving at profit or loss for the year.

Statement of changes in equity: the profit for the year is transferred to this statement. The statement is expected to reconcile the carrying amount of equity at the beginning with the carrying amount at the end of the year. Which must agree with the balance of equity shown in the statement of financial position.

5.13.5 STATEMENT OF FINANCIAL POSITION

A Statement of financial position is a position statement showing the state of affairs of the firm at any point in time.

Technically, it is better described as a classified summary of the debit and credit balances existing in the ledger or Trial Balance after statement of profit or loss has been constructed.

A typical Statement of Financial Position of a sole trader is made up of the following:

a) ASSETS

b) CAPITAL and

c) LIABILITIES

(a) ASSETS

Assets are classified under two headings:-

(i) **NON-CURRENT ASSET POSSESS THE FOLLOWING FEATURES**:

- (i) They have a lifespan which is longer than one year
- (ii) They are used for the purpose of business
- (iii) They are not bought for the purpose of resale.

Examples of Non-current assets include motor vehicles, land & buildings, furniture and fittings, plant and machinery. They are generally referred to as property plant and equipment (PPE).

(ii) **CURRENT ASSETS**

These are assets which are held for resale at profit or items that have lifespan that is short. Examples of current assets include inventory, trade receivables, cash at bank, and cash in hand.

TUTORIAL NOTE

Readers should note that an item which is a non-current Asset in one firm may be a current asset in another firm. For example where a firm is a motor vehicle dealer and therefore purchases motor vehicles as inventory, motor vehicles purchased for resale will be treated as Current Assets but if the vehicle is purchased for use of business and not for resale the motor vehicle will be treated as non-current ASSET.

(b) **LIABILITIES:** This is an obligation which a business is legally bound to pay. It is a claim by an outsider on the asset of the business. Liabilities can be classified into:

CURRENT LIABILITIES: These are short term liabilities i.e. liabilities due for payment with in a period of one year. Examples of current liabilities are trade payables, accruals etc.

NON-CURRENT LIABILITIES: These are liabilities payable in future i.e. liabilities payable within a period which is longer than one year. Examples of non-current liabilities are loan notes, long-term loans.

(c) **CAPITAL**

This is the amount injected by the owner of the business to finance the operations of the firm. It is used for acquiring the non- assets and current assets of the firm

ILLUSTRATION 5.6

YAHO Ventures is a trading organisation. The trial balance of the firm for the year ended 31 December 2021 is as follows:-

	DR **₦**	**CR** **₦**
Inventory(01/01/2021)	61,290	
Revenue		489,600
Purchases	320,560	
Salaries & Wages	99,925	
Motor Vehicles	129,375	
Furniture & Fittings	55,620	
Motor Vehicle Expenses	17,190	

Insurance	2,025	
Office Expenses	5,580	
Rates	7,775	
Lighting Expenses	4,295	
Trade receivables & Payables	100,800	44,800
Cash &Bank	12,465	
Drawings	31,050	
Capital	———	313,550
	847,950	847,950

You are also provided with the following additional information.

(i) Inventories as at 31 December 2021 ₦76,230.

(ii) Rates outstanding as at 31 December, 2021 amounts to ₦1,555.

(iii) Insurance expenses include ₦315 meant for the next period up to 31 March, 2022

(iv) Accrued expenses on lighting amounts to ₦835.

(v) Depreciation provisions are as follows: Motor Vehicles 20% Furniture & Fittings 10%

(vi) 2½% should be provided on Receivables for doubtful debts.

You are required to:

(a) Make necessary adjusting entries in the ledger

(b) Extract the Adjusted Trial Balance or Final Trial Balance

(c) Present Statement of Profit& Loss and Statement of Financial Position as at 31 December, 20116 using T account and vertical format.

SUGGESTED SOLUTION TO ILLUSTRATION 5.6

a JOURNAL ENTRIES

	DR	**DR**
	₦	**₦**
RATES	1,555	
Accrued Rates Account		1,555

Being rates outstanding as at 31/12/2021		
(ii)	DR	CR
INSURANCE	₦	₦
Prepaid Insurance	315	
Insurance Account		315
Being Insurance paid in Advance up to 31 March, 2022		
(iii)		
LIGHTING EXPENSES		

Accrued Lighting Expenses		835
Being Accrued Expenses on lighting for the year		
(iv)		
DEPRECIATION PROVISION		
(a) Motor Vehicles		
Depreciation Account	25,875	
Provision for Depreciation on motor vehicle		25,875
Being provision for Depreciation on Motor vehicles at the rate of 20% on cost.		
(b) Furniture & Fittings		
Depreciation Account	5,562	
Provision for Depreciation Account		5,562
Being provision for Depreciation on Furniture & Fittings at the rate 10% on cost		
(v)		
DOUBTFUL DEBT PROVISION		
Bad & Doubtful Debts A/c	2,520	
Allowance for Bad & Doubtful Debts		2,520
Being 2½% Allowance for Bad & Doubtful Debts on Receivables		
Lighting Expenses	835	

(b) **EXTRACTS OF FINAL TRIAL BALANCE**

	Opening Trial Balance		Adjustments		Final Trial Balance	
	DR	**CR**	**DR**	**CR**	**DR**	**CR**
Inventories	61,290				61,290	
Revenue		489,600				489,600
Purchases	320,560				320,560	
Salaries &Wages	99,925				99,925	
Motor Vehicles	129,375				129,375	
Furniture & Fittings	55,620				55,620	
Motor Veh. Exp.	17,190				17,190	
Insurance	2,025			(ii)315	1,710	
Office Expenses	5,580				5,580	
Rates	7,775		(i) 1,555		9,330	
Lighting Expenses	4,295		(ii) 835		5,130	
Receivables	100,800				100,800	
Payables		44,800				44,800
Cash &Bank	12,465				12,465	
Drawings	31,050				31,050	
Capital		313,550				313,550
Accrued Rates				(i)1,555		1,555
Prepaid Insurance			(ii)315		315	
Accrued Light Exp.				(iii)835		835
Depreciation Account M/V			(iva)25,875		25,875	
Provision for Depreciation MV				(iva) 25,875		25,875
Depreciation A/c Furniture & Fittings			(iv(b)5,562		5,562	
Provision for Depreciation F&F				(iv(b)5,562		5,562

Bad & Doubtful Debt			(v)2520	~~(v)2,520~~	2,520	
Allow. For Bad & Doubt Debt			~~2520~~	(v)2,520		2,520
	847,950	847,950	36,662	36,662	884,297	884,297

TUTORIAL NOTES

- The Opening Trial Balance Columns contain figures obtained directly from the Trial Balance in the question.
- The Adjustment Columns contain figures obtained from the Adjusting Entries (i.e .the Journal & Ledger Entries).
- Final Trial Balance or Adjusted Trial Balance Columns contain the Net Sum of the figures in Opening Trial Balance Columns and the Adjustment Columns while taking note of debit and credit entries.
- The figures in the final Trial Balance or Adjusted Trial Balance will now be used to prepare the financial statements.

(ai) STATEMENT OF PROFIT OR LOSS

	₦	₦		₦
Opening inventories	61,290		Revenue	489,600
Purchases	320,560			
	381,850			
Less:				
Closing inventories (31/12/2021)	(76,230)			
Cost of sales		305,620		
Gross Profit C/d		183,980		
		489,600		489,600

EXPENSES	₦		₦
		Gross Profit B/d	183,980
Salaries &Wages	99,925		
Motor vehicles Exp.	17,190		
Insurance	1,710		
Office Exp.	5,580		
Rates	9,330		
Lighting Expenses	5,130		
Depreciation Exp (M/V)	25,875		
Depreciation Exp (Furniture & Fitting)	5,562		
Bad & Doubtful Debt	2,520		
Net Profit for the year	11,158		
	183,980		
			183,980

USING HORIZONTAL FORMAT YAHO VENTURES STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2021

ASSETS

	₦	₦		₦	₦	₦
CAPITAL			Non-current Assets			
Capital A/c		313,550	Motor Vehicle (Cost)		129,375	
			Less: Prov. Deptn.		(25,875)	
Add: Net Profit		11,158				
		324,708	Net Book Value			103,500
Less: Drawings		(31,050)	Fur.& Fitt. (Cost)		55,620	
		293,658	Less:			

			Prov. For Deptn.		(5,562)
CURRENT LIABILITIES			Net Book Value		50,058
Payables	44,800				153,558
Accrued Rate	1,555		**CURRENT ASSETS:**		
Accrued Lighting Exp.	835		Inventories	76,230	
			Receivables 100,800 Less Provision for		
			Doubtful Debt (2,520)	98,280	
			Prepaid Insurance	315	
			Cash &Bank	12,465	
					187,290
		340,848			340,848

(aii) **PRESENTATION OF THE FINAL ACCOUNTS IN VERTICAL FORMAT**

YAHO VENTURES

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2021

	₦	₦
Revenue		489,600
Opening inventory	61,290	
Add: Purchases	320,560	
Cost of goods available for sale	381,850	
Less Closing inventories	(76,230)	
Cost of sales		(305,620)
Gross Profit		183,980
Less: Expenses		
Salaries &Wages	99,925	
Motor vehicle Expenses	17,190	
Insurance	1,710	
Office Expenses	5,580	
Rates	9,330	

Lighting Expenses	5,130	
Depreciation Exp. (Motor Vehicle)	25,875	
Depreciation Exp. (Furniture & Fittings)	5,562	
Bad & Doubtful Debt	2,520	172,822
Profit for the year		11,158

YAHO VENTURES

STATEMENT OF FINANCIAL POSITION AS AT31 DECEMBER 2021

Non-current Asset	₦	₦	₦
Motor vehicle at cost			
Less		129,375	
Provision for Depreciation		(25,875)	
Carrying Value			103,500
Furniture & Fittings at cost		(55,620)	
0) Less			
Provision for Depreciation		5,562	50,058
			153,558
CURRENT ASSETS			
Inventories		76,230	
Receivables	100,800		
Less			
Allowance for Doubtful Debt	(2,520)	98,280	
Prepaid Insurance		315	
Cash & Bank		12,465	
		187,290	
CURRENT LIABILITIES			
Payables	44,800		
Accrued Rates Expenses	1,555		
Accrued Lighting Exp.	835	(47,190)	
			140,100
			293,658

CAPITAL	
Capital Account	313,550
Add: Net Profit	11,158
	324,708
Less: Drawings	31,050
	293,658

5.14 Chapter Summary

This chapter dealt with accounting process and documentations that leads to preparation of Financial statement, with particular emphasis on how to make necessary Adjusting entries for prepayment, accruals, provision for depreciation and allowance for Bad & Doubtful Debts.

It also deals with the preparation of Work Sheet or Extended Trial Balance as a means of preparing financial statement of Sole Proprietorship . Correction of bookkeeping errors was also discussed.

3. 15 REVISION QUESTIONS

3.15.1 MULTIPLE CHOICE AND SHORT ANSWER QUESTIONS

1. Accrued Salaries of ₦18,000 due to employees for December 31 2021 was omitted and not included in the financial statements prepared for the year ended 31 December 2021.
   Which of the following will be correct?

   A. Assets of the company would be over-stated by N18,000

   B. Liabilities of the company would be over-stated by N18,000

   C. Net profit of the company would be over-stated by N18,000

   D. Liabilities of the company would be under-stated by N18,000

   E. Capital of the company would be over-stated by N18,000

2. A sole proprietor paid his personal Income Tax by withdrawing cash for the payment from his business. The double entry posting in ledger with respect to the above transaction is:

   A. DR Taxation A/C; CR cash A/C

   B. DR Personal Tax A/C; CR Bank A/C

   C. DR Drawings A/C; CR Cash A/C

   D. DR Cash A/C; CR Drawing A/C

   E. CR Cash A/C; DR Taxation A/C

3. The Agreement of a trial balance will not disclose **ONE** of the following fundamental errors in the accounting books.
   - A. Error in computation of balances
   - B. Transposition of figures
   - C. Errors of wrong posting in the debit and credit columns
   - D. Errors of principle
   - E. Double entry errors

4. The opening inventory of a firm at the beginning of the financial year isN30,0000 and at the end of the financial year it isN20,000 while the sales and purchases are N350,000 and N250,000 respectively.
   What is the Gross Profit or Loss?
   - A. ₦90,000 Loss
   - B. ₦50,000 Profit
   - C. ₦10,000 Loss
   - D. ₦20,000 Profit
   - E. ₦90,000 Profit

5. The Depreciation methods that ensure that the depreciation charged against income reduces as the year of usage of the non- current assets increases is known as?
   - A. Straight Line Method
   - B. B Revaluation Method
   - C. Sinking Fund Method
   - D. Reducing Balance Method
   - E. Depletion method

6. Error of Commission is ONE of the errors that will not be disclosed with Agreement of a Trial Balance. State **TWO** other errors of this nature.

7. What is an Extended Trial Balance?

8. State the various phases of an Accounting Cycle.

9. State **FOUR of** the various methods of providing for Depreciation on Property plant and equipment.

10. State TWO acceptable methods of presenting the financial statement of a Sole trader.

3.15.2 SOLUTION TO MULTIPLE CHOICE AND SHORT ANSWER QUESTIONS

1. D
2. C
3. D
4. E
5. D
6. (i) Error of principle,
(ii) Compensating error.

7. An Extended Trial Balance is an extension of the initial trial balance. It incorporates details of accounting adjustments made to the initial trial balance, in order to arrive at the final trial balance required for the preparation of the financial statement.

8. (i) Transaction should be analysed
(ii Transaction should be journalized.
(iii) Journal entries should be posted into the ledger.
(iv) Trial balance prepared from the ledger accounts
(vi) Data needed to adjust the accounts should be obtained.
(vii) Work sheet in form of extended trial balance is prepared.
(viii) Financial Statements are generated.

9. (i) Straight line method
(ii) Reducing balance method or declining balance method
(iii) Sum-of-the-years digit method.
(iv) Production unit method

10 (i) Horizontal method or T accounts
(ii) Vertical method.

CHAPTER SIX

CONTROL ACCOUNTS AND RECONCILIATIONS

Chapter contents

a) Introduction
b) Usefulness of Control Account
c) Receivables Control Account and reconciliations
d) Payables Control Account and reconciliations
e) Suppliers Statement reconciliation with Ledger Account
f) Chapter Summary

6.0 Objectives

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

a) Explain the meaning of Control Accounts
b) Understand the relationship between control accounts and receivables and payables ledgers
c) Prepare Receivables Control Account and Payables Control Account
d) Perform Control account reconciliations for both receivables and Payables control accounts
e) Perform Supplier's Statement reconciliation with Payables ledger information.
f) Identify and correct errors through Control accounts reconciliation

6.1 Introduction

A control account is an account which is debited and credited with the totals of the individual transactions already recorded in the individual ledger accounts. It follows therefore that the balance in the control account must be equal to the sum of the separate balances extracted from the individual ledger accounts. In this way it provides a check or control over the entries made in the ledger accounts. Control accounts are also referred to as total accounts.

6.2 Usefulness of Control Accounts.

Control accounts are useful and important in the following ways:

(i) The balances extracted from control accounts could be used when preparing interim financial statements rather than going through labourous extraction of schedule of balances of the individual ledger accounts.
(ii) Control accounts operate as a check or control over entries in the individual ledger accounts especially where different officers maintain the records.
(iii) It helps in early detection of booking errors revealed in the trial balance, as the search for error is restricted to the particular ledger in which the balance of the control account failed to agree with the sum of the individual account balances.
(iv) The application of control accounts knowledge is useful for deterring missing figures/unknown figures of financial items under incomplete record situations.

Control account can be maintained for all the different classes of ledger kept by an enterprise. However maintaining control accounts for trade receivables (credit sales customers) and trade payables (credit purchases suppliers) are more popular because it involves persons outside the enterprise environment.

6.3 Trade Receivable Control Account

The Trade Receivable Control Account is also referred to as Sales Ledger Control Account or Total Receivable Account. It is an account for recording the value of transactions in totals with credit customers. In the account, all transactions which increase the amount owed by the trade receivables are debited in total while all items or transactions which decrease the amount owed by the trade receivables are credited in totals.

The receivable control account will contain some or all of the totals to date for the following transactions posted to the account.

Receivable Control Account

1. Opening debit balance b/d	XX	1. Opening balance (if any)	X
2. Credit sales for the period	XX	2. Cash/cheques received from customers	X
3. Dishonoured cheques (if any)	X	3. Discount allowed	X
4. Dishonoured bills receivable (if any)	X	4. Returns inward/sales returns	X
5. Cash/cheques paid to customers (if any)	X	5. Bills receivables	X
6. Interest charged on customers (if any)	X	6. Bad Debts written off	X
7. Disallowed discount allowed (if any	X	7. Revenue adjustment (customer takes	
8. Revenue adjustment (customer fails to a discount when not expected to do so)	X		
take a discount expected to do so)	X	8. Transfer and set offs (if any)	X
9. Debt recovery expenses (if any)	X	9. Credit notes	X
10. Transfer and set offs (if any)	X	10. Closing debit balance c/d	XX
11. Closing credit balance c/d (if any)	X		
	XX		XX

Illustration I

The information below were extracted from the books ok Kwame Mensa, a sole proprietor at Accra-Ghana for the year ended April 30, 2022.

	¢
Total trade receivables balance at May 1, 2021	2,056,190
Totals during the year: Sales daybook	15,996,500
Returns inward journal	784,600
Cash and cheques received from customers	13,235,400
Bad debts written off	416,500
Discount allowed	1,006,200
Dishonoured cheque	2,013,500
Bills receivables	2,469,280
Legal expenses on debt recovery charge to customers	378,900
Disallowed discount	207,800
Receivables ledger balance transferred to payables ledger	311,614

Required:

Prepare the trade receivables control account indicating clearly the balance due from trade receivables at the end of the year.

Kwame Mensa Enterprise
Trade Receivables Control Account

	¢		¢
Balance b/d	2,056,190	Returns Inwards	784,600
Credit sales	15,996,500	Cash and cheques received	13,325,400
Dishonoured cheques	2,013,500	Bad debts	416,500
Legal expenses charged	378,900	Discount allowed	1,006,200
Disallowed discount	207,800	Bills receivables	2,469,280
		Transfer/setoff	311,614
		Balance c/d	2,429,296
	20,652,890		20,652,890
Balance b/d	2,429,296		

Receivables Control Account Reconciliation

Where transactions have been recorded correctly the balance on the receivable control account in the general ledger must be equal or same with the total of the balances on all the individual customers accounts in sales (receivable) ledger. If the two totals are not equal, a reconciliation check is made to discover the cause of the error(s) which have to be corrected to agree the totals.

A Receivables control account reconciliation therefore, involves a comparison between the totals, searching for and identifying the reasons for any differences between them, and correcting errors that are discovered in the checking process.

Some Bookkeeping Errors which cause difference in Balance

Errors which make the receivable control account balance different from the total of the list of balances extracted from the sales or receivables ledger accounts include the following:

1) Correct debiting of the receivables control account with the total credit sales recorded in the sales daybook while the posting of one or more individual transactions was omitted in the individual customers' accounts in the receivable ledger.
2) Correct crediting of the receivable control account with the total cash received from customers as recorded in the cashbook, but a receipt from a customer is not posted or credited to the customer's personal account in the receivables ledger.
3) Correct debiting of the receivables control account with the total amount of dishonoured cheques from customers as recorded in the cashbook, but a dishonoured cheque from a customer was not posted or debited to the customers personal account in the receivable ledger.
4) Over or under casting of the sales day book such that the wrong total credit sales amount/figure was used in debiting the receivables control account while the customer's

personal accounts in the receivable ledger were correctly debited with the credit sales made to each of them.

5) The recording of transfers or set offs between two accounts of same customer made in the general ledger but not made in the receivables ledger.

Preparation of Receivables Control Account Reconciliation

The first step in any control account reconciliation is to compare the control account balance with the total of all the balances on the individual customer's personal accounts in the receivables ledger or the supplier's personal accounts in the payables ledger as the case may be.

Where a difference exists between the totals, the reason(s) for the difference must be ascertained and the error(s) discovered would be corrected to make the two totals equal. The correction may result in either:

(i) Adjusting the control account balance, or
(ii) Adjusting one or more balances on the individual customer's personal accounts or individual supplier's personal account. Except where there is an undetected error, the two totals purpose to agree after all corrections have been made.

Illustration 2

The balance of the receivables ledger control account in the general ledger of Abedi Enterprise is ¢1,182,180 while the balances on the individual customers personal accounts in the receivables ledger are as detailed below:

	¢
Customer Ayew	330,000
Customer Gyan	242,000
Customer Mensa	176,000
Customer Afrifa	132,000
Customer Nkansah	264,000
	1,144,000

Abedi Enterprise's investigation into the difference between the two totals highlighted the following:

a) Sales returns of ¢17,600 by customer Ayew have not been recorded in the customer Ayew's account in the receivables ledger but are included in the control account balance.
b) Not withstanding the strict discount policy of Abedi Enterprise, customer Gyan was allowed a discount of ¢5,280. This has been posted to his personal account in the receivables ledger, but the transaction was not recorded in the general ledger.
c) Customer Mensa had supplied goods valued at ¢7,800 on credit to Abedi Enterprise. It was agreed that this amount should be set off against amount owed Abedi by Mensa. No postings have yet been made to effect this adjustment in the general ledger or the receivables and payables ledgers.
d) Credit sales amounting to ¢38,400 made to customer Nkansah has not been recorded in his personal account in the receivables ledger, but is included in the receivables control account balance.
e) Bills receivables of ¢12,100 accepted from customer Afrifa for part settlement have been recorded in his personal account in the receivables ledger, but not posted to receivables control account in the general ledger.

Required:
Prepare the Receivables Control Account Reconciliation.

Solution to illustration 2
Abedi Enterprise
Receivables Control Account

	¢		¢
Balance b/d	1,182,180	Discount allowed	5,280
		Setoff/ contra entry	7,800
		Bills receivables	12,100
		Balance c/d	1,157,000
	1,182,180		1,182,180
Balance b/d	1,157,000		

The balances on customer's personal accounts in the receivables ledger in total are:

	¢
Total balances in receivable ledger	1,144,000
Sales returns-customer Ayew	(17,600)
Set off/contra-customer Mensa	(7,800)
Credit sales-customer Nkansah	38,400
	1,157,000

Note that the totals are now reconciled to stand at the correct amount of ¢1,157,000. Consequently the balance on the customer's personal accounts in the receivables ledger would all be corrected to stand as follows:

	¢
Customer Ayew : 330,000 - 17,600	312,400
Customer Gyan : 242,000	242,000
Customer Mensa : 176,000 - 7,800	168,200
Customer Afrifa : 132,000	132,000
Customer Nkansah : 264,000 + 38,400	302,400
	1,157,000

6.4 Trade payable Control Account

The trade payable control account is also referred to as Purchases ledger control account or Total payables account. It is an account for recording the value of transactions in totals with credit suppliers. In the account all transactions which increase the amount of money owed to the trade payables are credited in totals while all items or transactions which decrease the amount owed to the trade payables are debited in totals.

The payables control account will contain some or all of the totals to date for the following transactions posted to the account:

Payables Control Account

1. Opening debit balance b/d (if any)	X	1. Opening credit balance b/d	X
2. Cash/cheques paid to supplies	X	2. Credit purchases for the period	X

3. Discount received	X	3. Interest charged by suppliers (if any)	X
4. Returns outwards/purchases returns	X	4. Interest on bills payable (if any)	X
5. Bills payable	X	5. Transfer and set offs (if any)	X
6. Transfer and set offs (if any)	X	6. Closing debit balance c/d (if any)	X
7. Closing credit balance c/d	XX		
	XXX		XXX

Illustration 3

The following details were extracted from the books Ebuka Enterprise for the year ended September 30, 2021.

	¢
Payables control account balance October 1, 2020	1,897,000
Totals during the year:	
Cash paid to suppliers	9,584,593
Discount received	920,045
Purchases daybook	12,330,500
Purchases returns	559,615
Bills payable	1,043,350
Interest on bills payable	18,970
Debit balance in receivables ledger transferred to payables	189,700

Required:

Prepare the Trade Payables Control Account

Solution to illustration 3

Ebuka Enterprise

Trade Payables Control Account

	N		N
Cash paid to suppliers	9,584,593	Balance b/d	1,897,000
Discount received	920,045	Credit purchases	12,330,500
Purchases returns	559,615	Interest on bills payable	18,970
Bills payable	1,043,350		
Transfer/set off	189,700		
Balance c/d	1,949,167		
	14,246,470		14,245,470
		Balance b/d	1,949,167

6.4.2 Payables Control Account Reconciliation

Where transactions are correctly recorded, the balance on the payables control account in the general ledger must be the same with the total of the list of balances on all the individual suppliers personal account in the purchases (payables) ledger. A payables control account reconciliation therefore involves a comparison between the totals on the payables control account and the list of balances in the payables ledger.

Some errors can cause difference between the two totals such as:

1) Correct crediting of the payables control account with the total credit purchases recorded in the purchases daybook while the posting of one or more individual transaction was omitted in the individual supplier's personal accounts in the payables ledger.
2) Correct debiting of the payables control account with the total cash paid to suppliers as recorded in the cashbook, but a payment to a supplier is not posted or debited to the supplier's personal account in the payable ledger.
3) Over or under casting of the purchases daybook such that the wrong total credit purchases figure was used in crediting the payables control account while the individual suppliers personal accounts in the payables ledger were correctly credited with the credit purchases made from each of them.
4) The recording of transfers or set offs between two accounts of the same supplier may be made in the general ledger but not made in the payables ledger.

Illustration 4

The balance on the payables control account of Gbenga Enterprise was N1,506,383 as at June 30, 2022 while the total of the list of balances extracted from the payables ledger on the same date amounted to N1,491,689. An investigation on the cause(s) of the difference in amount revealed the following:

a) Total cash paid to suppliers of N998,800 was posted to the payables control account as N971,800.
b) A credit balance of N22,383 on the payables ledger had been set off against a receivable's ledger balance but no record had been made in the control accounts.
c) The purchases daybook was undercast by N93,000
d) There was an omission of N58,311 from the list of balances extracted from the suppliers personal accounts in the payables ledger.

Required:

Prepare the Payables Control Account Reconciliation

Solution to illustration 4

Gbenga Enterprise

Payables Control Account

	N		N
Error-cash paid	27,000	Balance b/d	1,506,383
Transfer/set off	22,383	Purchases daybook-Undercast	93,000
Balance c/d	1,550,000		
	1,599,383		1,599,383
		Balance b/d	1,550,000

The balances on the supplier's personal accounts in the payables ledger in totals are:

	N
Total balances in payables ledger at June 30, 2022	1,491,689
Balance previously omitted	58,311
	1,550,000

Note that the balances are now reconciled to stand at the correct amount of N1,550,000.

Reconciliation of Supplier's Statements with Supplier's Ledger Account

Most times suppliers do send monthly statements to their regular credit customers stating all the transactions carried out between the supplier and the customer during the period. The statement will show the amount owed by the customer as determined from the supplier's accounting records. On receipt of the supplier's statement, the customer will naturally compare the information on the statement with his own record of transactions with the supplier for the same period. Any differences between the supplier's statement balance and the supplier's personal account balance as shown in the payables ledger maintained by the customer should be investigated.

The differences in the balance are often caused by errors arising from omissions or incomplete recording of transactions by either the supplier or the customer or both of them. Such as failure to include some sales/purchases transactions, payments made, discounts agreed, returns made and agreed set offs. During reconciliation, the two totals are compared and the reason(s) for any discovered difference is established. Where the error or omission was committed by the supplier, he should be notified and the supplier's statement balance amended accordingly to correct the error. In the same way if the error or omission was committed by the customer in his records, the error or omission should be corrected and the balance standing on the supplier's personal account in the payables ledger will be changed to correct the error. With all the errors identified, explained and necessary corrections effected, the amended balance in the supplier's statement must agree with the corrected balance on the supplier's personal account in the payables ledger maintained by the customer.

Illustration 5

Madam Abike received a statement of account from her supplier Haruna indicating that the money due from her amounted to N191,750 while the records of Madam Abike's payables ledger showed a balance of N109,200 standing in the personal account of Haruna in that ledger. An investigation into the cause of the difference in balance showed the following

a) Madam Abike is yet to record the portion of cash discount amounting to N3,575 disallowed by Haruna.
b) Madam Abike return goods worth N25,350 to Haruna which Haruna has not yet allowed.
c) Madam Abike's cash payment of N43,625 for part settlement has not been allowed for by Haruna.
d) Bills receivable of N10,000 issued by Madam Abike and accepted by Haruna was omitted in statement from Haruna.

Required:

Prepare a reconciliation of Haruna's (supplier) statement with the suppliers account in the payables ledger.

Solution to illustration 5

Reconciliation of suppliers statement balance to supplier's account balance

Supplier's statement:	N
Balance due from Abike	191,750
Adjusted for:	
Sales returns	(25,350)
Cash payment	(43,625)
Bills receivable	(10,000)
Amended balance	112,775
Supplier's Personal Payables Ledger Account:	N
Balance due to Haruna	109,200
Adjustment for:	
Disallowed discount	3,575
Corrected balance	112,775

Chapter Summary

This chapter dealt with control accounts and reconciliation. It focused on the preparation of trade receivables control account and trade payables ledger control account and highlighted the usefulness of control accounts.

It also dealt on the reconciliation of control account balances with individual personal accounts balances in the receivables and payables ledgers. It further considered the reconciliation of the suppliers statement balance with suppliers personal account balance in the payables ledger.

Revision Questions

Multiple choice and short Answer Questions

1) Which of the following items are not recorded in the trade receivable control account?

A. Cash received from customers
B. Discount Allowed
C. Returns Outwards
D. Disallowed Discount
E. Total Credit Sales to Customers

2) Which of the following items are not recorded in trade payables control account?

A. Total Credit Purchases from suppliers
B. Discount Received
C. Cheques Paid to Suppliers
D. Interest on Bills Payable
E. Returns Inward

3) Which of the following will decrease the balance revealed by trade receivables control account?

A. Credit Sales to Customers
B. Dishonoured Cheques
C. Debt Recovery Expenses
D. Payables Ledger Debit Balance Transferred to Receivable Ledger
E. Bills Receivable

4) Which of the following will increase the balance revealed by trade payables control account?
A. Cheque Received from Supplier
B. Purchases Returns
C. Total Credit Sales
D. Bills Payable
E. Receivable Ledger Debit Balance Transferred to Payables Ledger

5) The balance of the receivables ledger control account of Okonkwo Enterprise of N968,420 did not agree with the total of the list of individual customers account balance extracted from the receivable ledger investigation revealed (i) Sales returns of N25,000 recorded in the customer account was not posted in the control account. (ii) Cheque of N36,500 received from a customer was recorded in the control account but not entered in the customers personal account. (iii) Credit sales of N150,000 was not recorded in the sales daybook but posted to the customers personal account. Calculate the amended receivable ledger control account balance
A. N1,143,420
B. N1,093,420
C. N1,056,920
D. N1,029,920
E. N943,420

6) Trade receivables Control account can be referred to as ____________

7) Another name for Purchases ledger control account is ______________

8) State the entries to post a normal receivable control account balance transferred to payables control account.

6.8. Solution to end chapter questions

1. C
2. E
3. E
4. A
5. B
6. Sales ledger Control Account or Total receivable account
7. Purchases ledger Control Account or Total payables account
8. Debit – Payables control account
   Credit – Receivables control account

6.9 Examination like Questions

1) The information below were extracted from the books of Nnamdi Enterprise on January 1, 2021:

Receivables ledger balance N9,996,800 Debit and N39,987 Credit
Payables ledger balance N5,473,248 Credit and N36,863 Debit

During the year end December 31, 2021	N
Credit Sales	28,740,800
Credit Purchases	24,579,632

Cash received from trade receivables	26,391,552
Cash paid to Trade payables	24,712,090
Discount allowed	1,099,648
Discount received	1,029,670
Returns inwards	531,080
Bills receivables	1,112,144
Bills payable	1,711,952
Dishonoured bills receivable	118,712
Disallowed discount	6,248
Returns Outwards	387,376
Bad debts written off	199,936

Debit balance in payables ledger transferred to receivables ledger N8,122.
Closing balances at December 31, 2021:
Receivables ledger N9,501,958 Debit and N5,623 Credit
Payables ledger N2,223,663 Credit and N40,612 Debit

Required:

Prepare for Nnamdi Enterprise a Trade Receivable Control Account and a Trade Payables Control Account for the year bringing down the balances as at December 31, 2021.

2) At June 30, 2022 the trial balance of Jubril Enterprise refused to balance. In an effort to locate the difference, it was decided to prepare control accounts for the total receivables and payables ledgers respectively.

From the following details prepare these accounts and indicate any error that has been made:

	N
July 30, 2021: Payables ledger balances	772,874
Receivable ledger balances	1,275,462
June 30, 2021: Purchases Journal	9,984,705
Sales Journal	12,898,165
Returns outwards Journal	171,061
Returns inwards Journal	294,318
Cheques paid to suppliers	9,438,060
Petty cash paid to suppliers	5,039
Cheques and cash received from customers	12,013,016
Discounts allowed	375,972
Discounts received	137,856
Bad debts written off	25,582
Customers cheques dishonoured	2,138
Balances on the receivables ledger set off against credit balances in the payables ledger	66,926

The list of balances taken from the Payables ledger shows a total of N938,637 and that from the receivable ledger a total of N1,399,107.

6.10 **Solutions to Examination like Questions**

1) Nnamdi Enterprise

Trade Receivable Control Accounts

	N		N
Balance b/d	9,996,800	Balance b/d	39,987
Sales	28,740,800	Cash received	26,391,552
Dishonoured bills	118,712	Discount allowed	1,099,648
Disallowed discount	6,248	Returns inwards	531,080
Transfer/set off	8,122	Bills receivable	1,112,144
Balance c/d	5,623	Bad debts written off	199.936
		Balance c/d	9,501,958
	38,876,305		38,876,305
Balance b/d	9,501,958	Balance b/d	5,623

Trade Payables Control Account

	N		N
Balance b/d	36,863	Balance b/d	5,473,248
Cash paid	24,712,090	Purchases	24,579,632
Discount received	1,029,670	Transfer/set off	8,122
Bills payable	1,711,952	Balance c/d	40,612
Returns outwards	387,376		
Balance c/d	2,223,663		
	30,101,614		30,101,614
Balance b/d	40,612	Balance b/d	2,223,663

2) Jubril Enterprise

Trade Receivables Control Account

	N		N
Balance b/d	1,275,462	Returns Inwards Journal	294,318
Sales Journal	12,898,165	Cheque and cash received	12,013,016
Cheque dishonoured	2,138	Discount allowed	375,972
		Bad debts written off	25,582
		Transfer/set off	66,926
		Balance c/d	1,399,951
	14,175,765		14,175,765
Balance b/d	1,399,951		

Trade Payables Control Account

	N		N
Returns outwards Journal	171,061	Balance b/d	772,874
Cheques paid	9,438,060	Purchases Journal	9,984,705
Petty cash paid	5,039		
Discount received	137,856		
Transfer/set off	66,926		
Balance c/d	938,637		
	10,757,579		10,757,579

	Balance b/d	938,637

The balance in the trade payables control account agreed with the total of the list of balances obtained from the payables ledger. But the balance in the trade receivables control account is N1,399,951 while that extracted from the list of balances in receivables ledger totalled N1,399,107. Therefore, there is an error of N844 in the receivables ledger.

CHAPTER SEVEN

PARTNERSHIP ACCOUNTS

Chapter contents

This section covers 20% of the syllabus and there is usually a question on this topic in every diet of the examination at this level. The areas of coverage on partnership accounts as stated in the syllabus include the following:

A. Features of Partnership to include:

i. Definition
ii. Formation
iii. Types of partners
iv. Partnership agreement and
v. Accounts peculiar to partnership

B. Changes in partnership structure to include:

i. Accounting for Goodwill
ii. Revaluation of Assets
iii. Admission of new partners
iv. Death or retirement of a partner (Dissolution of partnership)
v. Amalgamation of a partnership (with a sole proprietor or another partnership)
vi. Conversion of partnership to Limited Liability Company

7.0 Learning Objectives

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

(i) Define Partnership And State Types Of Partners In A Partnership

(ii) Explain How A Partnership Is Formed

(iii) State The Contents Of A Partnership Agreement And Rules Applicable In Case There Is No Agreement

(iv) Identify Accounts That Are Peculiar To The Partnership Business And

(v) Prepare Partnership Accounts under normal situations

7.1 Definition of Partnership

A partnership is an association that brings the talents and resources of two or more people together to carry on a business in common with a view of profit. The business could be carried on by all or any of them for the benefit of all of them. The minimum number to form a partnership is two people with a maximum limit of twenty persons except for firms of professionals such as solicitors, accountants and chartered engineers and surveyors, which are exempted from the maximum rule.

7.2 Types of Partners in a Partnership

In a partnership, there are different types of partners based on different types of classification. Participation in management and the extent of liability borne are the two major criteria used to classify the partners. The different types are enumerated and discussed below one after the other with their different characteristics.

General Partner or Active Partner: this partner has full power of participating in the conduct of the partnership business and is liable to the full extent of his estate for the partnership debt hence have unlimited liability.

Limited Partner: this partner is liable for the debts of the partnership only up to the amount he has agreed to contribute to the business and he cannot take part in the management of the business.

Sleeping or Dormant Partner: he does not take active part in the management of the partnership business; he contributes money and share in the partnership profit. By inference, this partner usually has limited liability.

Nominal Partner: this partner has no capital contribution in the partnership business but share in the profit. This is usually based on agreement as such partner must have allowed his name to be used by the business as a result of his good image, which the partnership would want to be associated with, to enhance their business privileges.

One or more partners in a partnership may limit their liability, but at least one partner must have unlimited liability. Every partner in a partnership is an agent of the firm and the other partners for the purpose of the business of the partnership.

7.3 Formation of Partnership

In order to form a partnership, a copy of the partnership agreement and a prescribed form signed by all the partners should be delivered to the regulatory authority in charge of business and company registration in the country where the partnership business is to be domiciled. For instance, in Ghana, the Registrar General is the relevant authority while in Nigeria; the documents will be delivered to the Corporate Affairs Commission for registration. The form would contain the following:

i. The name of the partnership
ii. The general nature of business
iii. The principal place of business and any other places where the business is carried on The address and post office box number

iv. The names and any other former names, residential addresses and business is carried on; and
v. The date of commencement of the partnership

The firm would be registered upon satisfaction that the contents of the documents are in order and after payment of the prescribed fee.

7.4 Partnership Agreement

It is possible to form a partnership at will with or without the existence of any agreement, whether oral or written. However, it is expedient that, the partners before doing business together should come to an understanding on how issues are to be handled in the course of the partnership. The basic document that sets out the conditions under which the partners would carry on the business of partnership is the Partnership Agreement otherwise known as Partnership Deed. Usually the issues set forth in the agreement would include the following:

a. **Capital:** The agreement would indicate whether each partner should contribute a fixed amount of capital or not and how much each partner should contribute.
b. **Profit Sharing:** How profits and losses should be shared among the partners will be spelt out; whether they are capital or revenue profits or losses.
c. **Interest on capital and drawings:** Whether interest on capital or drawings should be allowed or charged before arriving at divisible profits, and if so at what rate.
d. **Interest on loan by partners:** The rate of interest payable on any loan advanced by any of the partners.
e. Whether current accounts are to bear interest, and if so at what rate;
f. Whether partners' drawings are to be limited in amount so that the current account does not turn into debit balance or not;
g. Whether partners are entitled to remuneration for their services before arriving at divisible profits and if so what amounts and which of the partners;
h. How the books of account would be kept and where they should be kept.
i. The method for the valuation of assets i.e. goodwill in case of an incoming or outgoing partner;
j. The method and procedures for settlement of disputes;
k. The condition for admission of new partner

It should be noted that partnership is by mutual agreement and issues that have been clearly spelt out in the deed cannot be set aside. However, the partners can all agree to either change or modify any of the clauses in the agreement at any time.

7.5 Rules Applicable in the Absence of Partnership Agreement

Where there is no partnership agreement, or the existing one is silent over a number of vital issues, then the following rules shall apply:

a) Partners shall share profits and losses equally and shall contribute equally to capital.

b) The firm shall indemnify every partner in respect of payments made and liabilities incurred by him/her in the ordinary and proper conduct of the business of the firm;

c) Any advance or payment in excess of agreed share of capital will attract an interest at the rate of 5%;

d) Every partner may take part in the management of the firm;

e) No partner shall be entitled to remuneration for acting in the firm's business;

f) No person may be introduced as a partner without his consent and the consent of all the existing partners.

g) Partners shall not be entitled to payment of interest on capital before ascertainment of profits of the firm;

h) The partnership books and accounts shall be kept at the place of business of the firm or at the principal place of business and every partner, may when he/she deems fit, have access to and inspect and copy any of them; and.

i) Differences arising from ordinary matters in connection with the partnership business may be decided by majority of the partners.

However, no change in the nature of the partnership business may be made without the consent of all existing partners.

7.6 Accounts That Are Peculiar To the Partnership Business

The capital of a partnership business would normally be contributed by more than one person. Therefore, in addition to keeping the record of the partnership business transactions, record of each partner's contribution to the business must be kept. This is usually done through a current account and/or a capital account depending on whether the capital account has been decided by the partners to be fixed or fluctuating.

In most cases, partners would want their original or initial contributions to remain intact, at least in the books. In such a case, there is the need to keep a "Current Account" on behalf of the partners to take care of other dealings between a partner and the firm. The Current Account, if it is kept, is a very important account which records all transactions between the partners and the firm, except the initial contributions. Thus, interest on capital, interest on loans, salaries and share of residual profits must pass through the Current Accounts. Drawings by partners, whether cash or in kind, should either be directly debited to either the Drawings Account or the Current Account.

Drawings should not be debited against the Profit or Loss Account because it is neither an expense nor a charge against profit. It is debited to the current account.

Where a partner makes an advance to the firm, the amount so advanced should be credited to a loan Account. Normally such advance would attract an interest of 5% or the partnership agreement might stipulate the rate agreed on by all the partners. Interest on loans would be deducted from profit before arriving at distributable profit. Where the partners agree that there should be interest on capital accounts, the interest on capital should never be charged to Income Statement, it must be charged against the statement of distribution of income.

The Statement of Distribution of Income would be credited with the interest on drawings, and debited with interest on capital, share of profit or loss, and salaries of partners if any.

Therefore in a partnership business, the following accounts could be found for each of the partners:

i Fixed Capital Account

ii. Current Account

iii. Fluctuating Or Floating Capital Account (combined i and ii)

iv. Loan Account

v. Salary Account

vi. Drawings Account

vii. Interest Account

In addition to the above, a partnership business will prepare a Statement of Distribution of Income to show how partnership profit is to be shared among the partners. This is the additional statement prepared by a partnership business which distinguishes it from a sole proprietor's business.

7.7 Guaranteed Share of Profit

Occasionally, there are agreements that a partner will not receive a share of profit that is less than a specified amount annually from the partnership business. If there is a year when the share of profit due to such partner is less than the stated amount, then the deficiency will be borne by the other partners in their profit and loss sharing ratio or the ratio in which they contribute to capital if that was the initial agreement.

7.8 Recording of Partnership Transactions

The relevant accounting entries for recording transactions in a Partnership are as follows:

Drawing of stocks for personal use:
Debit: Partner's Current Account
Credit: Trading Account
Payment of expenses of the Firm from personal resources:
Debit: Profit & Loss Account
Credit: Current Account

Interest on loan advanced by a partner:
Debit Profit & Loss Account
Credit Partner's Current Account

Interest on drawings:
Debit Partner's Current Account
Credit Statement of distribution of income

Interest on Capital Account:

Debit Statement of distribution of income
Credit Partners Current Account

Partner's Salary:
Debit Statement of distribution of income
Credit Partner's Current Account

Share of Profit:
Debit Statement of distribution of income
Credit Partner's Current Account

Share of Loss:
Debit Partner's Current Account
Credit Statement of distribution of income

Drawings by a partner:
Debit Partner's Current Account
Credit Partner's Drawings Account

7.9 Worked Examples

Let us illustrate some of the points raised with the following examples

Illustration 7.1

Mamah and kwesi have been in partnership for the past ten years. The accounts of the partnership are made up to 31 December. Interest on drawings is charged at the rate of 15% and interest allowed on Capital is at 10%. Kwesi received a salary of □ 76 million per annum. The balance of profit is shared as follows: Mamah 3/5 and Kwesi 2/5. At 31/12/2021 the following balances appeared in the firm's books:

Capital Accounts:	□ m
Mamah	190
Kwesi	114
Current Accounts:	
Mamah	95 Cr
Kwesi	57 Cr

The net profit for the year ended 31 December 2021 was □ 285 million and at that date, the balances on the Partner's Drawings Accounts were: Mamah □□□□ million and Kwesi □ 95 million.

Prepare the following:

(a) The Statement of Distribution of income of the Partnership for the year to 31 December 2021.
(b) The Partner's Current Accounts as at 31 December 2021.

Solution 7.10.1

<u>Statements of Distribution of Income for the Year Ended 31 December 2021</u>

		□ m			□ m
Current Accounts:			Net Profit B/d		285.0
Interest on Capital	Mamah	19.0	Current Accounts:		
	Kwesi	11.4	Interest on Drawings:	Mamah	17.1
				Kwesi	14.3
Salary	Kwesi	76.0			
Share of Profit					
	Mamah (3/5)	126.0			
	Kwesi (2/5)	84.0			

316.4 316.4

Table 7.1

Partners' Current Accounts

	Mamah	Kwesi		Mamah	Kwesi
31/12/2021 Interest on Drawings	□m	□m	1/7/2021 Bal. B/d	□ m	□ m
	17.1	14.3	31/12/2021	95.0	57.0
31/12/2021 Drawing			Interest on Capital Salary Share of Profit	19.0	11.4
				-	76.0
Bal. c/d	114.0	95.0		126.0	84.0
				240.0	228.4
	108.9	119.1			
	240	228.4			

Illustration 7.2

Zumi, Brah and Zotu started a partnership on the 14th of January, 2015 sharing profits and losses in the ratio 2:2:1. The partners agreed that partners' capital accounts and drawings were to attract interest. The trial balance of the partnership as at 30 September 2020 after the preparation of the Profit & Loss Account for the period was as follows:

	DR	CR
Current Accounts:	₦	₦
Zumi		24,000
Brah	6,000	
Zotu		13,500
Capital Accounts:		

Zumi		150,000
Brah		135,000
Zotu		120,000
Loan By Zotu		30,000
Bank & Cash	31,500	
Creditors		27,000
Profit & Loss Account		51,000
Debtors	40,500	
Stocks at 30/9/06	52,500	
Vehicle	97,500	
Furniture & Fittings	22,500	
Buildings	300,000	———
	550,500	550,500

The following have not been taken into consideration before preparing the trial balance.

(a) Goods taken for personal use by Zumi ₦7, 000; and Brah ₦3, 500.

(b) General expenses paid by Brah personally was ₦2, 250

(c) Zotu received ₦4, 500 as salary from the partnership

(d) Cash drawings made were as follows:

Zumi N9, 000 Brah ₦6,000 and Zotu ₦4,500

(e) Interest on drawings: Zumi ₦1, 000; Brah ₦550: Zotu N450

(f) Interest on loan Zotu ₦3,000

(g) Interest on Capital account is charged at the rate of 5%

You are Required to Prepare:

(a) The Profit & Loss and the Statement of distribution of incomes

(b) The Partners Current Accounts

(c) The statement of financial position as at 30/09/20

Solution 7.2

(a) **Income Statement Zumi, Brah, Zotu & Co. for the year ended 30 September 2006**

		₦	₦
Balance per Trial Balance			51,000
Current A/cs: Goods taken			
	Zumi	7,000	
	Brah	3,500	
			10,500
			61,500
Current A/cs: Brah	(General expenses)	2,250	
Zotu	(interest on loan)	3,000	(5,250)
Net Profit			56,250

Statement of Distribution of Income Account for the year ended 30 September 2020

		₦	₦
Net Profit		56,250	56,250
Current A/cs:	Interest on drawings:		
	Zumi	1,000	
	Brah	550	
	Zotu	450	
2,000			
			58,2
		50	
Current Accounts:	Salary to Zotu		
	4,500 Interest on Capital		
	Zumi	7,500	
	Brah	6,750	
	Zotu	6,000	24,750
Current Accounts:	Share of Profit:		
	Zumi (2/5)		13,400
	Brah (2/5)		13,400
	Zotu (1/5)		6,700
			58,250

Partners Current Account

	Zumi	Brah	Zotu		Zumi	Brah	Zotu
	₦	₦	₦		₦	₦	₦
Bal B/d	-	6,000	-	Bal B/d	24,000	-	13,000
Goods taken	7,000	3,500	-	Interest on loan	-	-	3,000
				Salary			4,500
Interest on Drawings	1,000	550	450	General expenses	-	2,250	-
Drawings	9,000	6,000	4,500	Interest on Capital	7,500	6,750	6,000
Balance C/d	22,900	6,350	28,750	Share of Profit	13,400	13,400	6,700
	44,900	22,400	33,700		44,900	22,400	33,700

7.10 Accounting for Goodwill in Partnership

Goodwill is an intangible asset usually not listed in an entity's financial statement like other tangible assets. It is the excess value of a business over the net realisable value of its separately ascertainable assets. Goodwill may be as a result of the following attributes found in a firm:

i. Monopolistic advantage
ii. Strategic location of the firm
iii. A long established list of experienced employees
iv. Reputable customers' patronage built sustained customers demand and taste satisfaction.
v. High reputation for credit ratings
vi. Good employer and employee relationship
vii. High quality products and services
viii. Competent Management Team
ix. Organized and effective advertising and marketing strategy

Goodwill could be purchased, un-purchased or negative. Un-purchased goodwill is inherent in the firm, generated within the business in the course of normal business activities. Purchased goodwill is derived from valuation during the acquisition of a business when the purchase consideration is more that the net book value of the assets acquired. If such purchase consideration is lower than the net book value of the assets then negative goodwill is the difference.

In a partnership, a number of events take place that will give rise to the recognition and valuation of goodwill in the partnership business whether such is to be kept in the books or not. As long as there is a change in the structure or composition of the partnership, then goodwill must be recognised and could be treated in different ways. These events include: Admission of a new partner, retirement or death of a partner, amalgamation and conversion of partnership business.

7.11.1 Recording of Goodwill in Partnership Accounts

Goodwill could be calculated based on:

i. Purchase of profits or average profits of some years

ii. Weighted average method or

iii. Super-profit method.

At this stage the bookkeeping aspects of goodwill is what is required, hence valuation issues are deferred to another stage of the examination.

There are a number of ways in which goodwill recognised and valued could be treated in the books of accounts. These include the following:

i. **Raising a goodwill account:** This method is adopted if goodwill is to be kept in the books of the firm. The amount of goodwill agreed upon is shared among the old partners and credited in their old profit and loss sharing ratio.
   Debit Goodwill Account

   Credit Capital Accounts of partners in the old firm in the existing profit sharing ratio

ii. **Payment for goodwill:** In this case the goodwill account is not to be maintained in the books; the new partner pays for his own share of the goodwill in addition to the capital contribution. The cash book will be debited with the payment while the old partners will be credited in the old profit and loss sharing ratio.

iii. **Direct payment to old members for goodwill:** No record of this in the partnership books as the new member paid directly to the old partners in old profit and loss ratio.

iv. **Withdrawal of cash by old partners:** Instead of crediting old partners and debiting goodwill, the old partners will withdraw cash equivalent to their share of goodwill. Goodwill account is debited while cash account is credited.

v. **Adjustment of capital account of partners:** If the new partner is not to pay cash for goodwill and goodwill account is not to be maintained in the books of the partnership despite its existence, then it might be necessary to adjust the capital account of partners. The new partner's share of goodwill will be credited to the old members in their profit and loss sharing ratio and debited to the new partner's capital account.

   Debit Goodwill Account

   Credit Capital Accounts of partners in the old firm in the old profit sharing ratios.

   Debit Capital Accounts of partners in the new firm in the new profit sharing ratio

   Credit Goodwill Account to close the account

7.11 Revaluation of Assets

Apart from recognition and valuation of goodwill, revaluation of assets also usually accompanies change in structure or composition of a partnership business in the interest of fairness and to maintain equity between the partners.

7.12.1 Bookkeeping in Respect of Revaluation

If an asset is re-valued, three situations can arise. The asset may increase in value; decrease in value or the value placed on it may be the same as the book value. If the value does not change, there will not be any bookkeeping entries to be made. If there is an increase in value, that is a capital profit, you need to debit the Asset account with the difference between the previous value and the new value and credit the Revaluation Account.

On the other hand, if there is a decrease in value, there is a capital loss on revaluation, debit the Revaluation Account of partners and credit Asset Account.

Illustration 7.12.1

Mensah and Babatunde have been partners for some time. On 26th March 2022, they decided to admit Shola. So they requested for a revaluation of the assets of the partnership.

The Statement of Financial position of Mensah and Babatunde as at 31st March 2022, was as follows:

Non-Current Assets	**Cost**	**Depreciation**	**Net Book Value**
	¢000	¢000	¢000
Freehold Property	7,600	2,850	4,750
Plant & Machinery	4,275	2,375	1,900
Motor Vehicles	3,610	2,185	1,425
	15,485	7,410	8,075
Current Assets:			
Inventories		1,330	
Receivables		1,140	
Bank and Cash		7,125	
		9,595	
Less Acct. Payable		4,485	5,110
			13,185
Capital Accounts			
Mensah			4,800
Babatunde			4,800

			Current Accounts:	
1.	Freehold Property	2,850	Mensah	1,585
	Plant and Machinery	2,375	Babatunde	2,000
	Motor Vehicles	2,185		13,185

The new valuations were as follows:

	¢000
Freehold Property	9,500
Plant and Machinery	1,425
Motor Vehicles	1,140

It was also agreed that allowance for doubtful debts should be made to 2½ of receivables. Creditors agreed to receive ¢3,000,000 for full settlement of their interest.

Required:

(a) Pass the necessary journal entries to give effect to the revaluation of the assets.
(b) Show the Partners Capital Accounts
(c) Show the Revaluation Account

Solution 7.12.1 Note:

Let us note that in the accounts proper, non-current assets are usually shown at cost or revalued amounts. Hence, the net assets shown in the balance sheet would not have any T accounts. Therefore, it would be necessary to close the provision for Depreciation Account. We would then be left with the assets accounts.

Compare the balances on the assets accounts with the revalued figures. If the revalued amounts are higher, it means the assets have increased in value. The only way to record increases in the assets accounts is to debit the assets accounts with the difference. In the same way, to record a decrease in an asset account, you need to credit the asset account. To complete the double entry you need to pass the other entry through the Revaluation Account.

On receivables, a 2½% of provision has to be made. So let us debit the Revaluation account with ¢28,500 and credit Provision for Doubtful Debt Account with the same amount.

	DR	CR
(a) ebit: Provision for depreciation:		
Credit: Revaluation Account		7,410

To close the provisions on depreciation accounts

2. Debit: Freehold Property 1,900

Credit: Revaluation Account 1,900

To record increase in the balance on freehold property

3. Revaluation Account 5,348.5

Plant and Machinery 2,850

Motor Vehicles 2,470

Provision for doubtful debt 28.5

Being adjustment needed to reflect the revalued amounts

4. Payables Account 1,485

Revaluation Account 1,485

To record the decrease in the payable balance

5. Debit: Revaluation Account 5,446.5

Credit: Partners‟ Capital Account
5,446.5
To close off the Revaluation Account

(a) Revaluation Account

	¢000		¢000
Plant and Machinery	2,850	Provision on Depreciation	
7,410 Motor Vehicles	2,470	Freehold Property	
	1,900	Provision for doubtful debts	28.5
		Creditors Account	
		1.485	
		Share of profit	
Partners' Capital Accounts		Mensah	(1/2)

	2,723.25	
Babatunde (1/2)	2,723.25	
	10,795	
		10,79

Capital Accounts

	Mensah ¢000	Babatunde ¢000		Mensah ¢000	Babatunde ¢000
Bal c/d	7,523.25	7,523.25	Balance b/d	4,800.00	4,800.00
			Revaluation	2,723.25	7,523.25
7,523.25		2,723.25	7,523.25		7,523.25
b/d	7,523.25	7,523.25			

7.12 Chapter Summary

A partnership is an association between two or more people carrying on a business in common with a view of profit. The business could be carried on by all or any of them for the benefit of all of them; any member could take active part in the management of partnership. The number of members ranges from two to twenty except for firms of professionals that could have up to fifty members. The partners could have their liability limited or unlimited but there must be at least a general partner whose liability will be unlimited. We also have sleeping or dormant partners who contribute capital and share in the profit but do not take active part in the management of the company. Nominal partners do not contribute capital but share in the profit of the partnership perhaps because he allowed his name to be used in the business.

Partnership business is one of the simplest business enterprises to form. The firm would be registered upon satisfaction that the contents of the partnership agreement and prescribed form are in order and with the payment of the prescribed fee. It is possible to form a partnership at will with or without the existence of any agreement, whether oral or written. Partnership is by mutual agreement and issues that have been clearly spelt out in the deed cannot be set aside. However, the partners can all agree to either change or modify any of the clauses in the agreement at any time. In case of dispute and circumstances not provided for in the partnership deed or when there is no written agreement at all, there are provisions in the Partnership Act on how to resolve issues relating to the business.

In addition to keeping the record of the partnership business transactions, a partnership keeps record of each partner's contribution to the business through a current account and/or a capital account depending on whether the capital account has been decided by the partners to be fixed or fluctuating. Therefore, it is usual to find the following accounts being kept in respect of each partner: Fixed Capital Account, Current Account, Fluctuating Or Floating Capital Account, Loan Account, Salary Account, Drawings Account and Interest Account. A Statement of Distribution of Income (known as Profit and Loss Appropriation Account) will also be prepared by the partnership business after determination of trading profit.

A partner may be given a guaranteed share of profit whereby if at any period the share of profit due to the partner is lower than the agreed amount, the other partners will share the deficiency in the profit and loss sharing ratio. Normal double entry principles are followed in the partnership rules with adherence to basic accounting principles and concepts except when there are changes in the structure of partnership.

CHAPTER EIGHT

PARTNERSHIP ACCOUNTS 2

Chapter contents

a. Changes in the structure of Partnership;

b. Goodwill;

c. Revaluation of assets and liabilities;

d. Admission of a new Partner;

e. Retirement and death of a Partner;

f. Amalgamation of Partnership;

g. Dissolution of Partnership; and

h. Conversion of Partnership to a Limited Liability company

8.0 Objectives

After studying this chapter, students should be able to understand:

a. The various types of circumstances that would change the structure of partnership;
b. The adjustments that are made to the partner's accounts on admission of a New partner(s);
c. Accounting for revaluation of assets, and dissolution of partnership;
d. The various treatments of goodwill in partner's accounts; and
e. The Accounting entries necessary to close the existing partnerships and form a new one.

8.1 Changes in the Structure of Partnership

The structure of a partnership can change as a result of admission of more partners, retirement of a partner or death of a partner. In any of the three events, the partnership structure would have changed. Before we take the three events one by one, it is necessary to consider two important issues that usually affect changes in structure of partnership, these are goodwill and revaluation.

Irrespective of the very reason for admitting a new partner, it is required that all the existing partners should agree on the ratio of sharing both profits and losses and the amount of capital the incoming partner should contribute.

8.2 Goodwill

"Goodwill is that which enables business to earn super-normal profit, because of the reputation or special advantages which the business engages with the rest of the world". It is also defined as "the difference between the value of the business as a whole and the aggregate of a fair value of its separable net assets".

The goodwill a firm has may be due to the following:

(a) Superior management skills of its top management

(b) The possession of efficient and dedicated employees;

(c) Advantageous or strategic location of the firm;

(d) The nature of the firm's services or products;

(e) Possession of favourable contract, trade marks, patents and others;

(f) High quality of goods or services; and

(g) Effective and efficient advertising campaign.

Goodwill is an intangible asset. Where it is internally generated. It is normally not recorded in the books. If it is unrecorded it means that the partners interests in the business have been understated.

8.3 Accounting for Goodwill

There are many different ways of calculating for internally generated goodwill. At this stage you would learn the bookkeeping aspects and leave the valuation out.

There are two cases

a. Goodwill to remain in the books**:**

Debit Goodwill Account

Credit Capital Accounts of partners in the old firm in the existing profit sharing ratio

b. If the goodwill is not to be in the books:

Debit Goodwill Account

Credit Capital Accounts of partners in the old firm in the old profit sharing ratios.

Debit Capital Accounts of partners in the new firm in the new profit sharing ratio

Credit Goodwill Account

To close the account

Illustration 8.1

Panyin and Kakrah are partners in a firm and share profits and losses equally. Their capital accounts have the following balances. Panyin ¢25,000,000; Kakrah ¢15,000,000. On 1/9/2020 they admitted Olu as a partner and agreed on profit sharing ratio as $^2/_5$, $^2/_5$, and $^1/_5$ for Panyin, Kakrah and Olu respectively.
z

Goodwill has been valued at ¢18,000,000 but has not been recorded in the books of the partnership. Olu paid into the firm's bank account an amount of ¢35,000,000 as his capital

Show the bookkeeping entries to record the above transactions:

(a) If goodwill is to remain in the books

(b) If goodwill is not to remain in the books

SOLUTION TO ILLUSTRATION 8.1

Partners' Capital Account

	Panyin	**Kakrah**	**Olu**		**Panyin**	**Kakrah**	**Olu**
	¢m	**¢m**	**¢m**		**¢m**	**¢m**	**¢m**
				1/9/2020 Bal. b/d	25	15	-
1/9/2020 Bal c/d	34	24	35	1/9/2020 Bank	-	-	35
				1/9/2020 Goodwill	9	9	9
	34	24	25		34	24	35
				Bal b/d	34	24	35

Goodwill Account

1/1/2020 Partners" Capital Account ¢m
¢m

18

(b) If Goodwill is not to remain in the books

In this case, in effect the goodwill account is to be closed against the partners" accounts

in the new profit sharing ratio. The full accounts would be as follows:

Partners' Capital Accounts

	Panyin	Kakrah	Olu		Panyin	Kakrah	Olu
	¢m	**¢m**	**¢m**		**¢m**	**¢m**	**¢m**
1/9/2020 Goodwill	7.2	7.2	3.6	1/1/2020 Bal b/d	25	15	
Bal. c/d	26.8	16.8	31.4	1/9/2020 Bank	-	-	35
				1/9/2020 Goodwill	9	9	-
	34	24	35	34	24	35	
				Bal. b/d	26.8	16.8	31.4

Goodwill Accounts

	¢m		¢m
1/9/2020 Partners Capital Accounts	18	1/9/2020 Partners Capital Account	18

8.4 Revaluation of Assets and Liabilities

Since partnership by its very definition implies the carrying on of business by more than one person for the purpose of making profit, it is desirable and necessary that the true interest of each partner in the firm, as far as possible is shown.

To be able to do this, the accounts of the partners must be adjusted periodically to reflect the financial position of the firm. Some of the assets of the firm may have either appreciated or deteriorated in value. Note that the partners‟ capitals must be equal to the net worth of their business. The net worth must also be equal to the net assets.

The "true" net assets would depend on a realistic valuation of the assets and liabilities. Hence, it is necessary to review the values of these assets and liabilities of the firm whenever there is a change in the partnership.

8.5 Bookkeeping in Respect of Revaluation

If an asset is revalued, three situations can arise. The asset may increase in value, decrease in value or the value placed on it may be the same as the book value. If the value does not change, there will not be any bookkeeping entries to be made. If there is an increase in value, you need to debit the Asset account with the difference between the previous value and the new value and credit the Revaluation Account.

On the other hand, if there is a decrease in value, the Revaluation Account in respect of the asset. This is done by debiting the Provision Account and crediting the Revaluation Account and credit the partners Capital Accounts. If there is a capital loss on revaluation, debit the Capital Account and credit Revaluation Account.

Let us illustrate the above points with the following question:

Illustration 8.2

Mensah and Babatunde have been partners for some time. On 26th March 2020, they decided to admit Shola. So they invited a valuer to revalue the assets of the partnership.

The Statement of Financial position of Mensah and Babatunde as at 31st March 2022, was as follows:

Non-Current Assets	Cost	Depreciation	Net Book Value
	¢000	¢000	¢000
Freehold Property	7,600	2,850	4,750
Plant & Machinery	4,275	2,375	1,900
Motor Vehicles	3,610	2,185	1,425
	15,485	7,410	8,075
Current Assets:			
Inventories		1,330	
Receivables		1,140	
Bank and Cash		7,125	
		9,595	
Less Acct. Payable		4,485	5,110
			13,185
Capital Accounts			
Mensah			4,800
Babatunde			4,800
Current Account:			
Mensah			1,585
Babatunde			2,000
			13,185

The new valuations were as follows:

Freehold Property	9,500
Plant and Machinery	1,425
Motor Vehicles	1,140

It was also agreed that allowance for doubtful debts should be made to 2½ of receivables.

¢000

Creditors agreed to receive ¢3,000,000 for full settlement of their interest.

Required:

(a) Pass the necessary journal entries to give effect to the revaluation of the assets.

(b) Show the Partners Capital Accounts

(c) Show the Revaluation Accounts

Solution 8.2 Note:
Let us note that in the accounts proper, non-current assets are usually shown at cost or revalued amounts. Hence, the net assets shown in the balance sheet would not have any T accounts. Therefore, it would be necessary to close the provision for Depreciation Account. We would then be left with the assets accounts.

Compare the balances on the assets accounts with the revalued figures. If the revalued amounts are higher, it means the assets have increased in value. The only way to record increases in the assets accounts is to debit the accounts with the difference. In the same way, to record a decrease in an asset account, you need to credit the asset account. To complete the double entry you need to pass the other entry through the Revaluation Account.

On receivables, a 2½% of provision has to be made. So let us debit the Revaluation account with

¢28,500 and credit Allowance for Doubtful Debt Account with the same amount.

(a) Debit: Provision for depreciation:

		¢000	¢000
1.	Freehold Property	2,850	
	Plant and Machinery	2,375	
	Motor Vehicles	2,185	
	Credit: Revaluation Account		7,410
	To close the provisions for depreciation accounts		
2.	Debit: Freehold Property	1,900	
	Credit: Revaluation Account		1,900
	To record increase in the balance on freehold property		
3.	Revaluation Account	5,348.5	
	Plant and Machinery		2,850
	Motor Vehicles		2,470
	Provision for doubtful debt		28.5
	Being adjustment needed to reflect the revalued amounts		
4.	Payables Account	1,485	
	Revaluation Account		1,485
5.	To record the decrease in the payable balance Debit: Revaluation Account	5446.5	
	Credit: Partners‟ Capital Account		5446.5
	To close off the Revaluation Account		

(b) **Revaluation Account**

	¢000		¢000
Plant and Machinery	2,850	Provision on Depreciation	7,410
Motor Vehicles	2,470	Freehold Property	1,900
Provision for doubtful debts	28.5	Creditors Account	1.485

Partners Capital Accounts		
Share of profit		
Mensah(1/2)	2,723.25	
Babatunde (1/2)	2,723.25	
	10,795	10,795

Capital Accounts

	Mensah	Babatunde		Mensah	Babatunde
	¢000	¢000		¢000	
Bal c/d	7,523.25	7,523.25	Balance b/d	4,800.00	4,800.00
			Revaluation	2,723.25	2,723.25
7,523.25		7,523.25		7,523.25	7,523.25
b/d	7,523.25	7,523.25			

8.6 ADMISSION OF A NEW PARTNER

A new partner may be invited to join a partnership for various reasons. It may be that the firm has expanded its operations so much that the existing partners feel they need an additional person with some skills. It may also be that more capital is required to take advantage of opportunities to expand the business. At times a new partner may be admitted to replace an outgoing partner, whether due to death or retirement.

For whatever reason for admitting a new partner, it is necessary to take account of the following:

a. Change in terms of the partnership agreement with particular reference to capital contribution and profit and loss sharing ratios.
b. Revaluation of the assets of the firm in order to reflect the true values of the assets; and
c. Put a value on the goodwill the firm has required.

It is only fair to adjust the books to ensure that the balances on the partners‟ capital represent a fair value of each partner`s interest in the partnership. This will mean that if there are undisclosed assets and liabilities, they should be reflected in the books. This may take the form of recognizing the existence of goodwill or revaluing the assets of the partnership. So long as you remember how to account for goodwill, revaluation of assets and liabilities, there would be very little difficulty in accounting for admission of additional partners.

Let us illustrate the necessary accounting treatment with an example:

Illustration 8.3

Gyamfi and Lawal were in partnership sharing profits and losses equally. As a result of expansion of business, they decided to admit Ekiti who contributed N65,000 as his capital. The partners agreed that the ratio of sharing profits and losses should be Gyamfi $^{2}/_{5}$, Lawal $^{2}/_{5}$ and Ekiti $^{1}/_{5}$. The balance sheet of the partnership was as follows:

Statement of Financial Position As At The Date Of Admission

	₦000		₦000
Capital Accounts:			
Gyamfi	75,000	**Non-current assets**	
Lawal	75,000	Plant and Machinery	120,000
		Motor Vehicle	65,000

Current Accounts:

Gyamfi	20,000	**Current Assets:**	
Lawal	30,000	Inventory	45,000
		Receivables	58,000
		Cash	4,000

Current Liabilities:

Payables	52,000	
Overdrafts	40,000	
	292,000	
		292,000

The following information were to be taken into account:

1. On the admission of Ekiti the following revaluations were made:
   Plant and machinery ₦250,000,000, Motor Vehicle ₦80,000,000, Inventory ₦40,000,000 Receivable ₦45,000,000
2. Goodwill had been estimated at ₦45,000,000 but it should not be kept in the books.
3. Suppliers had given the partnership a discount of ₦6,000,000

You are required to prepare the following accounts:

(a) Revaluation Account

(b) Partners Capital Accounts

(c) Statement of financial position immediately after the admission of Ekiti.

Solution 8.3

Goodwill was not shown on the Statement of Financial Position. The only reason for its estimation was to ensure that the old partners are compensated. Hence, the Capital Accounts of the old partners should be adjusted. In the same way, the net effect of the revaluation of the assets and liabilities should be for the benefits or to the detriment of the existing partners.

In writing off the goodwill, the new partner would be affected.

Revaluation Account

	N000		N000
Inventory	5,000	Plant & Machinery	130,000
Receivables	13,000	Motor Vehicle	15,000
		Goodwill	45,000
Capital Accounts:		Suppliers (Payable)	6,000
Share of Rev. profit			
Gyamfi	89,000		
Lawal	89,000		
	196,000		**196,000**
Goodwill Account	45,000	Capital Accounts:	
		Gyamfi	18,000
		Lawal	18,000
			9,000
45,000		**Ekiti**	**45,000**

Partners Capital Accounts

	Gyamfi	Lawal	Ekiti		Gyamfi	Lawal	Ekiti
	₦000	₦000	₦000		₦000	₦000	₦000
Revaluation Account	18,000	18,000	9,000	Balance b/d	75,000	75,000	-
Bal. c/d	146,000	146,000	56,000	Bank	-	-	65,000
				Revaluation A/c	89,000	89,000	-
	164,000	164,000	65,000		164,000	164,000	65,000
				b/d	146,000	146,000	56,000

Gyarafi, Lawal & Ekiti

Statement of Financial position (After the revaluation)

	N`000		**N`000**
Capital Accounts:		Non-current assets	
Gyamfi	146,000	Plant & Machinery	250,000
Lawal	146,000	Motor Vehicle	80,000
Ekiti	56,000		330,000
	348,000	Current Assets:	
		Inventories	40,000
Current Accounts:		Receivables	45,000
Gyamfi	20,000	Bank and Cash	69,000
Lawal	30,000		154,000
Ekiti	50,000		
Current Liabilities			
Payables	46,000		
Overdraft	40,000		
	484,000		**484,000**

8.7 RETIREMENT AND DEATH OF A PARTNER

A partner may retire from a partnership for many reasons. Indeed, when a partner dies, he has effectively retired from the partnership. For purposes of accounting, the reasons for retirement would not be important. Usually, the partnership deed, if it is properly drawn, would provide the necessary guidelines as to how the affairs between the partners should be settled. In the absence of specific guidance from the partnership agreement, the normal rules are as follows:

(a) Prepare a Profit and Loss Account to the date of retirement/death. Note that retirement/death might not coincide with the end or beginning of the accounting period. Hence the results of the operation to the date of retirement/death must be shared i.e. credited to the partners Capital Accounts in their profit sharing ratios. If the result is a loss, the partners Capital Accounts must be debited accordingly;

(b) Transfer the balance on the current account of the retiring partner to the Capital Account;

(c) Credit/debit the outgoing partner with his share of the difference between the net revalued amount of the assets and the book value; and

(d) Credit the outgoing partner with his share of goodwill of the firm, if any.

(e) The credit balance on the retiring partner's account becomes a liability to the firm which should be settled. The partnership deed would give an indication of how the settlement of the retiring partner should be dealt with.

Illustration 8.4

Yekini, Olu and Essien formed a partnership in 1990 and agreed to share profits or losses in the ratio 4:3:3. Olu decided to retire on 31/12/2021 due to both ill health and misunderstanding between the partners. The Statement of financial position as at 31/12/2021 was as shown below:

Statement of financial position as at 31/12/21

	¢m	¢m
Non-current Assets:		
Freehold Land and Buildings	540	
Machinery	180	
Office Equipment	45	
Motor Vehicles	105	
		870
Current Assets:		
Inventory	100	
Receivable	125	
Bank	23	
		248
Current Liabilities:		
Payables	158	
Bank Overdraft	30	
	188	
	60	

	930
Capital Accounts:	
Yekini	420
Olu	300
Essien	210
	930

The partners noted that the account did not reflect the following:

a. Interest on the following drawings should have been charged at 5%.

	¢m
Yekini	60
Olu	60
Essien	60

b. Interest on partners Capital Account at 6% had not been credited. Partners account for the purpose of the interest calculation was to be taken as follows: Yekini ¢210m; Olu ¢150m and Essien ¢105m.

c. Olu received ¢24 million payable by cheque immediately.

d. Goodwill was valued at ¢300 million and was to be kept in the books.

e. Other assets and Liabilities were revalued as follows:

Freehold Land and Buildings ¢600 million. Machinery ¢ 240 million; Office Equipment ¢35 million and Motor Vehicles ¢156 million.

f. Discount to be received from creditors amounted to ₦27 million.

g. 20% of the receivables was irrecoverable, whilst 15% of inventory was obsolete

h. The balance due to Olu was to be kept in the firm as a loan.

Required:

Prepare the Revaluation Account, the Partners Capital Accounts and the Adjusted Balance Sheet on 31/12/2021.

Solution 8.4

Note the import of notes b, e, and f carefully

Revaluation Account

			¢m			¢m
Office Equipment			10	Freehold Land and Building		60
Receivables		25		Machinery	60	
Inventory		15		Motor Vehicles	51	
Bal. c/d	448			Goodwill	300	
				Payables	27	
	498				498	
Capital Accounts: Share of profit						
Yekuni (4/10)	179.2					
Olu (3/10)	134.4			Bal. b/d	448	
Essien(3/10)	134.4					
	448.0				448.0	

Partners‟ Capital Accounts

	Yekini	**Olu**	**Essien**		**Yekini**	**Olu**	**Essien**
	¢m	¢m	¢m		¢m	¢m	¢m
Interest on Drawings	3.0	3.0	3.0	Balance b/d	420.0	300.0	210.0
Bank		24		Revaluation A/c	179.2	134.4	134.4
P &L Appr. A/c	7.56	5.67	5.67	Interest on Capital	12.6	9.0	6.3
Bal. c/d	601.24	410.73	342.03				
	611.8	443.4	350.7		611.8	443.4	350.7
				B/d	601.24	410.73	342.03

Yekini, Essien & Co

Statement of financial position as at 31/12/2005300

	¢m		¢m	¢m	
Non-current Assets					
Goodwill			300		
Freehold, Land and Buildings			600		
Machinery			240		
Motor Vehicles			156		
Office Equipment			35	1,331	
Current Assets:					
Inventory	85				
Receivable	100		185		
Current Liabilities:					
Payable	131				
Bank Overdraft	31		162		
				23	
				1,354	
Non-current Liabilities (Loan)	(410.73)			943.27	
Capital Accounts:					
Yekini		601.24			
Essien		342.03			943.27

Workings:

Statement of Income Distribution

Interest on Capital:	¢m		Interest on Drawing		¢m
Yekini		12.6	Yekini		3
Olu		9.0	Olu		3
Essien	6.3		Essien	3	
				9	
			Share of Balance		
			Yekini 7.56		
			Olu 5.67		
		____	Essien 5.67	18.9	
	27.9			27.9	

8.8 AMALGAMATION OF PARTNERSHIPS

Two separate partnerships may decide to merge into one firm. The reasons may include the following:

The partners of each firm believe that coming together would bring economies of scale or they might have worked together in the past, or the businesses are similar, or they are complimentary. It may often due to the existence of variety of skills, expertise and experience concentrated in one firm.

So far as accounting for the amalgamation goes, the main point to note is that the accounts of the two firms would need to be adjusted to ensure that the capital accounts are fairly stated in their individual books before the amalgamation.

In order to fairly state the balances of each partner's account, the assets may be revalued and goodwill may need to be recognized.
Let us illustrate some of the points

Illustration 8.5

Eghan and Adepate are partners in the firm of Egapate & Co. sharing profits and losses equally. Shola and Boafo are partners in the firm of ShoBoafo & Co and share profits and losses in the ratio 3/5 amd 2/5 respectively.

The partners of each firm agree to amalgamate under the new name EgaSho & Co. The profits and losses in the new firm will be shared as follows:

Eghan	25%
Adepate	30%
Shola	25%
Boafo	20%

Statement of Financial position are:

	Egapate	ShoBoafo	
	¢m	¢m	
Non-current Assets	120		160
Inventory	8	24	
Cash	10		5
	138		189
Capital Accounts:			
Eghan	100		
Adepate	38		
Shola		99	
Boafo		90	
	138		189

For the purpose of the amalgamation, the assets were revalued as follows:

	Egapate	SholaBoafo
	¢m	¢m
Non-Current Assets	180	200
Inventory	12	16
Goodwill	80	320

The new partnership does not want to show goodwill in its balance sheet. The capitals of the partners in the new firms are to be:

	¢m
Eghan	100
Adepate	150
Shola	300
Boafo	250

Required:

a. The Capital Accounts of the partners.

b. The Opening Statement of financial Position of Egasho & Co.

Solution 8.5

Before the amalgamation, it is necessary to adjust each partners account to reflect his true interest in the business. Since goodwill will not be shown in the books of the new partnership, the total goodwill (80 + 320) should be written off against the four partners in their new profit and loss sharing ratio. The question did not ask for a revaluation account but it will be advisable to prepare one.

Revaluation Account of Egapate & Co.

Capital Accounts:	¢m		¢m
Share of Rev. profit			
Eghan (1/2)	72	Non-Current Assets	60
Adepate (1/2)	72	Inventory	4
		Goodwill	80
	144		144

Revaluation Account of Shoboafo & Co.

	¢m		¢m
Inventory	8		
Capital Accounts:			
Share Rev. profit			
Shola (3/5)	211.2	Non-Current Assets	40
Boafo (2/5)	140.8	Goodwill	320
	360		360

Partners' Capital Account

	Eghan	Adepate	Shola	Boafo		Eghan	Adepate	Shola	Boafo
	ÿm	ÿm	ÿm	Ÿm		Ÿm	ÿm	ÿm	ÿm
Goodwill	100	120	100	80	Balances b/f	100	38	99	90
Bal c/d	100	150	300	250	Revaluation	72	72	211.2	140.8
					Bank	28	160	89.8	99.2
	200	270	400	330		200	270	400	330
					b/d	100	150	300	250

Statement of financial position Egasho & Co.

	¢m
Non-Current Assets	380
Inventories	28
Cash	392
	800
Capital Accounts:	
Eghan	100
Adepate	150
Shola	300
Boafo	250
	800

8.9 Dissolution of Partnership

Partners of a firm may decide to dissolve the firm for various reasons. The reasons may include the following:

- The death of a partner
- The bankruptcy of a partner
- The lunacy of a partner
- The partnership can only be carried on at lose
- The partnership business becomes illegal/outlawed.

Whatever the cause of the dissolution, the following steps are necessary:

- Transfer all non cash assets to the Realization Account by debiting the Realization Account with the book value of the assets and crediting the Assets Accounts with the same.
- Debit the Realization Account with all relevant expenses and credit Cash or Bank Account.
- Debit Bank or Cash with proceeds on sale of assets and credit Realization Account.
- Assets taken over by any partners must be debited to the partners Capital Account and Realization Account credited with the agreed price.

- Pay off liabilities by crediting Bank or Cash and debiting the Liability Account. Any discount allowed by creditors must be debited to the Creditor's Accounts and credited to the Realization Account.
- Close the Realization Account to the Partner's Capital Accounts.
- Transfer the Partner's current accounts to their capital accounts, by debiting the Current Accounts and crediting Partner's Capital Accounts.
- Close off the Partner"s Capital Accounts by paying the amount due to them or by receiving the amount due from them.

Rule in Garner VS Murray

Where a partner becomes insolvent during dissolution of a partnership, the solvent partners must bear the deficiency of the insolvent partner in their last agreed capital ratio and NOT in their profit sharing ratio. The accounting treatment will be:

Debit – Solvent Partners Capital Accounts.

Credit – Insolvent Partner Capital Account

With the amount of the deficiency shared.

Let us illustrate the above points

Illustration 7.6

John David and Ajomale have been partners for some time, making up their account to 30th September every year. The following was their balance sheet as at 30th September 2021.

Non-current Asset	¢m	¢m	¢m
Leasehold Properties		550	
Motor Vehicles		220	
Furniture and fittings		150	
			920
Current Assets:			
Inventories	420		
Receivables	350	770	
		1690	
Current Liabilities			
Trade payables	390		
Bank Overdraft	91	481	
			289
Loan from Amogu		(305)	
		904	

			1,209
Capitals:			
John	255		
David	200		
Ajomale	275	730	
Current Accounts:			
John	75		
David	50		
Ajomale	49	174	
		904	

The partners share profits and losses in the ratio 2:2:1. On 30 September 2006, they agreed to dissolve the partnership. John took over one of the vehicles which had a book value of ¢80m at a valuation of ¢150m. Mr. Ajomale took over half of stock for ¢250m. The leasehold properties, the remaining vehicle, fixtures and fittings realized ¢720m. Receivable realized ¢320m. After paying the trade payables in full, the partners received the monies due them on capital account or paid what was due to the firm from them.

Required:

1. Show the Realization Account
2. The Bank Account
3. The partner's Capital Accounts

Solution to Illustration 8.6

Realization Account

	¢m		**¢m**
Sundry Assets:			
Leasehold Properties	550	Capital Accounts:	
		Assets taken over	
Motor Vehicle	220	John	150
Furniture and Fittings	150	Ajomale	250
Account Receivables	350		
Stocks	420		
		Bank:	
		Sundry Assets	720
		Account Receivables	320
		Capital Accounts:	
		Share of loss	
		John (2/5)	100
		David (2/5)	100
		Ajomale (1/5)	50
	1,690		1,690

Partners Capital Accounts

	John	David	Ajomale		John	David	Ajomale
	¢m	**¢m**	**¢m**		**¢m**	**¢m**	**¢m**
Assets taken over	150	-	250	Balance b/d	255	200	275
Realization	100	100	50	Current A/c	75	50	49
Bank	80	150	24				
	330	150	324		330	250	324

Bank Account

	¢m		¢m
Sundry Assets	720	Balance b/d	91
Account Receivables	320	Loan Account	305
		Account Payable	390
		Partners Accounts: John	80
		David	150
		Ajomale	24
	1,040		1,040

8.10 Conversion of a Partnership to a Limited Company

When a partnership is converted to a Company, the partnership is dissolved. The former partners may become shareholders in the company or not. The price put on the firm is known as the purchase price or the purchase consideration. The purchase consideration can be settled by cash, by issue of shares to the partners or by issue of debentures. It could also be partly by cash and shares or partly by shares and partly by debentures. It could also be partly by cash and shares or partly by shares and partly by debentures or by a combination of the three. In order to retain their comparative positions in the shareholding in the new company, the shares could be divided in the partners‟ profit sharing ratio and the balances in their capital accounts are settled through either cash being paid by or received from the dissolution.

It is obvious that since the partnership would cease forthwith, the Realization Account and the Capital Accounts of partners would be used. Indeed, the accounting treatment of the sale of the partnership would be akin to the entries passed when considering the dissolution of partnership.

Note that the settlement of the purchase would cease forthwith, the Realization Account and the Capital Accounts of partners would be used. Indeed, the accounting treatment of the sale of the partnership would be akin to the entries passed when considering the dissolution of partnership.
Note that the settlement of the purchase consideration would necessitate the following:

1. Treat the purchaser as a Receivable: That is, debit the Purchaser and credit the Realization Account.
2. Payment by cash. Debit Bank Account and Credit the Purchaser
3. Payment by issue of shares. Debit Ordinary Shares in Purchaser Name and Credit the Purchaser.
4. Payment by issue of loan notes. Debit loan notes in Purchaser’s Name and Credit Purchaser.
5. Closure of Partners Capital Account.

Debit Partners‟ Capital Accounts and Credit Bank, Ordinary Shares, loan notes in Purchaser’s Account with appropriate amounts.

You should remember that in this instance the purchaser is a limited liability company.
Let us illustrate the bookkeeping aspects with a question.

Illustration 8.7

Olu, Mosho and Aryee have been in partnership for several years sharing profits and losses in the ratio 5:3:2 respectively. On 1/1/2022 they decided to convert their business into a limited liability company Olumosho Ltd, on the same date. The statement of financial position at the close of business on 31/12/2021 was as shown below:

Statement of Financial Position as at 31/12/2005

	Olu	**Mosho**	**Aryee**	Total
	¢000	¢000	¢000	¢000
Capital Account	36,000	24,000	18,000	78,000
Current Account	1,560	1,920	840	4,320
Loan	2,000	2,000	2,000	2,000
	39,560	27,920	20,840	88,320

Freehold buildings	36,000
Vehicles (Cost less Depreciation)	14,400
Equipment (Cost Less Depreciation)	7,500
Inventories	18,375
Receivables(Less provision for doubtful debt)	14,445
Bank	6,600
	97,320
Less Payables	9,000
	88,320

Apart from the cash and one of the vehicles, all assets and liabilities were taken over by the company. Mr. Aryee took over one of the vehicles at a valuation of ¢6,000,000. The purchase consideration was calculated as follows:

¢000

Freehold buildings	69,000
Vehicle	7,200
Equipment	4,800
Inventories	12,000
Receivable	13,800
Goodwill	24,000
	130,800
Trade payables	9,000
	121,800

The company was to issue fully paid shares of ¢1,000 each to meet the purchase consideration.

Required:

Close the books of the partnership on the assumption that realization expenses was ¢5,000,000.

Solution to Illustration 7.7

Realization Account

¢000			¢000	
Expenses		5,000	Capital (Car taken over by Aryee)	6,000
Freehold buildings		36,000		
Vehicles		14,400	Olumosho – Ltd	
Equipment		7,500	Purchase Consideration (PC)	121,800
Inventories		18,375	Trade payables	9,000
Receivables		14,445		
Bal c/d		41,080		
136,800			136,800	
			Bal b/d	41,080
Capital Accounts				
Olu (5/10)	20,540			
Mosho (3/10)	12,324			
Aryee (2/10)	8,216	41,080	41,080	
41,080				

Olumosho Ltd Account

	¢000			¢000
Realization (PC)	121,800	Shares in Olumosho Ltd Account:		121,800
		Olu	60,900	
		Mosho	36,540	
	121,800	Aryee	24,360	
		121,800		
	211,800			

Shares in new Olumosho's Ltd Account

	¢000		¢000
Olumosho Ltd	121,800	Partners Capital Accounts:	
		Olu (5/10)	60,900
		Mosho (3/10)	36,540
		Aryee (2/10)	24,360
	121,800		121,800

Partners' Capital Accounts

	Olu	Mosho	Aryee		Olu	Mosho	Aryee
	¢m	¢m	¢m		¢m	¢m	¢m
Realization – Car	-	-	6,000	Balance b/d	36,000	24,000	18,000
Shares Olumosho	60,900	36,540	24,360	Current A/c	1,560	1,920	840
Bank a/c	-	1,704	-	Realization	20,540	12,324	8,216
	60,900	38,244	30,360	~~Cash~~	~~60,900~~	~~38,244~~	~~30,360~~
				Bank a/c	2,800	3,304	3,304
					60,900	38,244	30,360

Bank Account

	¢000		¢000
Bal. b/f	6,600	Realisation Expenses	5,000
Olu‟s Capital A/c	2,800	Partners Loan A/cs	6,000
Aryee‟s Capial A/c	3,304	Mosho‟s Capital A/c	1,704
	12,704		12,704

8.11 Chapter Summary

Surpluses and deficits on revaluation will be transferred to a revaluation account. The balance on this account must be shared between the partners in their profit sharing ratio.

Goodwill is an intangible asset; it is the value placed upon the ability of an organization to earn supernormal profits. Any value placed on unrecorded goodwill can be adjusted for by contra entries on the partners‟ capital accounts.

If there is a change in partnership pathway through an accounting period, the profit up to the date of the change will be shared between the old partners in accordance with the old agreement.

Note that a realization account will record the book values of assets disposed of and the proceeds realized. The profit or loss on disposal will be shared between the partners in their profit sharing ratio. The partners‟ capital accounts will be debited with the value placed upon assets they receive from the firm and with the final cash settlement.

8.12 Multiple Choice and Short Answer Questions

Use the following information to answer questions 1 and 2.

Shola and Bada are in partnership and share profits in the ratio 2:3 on 1 September 2021, a new partner; Carol joins the business introducing N24 million capital.

The following also took place at this date

A. Goodwill is valued at N80 million

B. The profit share ratio is to be 3:6:1

C. Property is re-valued upwards by N70 million

Shola had a balance of N90m credit prior to adjusting the accounts. Goodwill is not retained in the business.

1. Calculate the total amount of goodwill and revaluation surplus credit into Bada‟s Capital Account.

A. N32m

B. N42m

C. N48m

D. N60m

E. N90m

2. What is the balance in Shola’s Capital account after all adjustment?

A. ₦112m

B. ₦118m

C. ₦126m

D. ₦136m

E. ₦150m

Use the following information to answer questions 3 and 4

Joe, Okon and Koko were in partnership, sharing profits in the ratio 1: 1: 2 respectively. The capital balance after the partnership was dissolved and all accounts closed were:

Joe ₦40 million Credit Okon ₦60 million Credit Koko ₦50 million Debit

3. State how Koko's debit balance should be accounted for if he is not insolvent.
4. How much would Joe contribute to the deficiency of Koko, assuming that Koko is insolvent?
5. When a partnership is converted to a Company, the purchase consideration could be in form of (i) Cash and (ii)……………………
6. What is the accounting entry for asset taken over by a partner, when a partnership is dissolved? When a partner retires, the balance in his capital account after all adjustments has been completed is transferred to… account.

8.13 SOLUTIONS

1. B
2. C
3. Koko deficit would be settled from the surplus in his private estate
4. N20 million (40/100 x N50m) The rule in Garner V Murray
5. Ordinary Share Capital account
6. Debit the partner's Capital account Credit the Realisation account
7. Bank Account

Tutorial

Question 1

Bada

Share of goodwill $^{3}/_{5}$ x $^{80}/_{1}$	= 48
Share of revaluation surplus =$^{3}/_{5}$ x $^{70}/_{1}$	<u>42</u>
	90
Goodwill written back $^{6}/_{10}$ x 80	<u>48</u>
	<u>42</u>

Capital b/f	90
Share of Goodwill 2/5 x 80	32
Share of surplus 2/5 x 70	28
Goodwill written back = 3/10 x 80	(24)

CHAPTER NINE

ACCOUNTING FOR INVENTORIES

Chapter contents

9.0 Objectives

At the end of this chapter, the readers will be able to

i. Determine the nature of inventory
ii. Determine the cost of inventories
iii. Recognise an expense, including any write-down to net realisable value.
iv. Identify and apply the cost formulas that are used to assign costs to inventories
v. Understand the procedures for computing a claim for loss of inventory

9.1 Definition of an Inventory

i. Inventories are assets held for sale in the ordinary course of business (finished goods),
ii. Assets in the production process for sale in the ordinary course of business (work in process), and
iii. Materials and supplies that are consumed in production (raw materials)

9.2 Cost of Inventories

Cost should include all:

- Costs of purchase (including taxes, transport, and handling) net of trade discounts received
- Costs of conversion (including fixed and variable manufacturing overheads) and
- Other costs incurred in bringing the inventories to their present location and condition

9.3 Cost of Purchase

Cost of purchase is the invoice price. It should be exclusive of recoverable VAT, trade discounts, rebates etc. but inclusive of import duties, transport and handling costs, non-recoverable taxes and any other directly attributable costs.

Illustration 9.1

Kofi Ltd (which is registered for VAT) purchased 10,000 units of raw materials from Kofi on credit on 31 October 2021. The invoice details were as follows:

	GH₵
10,000 units of product Kofi	100,000
Less trade discounts @ 5%	(5,000)
	95,000
Transport and handling costs	8,000
	87,000
VAT @ 7.5% (₦95,000 x 7.5%)	7,125
Total invoice price	79,875

Required:

Show how Kofi Ltd should record the purchase of raw materials.

Solution to Ilustration 9.1

Kofi Ltd should be record the purchase of raw materials in its nominal ledger as follows:

	Dr	Cr
	GH ₵	GH₵
Raw materials purchased	95,000	
VAT – statement of financial position		7,125
Trade payables		79,875

Conversion cost

- Costs of conversion include costs directly related to the units of production, such as direct labour;
- Systematically, allocated fixed (such as depreciation) and variable production overheads(such as indirect materials and indirect labour) incurred in producing finished goods; and
- Other costs like design and borrowing costs.

Fixed production overheads are allocated to the costs of conversion based on the normal capacity of the production facilities. Any unallocated fixed overhead cost is expensed in the period it is incurred. Normal capacity is the production expected to be achieved on average over a number of periods over a number of periods under normal circumstances.

Costs of conversion will be incurred in respect of work in progress and finished goods, both of which are added to as part of the production process

9.3.1 Costs excluded from valuation of inventory

Under IAS 2, the costs that are excluded from inventory include:

- Abnormal costs that are incurred as a result of material waste, labour or other production conversion (overheads) costs;
- Storage costs (unless required as part of the production process),
- Administrative overheads; and
- Selling costs.

These excluded costs are treated as expenses and recognised in the statement of profit or loss during the period in which they are incurred.

9.4 General Principle for Valuation of Inventory

IAS 2 requires that inventory should be valued at the lower of cost and net realisable value (NRV).

NRV is defined by IAS 2 as the selling price less:

- All further costs to completion; and
- The estimated costs necessary to make the sale.

These estimates are based on the most reliable evidence at the time the estimates are made. To arrive at these estimated values, the reasons for holding the inventories should be taken into account.

Inventories are usually written down to NRV based on the following principles:

- Items are treated on an item-by-item basis not on total inventory
- Similar items are normally grouped together

NRV of inventories may be lower than their costs due to the following reasons:

- Inventories are damaged;
- Inventories have become obsolete; and
- Selling prices of the goods have fallen.
- A decision as part of a company's marketing strategy to manufacture and sell products at a loss
- Errors in production or purchasing

9.4.1 Accounting for write down on inventory

The amount of any write down of inventories to NRV and all losses of inventories are recognised as an expense in the period the write down occurs.

Illustration 9.2

In year ended 30 June 2021, the cost of the inventory of a beverage company ₦34m but the NRV was ₦32.8million.

Explain the effect of the write down in the financial statements for the year ended 30 June 2021.

Solution to Illustration 9.2

In the year ended 30 June 2021, the company write down the inventory by ₦1.2m, that is to the NRV of ₦32. 8m. Inventory will decrease by ₦1.2m while cost of sales will also increase by ₦1.2m

Dr. cost of sales with ₦1.2m

Cr,. inventory with ₦1.2m

When the goods produced with raw materials which net realisable value is less than the cost, the value of raw materials is not reduced below cost only if the NRV of the goods produced is not greater than the cost.

Illustration 9.3.

Liam plc has 100 units of raw material in inventory at 31 July 2015. These cost a total of ₦30,000. Since purchasing the material, the purchase price has dropped to ₦19,000. However, the material will be incorporated into a final product which is expected to sell for ₦75,000 after further conversion costs of ₦25,000 are incurred. At what amount should the inventory be carried in the financial statements for reporting date 31 July 2015?

Solution to Illustration 9.3

Here, the cost of the raw material is ₦30,000. The NRV of the raw material is ₦19,000. However, the NRV of the completed product in its current state is ₦75,000 – ₦25,000 = ₦50,000. This is in excess of its cost, hence the appropriate accounting value for the raw material is its cost, ₦30,000

9.5 Methods of calculating cost of inventories:

There are various methods for calculating cost of inventory, but we shall deal with three acceptable ones under IAS 2,

i. Specific identification method: This is the actual cost of purchasing identifiable units of inventory. This method can only be used when item of inventory is individually distinguishable and of high value
ii. First-in-first-out method (FIFO): This method is based on the assumption that the first goods acquired is first sold. Each sale is made out of the oldest goods in the store, while the closing inventory consists of goods most recently acquired

.

Advantages of FIFO method

The inventory valuation reflects recent costs and it provides a realistic value of the inventory balance recognised in the statement of financial position.

Weighted Average Method (WAC)

The cost of goods sold per unit is computed by dividing the number of the total cost of goods available for sale by the number of units of the goods available for sale. Then the unit cost is multiplied by the units of the goods not yet sold, to obtain the value of closing inventory. The methods produce different closing inventory, hence they produce different profits

Illustration 9.4
Flomo Limited purchases and sells identical articles. The table below shows the inventory movement in the store. The company's accounting period ends on December 31, each year.

Month	Quantity Purchased	Unit Price Le	Quantity issued
Brought forward	150	100	
February 2020	350	150	
April 2020			340
June 2020	440	180	
August 2020			420
October 2020	420	210	
December 2020			360

Required:
Present a table of the inventory keeping from January to December 2020 and show the cost of inventory on December 31, 2020, Using first-in-first-out and weighted average method.

SOLUTION TO ILLUSTRATION 9.4
a) Flomo Limited

Date	**Receipts**			**Issued**			**Balance**		
2020	Qty	Unit Price	Value	Qty	Unit Price	Value	Qty	Unit Price	Value
		Le	Le		Le	Le		Le	Le
01/02	150	100	15,000	-	-	-	150	100	15,000
28/02(i)	350	150	52,500	-	-	-	500		67,500
31/04	-	-	-	150	100	15,000	150	100	15,000

3	-	-	-	190	150	28,500	**190**	**150**	28,500
(ii)				340		43,500	**(340)**		(43,500)
(i-ii)							***160***	**150**	**24,000**
31/06 (iii)	440	180	79,200	-	-	-	600		103,200
31/08	-	-	-	160	150	24,000	160	150	24,000
	-	-	-	260	180	46,800	260	180	46,800
(iv)							(420)		(70,800)
(iii-iv)							**180**	**180**	**33,400**
31/10 (v)	420	210	88,200	-	-	-	600		121,600
31/12	1,360	-	234,900	180	180	33,400	180	180	33,400
				180	210	43,200	180	210	43,200
(vi)							(360)		(76,600)
Closing inventory (v-vi)			-				**240**	**210**	**50,400**

Inventory ledger account, using weighted average cost

At 31 December 2020, the cost of goods available for sale is Le 234,900 while the closing inventory is Le 50,400, hence the cost of goods sold is Le 184,500

b) Flomo Limited

Date	**Receipts**			**Issued**			**Balance**		
2020	Qty	Unit Price	Value	Qty	Unit Price	Value	Qty	Unit Price	Value
		Le	Le		Le	L$		Le	Le
01/02	150	100	15,000	-	-	-	150	100	15,000
28/02	350	150	52,500	-	-	-	350	150	52,500
	-	-	-	-	-	-	**500**	**135**	**67,500**
31/04	-	-	-	340	134	45,900	(340)	135	(45,900)
	-	-	-	-	-	-	**160**	**135**	**21,600**
31/06	440	180	79,200	-	-	-	440	180	79,200
	-	-	-	-	-	-	**600**	**168**	**100,800**
31/08	-	-	-	420	168	70,560	(420)	168	(70,560)
	-	-	-	-	-	-	**180**	**168**	**30,240**
31/10/	420	210	88,200	-	-	-	420	210	88,200
Purchases	1,210	-	219,900	-	-	-	**600**	**197.4**	**118,440**
31/12	-	-	-	360	197.4	71,064	(360)	197.4	(71,064)

Closing inventory	-				**240**	**197.4**	**47,376**

Inventory ledger account, using weighted average cost

At 31 December 2020, the cost of goods available for sale is Le234,900 while the closing inventory is Le47,376 hence the cost of goods sold is Le187,524 .

Conclusion: The closing inventory under FIFO is higher than that of weighted average because of rising prices.

9.6 Methods of recording inventory

After purchase, in order to prepare a statement of profit or loss, it is important to compute gross profit. This is done by comparing the sales revenue from items of inventory to the cost of those items. To arrive at the cost of the items sold, there is need to record opening inventory, purchases and closing inventory. There are two methods of recording inventory. They are periodic inventory method and perpetual inventory method.

9.6.1 Periodic Inventory methods

The periodic system uses end of period physical count to measure the level of inventory and the cost of goods sold (COGS). Goods purchased are recorded in the purchases account. The inventory account and the cost of goods sold account are updated at the end of the period. When cost of goods sold is subtracted from revenue, it shows a company's gross margin. Using the **Flomo Limited** example under average weighted approach, cost of goods sold under the periodic inventory system is calculated as follows:

	Le
Opening inventory	15,000
Purchases	219,900
	234,900
Closing inventory	(47,376)
Cost of Goods Sold	187,524

9.6.2 Perpetual Inventory methods

By contrast, the perpetual system keeps track of inventory balances continuously, with updates made automatically whenever a product is received or sold. Purchases and returns are immediately recorded in the inventory account. As long as there is no theft or damage, the inventory account balance should be accurate. The cost of goods sold account is also updated continuously as each sale is made. Perpetual inventory systems use digital technology to track inventory in real time using updates sent electronically to central databases.

Entries to link to statement of profit or loss

Two ledgers are involved; the purchases ledger to record purchases during the during the year and inventory ledger to record inventory at beginning and inventory at the end.

Purchases during the year

	Dr	Cr
	Le	Le
Purchase account	219,900	
Cash or liability account		219,900

At the end of the period or year, the two accounts are closed to extract trial balance. The value in purchase account is transferred to cost of sales by these entries:

	Dr	Cr
	Le	Le
Costs of sale account	219.900	
Purchase account		219,900

Physical inventory count takes place to establish the quantity of closing inventory, this is valued to know the amount to be included in financial statement. Closing inventory is brought to the ledger by the following entries:

	Dr	Cr
	Le	Le
Inventory (statement of financial position)	47,375	
Cost of sales (statement of profit or loss)		47,375

Opening inventory will be brought forward balance from the previous period. This will be transferred to the statement of profit or loss by the following entries:

	Dr	Cr
Cost of sales (statement of profit or loss)		15,000
Inventory		15,000

9.7 Accounting for loss of Inventory

The following procedures are normally followed in the determination of the inventory loss and the amount of claim from insurance company.

a) Calculate the gross profit, % for the previous accounting period immediately before the period of the fire.

b) Prepare a trading account for the period of fire and insert the available data which are most likely to be:
   i. Opening inventory which is the closing inventory of the previous year brought forward
   ii. Purchases made from the beginning of the year to the date of the incident
   iii. Sales from the beginning of the period to the time of the fire

c) Apply the gross profit percentage calculated in (1) above to the sales figure in (2) To obtain gross profit made to the time of the incident.

d) Obtain cost of sales by deducting the gross profit from the sales

e) The inventory lost is equal to the amount obtained by this formula:

Inventory Lost = Opening Inventory + Purchases – Cost of Goods Sold.

Illustration 9.5

Gbago Enterprises sells artefacts. On 30 June 2021, the premises and the goods therein were destroyed by fire. Some artefacts valued at ₦30,000 and some financial records were removed through rescue efforts. The following information was extracted from the record:

	₦'000
Inventory:	
01/01/2020	1,750,000
31/12/2020	1,855,000
Purchases:	
For the reporting dated 31/12/2020	13,941,000
Jan 1 to 30 June 2021	10,529,000
Sales:	
For the reporting dated 31/12/20	19,200,000

January – June 30, 2021	14,356,000

The gross profit percentage in 2021 was the same as those disclosed for the reporting dated 31 December 2020. You are to compute the claims to be presented to the insurance company.

SOLUTION TO ILUSTRATION 9.5

Computation of Gross Profit Percentage for the reporting dated 31 December 2020

	₦ '000	**₦ '000**
Sales		19,200
Opening inventory	(1,750)	
Purchases	(13,941)	
	(15,691)	
Closing inventory	1,855	
Cost of goods sold		(13,836)
Gross Profit		5,364

Gross Profit % = $\frac{5364}{19,200} \times \frac{100}{1}$ % = 28%

Computation of Inventory on 30 June 2021

	₦'000	N000
Sales		14,356
Opening inventory	1,855	
Purchases	10,529	
Goods available for sale	12,384	
Closing inventory	2,048	
Cost of goods sold		(10,336)
Gross Profit (28% x 14.356m)		4,020
Insurance Claim		
Inventory at the time of fire	2,048	
Inventory salvaged	(300)	
Claims	1,748	

Note:

1) The gross profit is deducted from sales to obtain cost of sales.

	₦ '000
Sales	14,356
Cost of sales	10,336
Gross Profit	2,048

2) The Closing Inventory

	₦ '000
Cost of goods available for sale	12,384
Cost of sales	(10,336)
Closing inventory	2,084

Inventory Adjustment

In order to get the normal gross-profit percentage of the previous period, the value and the sale proceed of inventory written down must be segregated from the normal inventory during the period.

a) The proceeds from the sales of inventory must be removed from the total sales figure.

b) The value of the inventory at its written down value must also be removed from the value of the opening inventory.

c) If any part of the inventory was sold in the previous accounting period, the proportion not yet sold is multiplied into the inventory at its written down value and the results is deducted from the closing inventory of that period.
d) The amount realized from the inventory written down in the year of fire incident is deducted from the sales proceed for the period.
e) The unsold part of the written down inventory is added to the inventory at the date of incident
f) The other steps as in illustration would then be applied to arrive at the inventory cost.

Illustration 9.6

Bonjour Enterprises sells foot wears and prepares accounts to 31 December annually.

The store was destroyed by fire on 30 June 2020. However, some records were saved from which the following information was obtained:

	₦'000
Value of inventory 1/1/2019	19,200
Value of inventory 31/12/2019	20,000
Purchases for the year 2019	164,665
From 1/1/2020 – 30/6/2020	107,125
Sales for the year 2019	233,965
From 1/1/2020 to 30/6/2020	156,500

The value of inventory 1/1/2019 was inclusive of certain goods bought for ₦2,400,000 but were valued at half the purchase price because the expiry date was approaching. During the reporting dated 31 December 2019, one half of these goods were sold for ₦788,000 and further one-quarter sold during the period to June 2020 realizing ₦150,000. The proceeds have been included in the sales figure shown above. The remainder were yet to be sold when the fire incident occurred. The value of goods undamaged amounted to ₦4,875,000.

Required:

Calculate the value of the inventory consume by fire assuming the same profit percentage as that of the reporting dated 31 December 2019.

SOLUTION TO ILLUSTRATION 9.6

Computation of Gross Profit Percentage for the reporting dated 31 December 2019

		₦ '000	₦ '000
Sales (w1)			233,177
Opening inventory (w2)		18,600	
Purchases		164,665	
		183,265	
	Closing inventory	19,700	
	Cost of goods sold		(163,565)
	Gross Profit		69,612

$$\text{Gross Profit \%} = \frac{69,612}{233,177} \times \frac{100}{1}\,\% = 29.9\%$$

Determination of inventory on 30 June 2020

Sales		156,500
Opening inventory	19,700	
Purchases	107,125	
Goods available for sale	126,825	
Closing inventory	17,745	
Cost of goods sold		(109,080)
Gross Profit (28% x 14.356m)		47,420

	₦ '000
Value of inventory on 30 June 2010	47,420
Add unsold inventory written down	300
Estimate value of inventory lost	47,720
Less inventory sold	150
Value of inventory destroyed	47,570

Unsold inventory written down = ¼ x ₦1.2m

Working Note:

Sales proceed of goods sold at normal selling price

	₦'000
Total sales for the reporting date 31/12/19	233,965
Less value of inventory written down	
½ x ₦2.4m	(788)
Sales proceed at normal selling price	233,177

Opening inventory to be sold at normal price

	₦'000
Value of opening inventory	19,200
Less value of inventory w/Down	
½ x ₦1.2m	(600)
Goods to be sold at normal price	18,600

iii. Total value of closing inventory 20,000 Less value of remaining inventory w/Down

¼ x ₦1.2m	(300)
Goods to be sold at normal price	19,700

Total sales 1/1/20 – 30/6/20	156,500
Less proceeds from sale of inventory w/Down	(150)
Sales proceeds of goods at normal s/price	156,350

Amount insured is less than Insurable Amount

We have assumed all along that the amount insured is equal to or greater than the insurable amount, therefore the amount calculated represents the amount due from the insurance company. However, if the amount insured had been less, the claim would have been averaged.

Illustration 9.7

Assume that in the above illustration 9.6, Bonjour took insurance cover for loss of inventory for ₦40million, calculate the amount of claim from the insurance company.

Solution

$$\text{Claim} = \frac{\text{Amount Of Insurance}}{\text{Estimated Value of Inventory}} \times \frac{\text{Inventory Lost}}{1} = \frac{₦40{,}000}{₦47{,}720} \times \frac{₦47{,}570{,}000}{1} = ₦39{,}874{,}000$$

9.8 Effect of Cut-Off Point on Inventory Valuation

The cut-off point may not coincide with the accounting reporting date of an entity, but sales and purchases of inventory must continue.

a) The accounting issues are that the goods that were sold after the cut-off date but before the reporting date will be regarded as sales and they should be excluded from the inventory at the reporting date.

b) All goods that were purchased after the cut-off point but before the reporting date must be included in the valuation of inventory.

c) The returns of goods would also be affected. Returns inwards should be included as part of sales while returns outwards are excluded.

d) If the value of the closing inventory falls below the cost at the cut-off date, the net realizable value should be recorded. The difference between the net realizable value and the cost should be expensed in the income statement.

9.9 End of chapter questions

1) The following information appear in the inventory records of Lemon Plc on 31 March 2022.

Item	**Quantity Units**	**Cost per unit ₦**	**NRV per unit ₦**
P	150	300	420
Q	175	400	350

1. Under IAS 2 *Inventory*, what amount should be reported as inventory in current assets in the statement of financial position as at 31 March 2022?

   A. ₦97,500
   B. ₦106,250
   C. ₦113,750
   D. ₦125,125

2. How much should be charged to the statement of profit or loss during the reporting date 31
   March 2022?
   A. ₦8,750
   B. ₦9,250
   C. ₦18,000
   D. ₦26,750

3. Which of the following is NOT required to be disclosed under IAS 2, Inventory?
   A. Accounting policies adopted for measurement of inventory
   B. Physical count of inventory at the end of the period
   C. Amount of inventories recognised as expense during the period
   D. Carrying amount of inventories pledged as security for liabilities
   E. Carrying amount of inventories carried at fair value less cost of sell

4. In accordance with IAS - 2 Inventories, which of the following costs should
   be included in the valuation of inventories of a manufacturing company?
   A. Carriage outwards
   B. Carriage inwards
   C. General administrative overheads
   D. Depreciation of land and buildings
   E. Discount allowed
   13. Which of the following is NOT a component

5. In preparing the statement of profit or loss , which of the following is deducted from goods available for sale to arrive at cost of sales?
   i. Inventory sold

ii. Closing inventory
iii. Lost inventory
iv. Inventory withdrawn by owner
   A. I and II
   B. II and III
   C. II and IV
   D. I, II and III
   E. II, III and IV

6. At the end of an accounting period, the cost of a company's inventory is ₦900,000. This includes damaged items with a cost of ₦40,000 which are expected to be sold for only ₦20,000; At what amount should the inventory be recognised.

7. The inventory items which are sold or consumed are those acquired longest ago; which cost formula is described by this statement?

9.10 Solution to end of chapter questions

1. B
2. A
3. B
4. B
5. E
6. N900,000- N40000 + 20000 = N880,000
7. First in first out method

9.11 Examination type question

Jayek Limited is a manufacturer of plastic buckets. On 1 January, 2018 Jayek

Limited held 15,000 plastic buckets at ₦11,865,000. During the year ended 31

December 2018, Jayek Limited produced 120,000 plastic buckets, compared to a normal production level of 150,000 plastic buckets. 12,000 plastic buckets' inventories were held at 31 December 2018.

Production costs for the year were as follows:

	₦
Raw materials	42,000
Direct labour	2,000
Variable overheads	14,040
Fixed overheads	25,950

At the reporting date, net realisable value of the plastic buckets is higher than cost.

Required:

Using First-in-First-Out method within the context of IAS 2 Inventory, calculate the cost of plastic buckets sold during the period.

2 Overcome PLC applied the weighted average cost (WAC) method to inventory valuation up to the year ended 31 December 2019. The retained earnings on 31 December 2019 and 31 December 2018 were ₦163million and ₦297 million respectively.
During the year ended 31 December 2020, the company changed from WAC to FIFO method.
The value of inventory under each method was as follows:
In the year ended 31 December 2020 and the comparative figures for 2019 are as follows

	FIFO	WAC
	₦'m	₦'m
As at 31 December 2018	120	108
As at 31 December 2019	152	144
As at 31 December 2020	161	152

The statement of profit or loss for the year ended 31 December 2020 and the comparative figures for 2019 are as follows

	2020	2019
	₦'m	₦'m
Revenue	1,124	643
Cost of goods sold	(450)	(230)
Gross profit	674	413
Operating expenses	(300)	(120)
Profit before tax	374	293
Income tax expense	(135)	(59)
Profit for the period	239	234

Dividends paid	110	100

You are required to prepare

a. The adjusted statement of profit or loss for the years ended 31 December 2020 and 2019 using FIFO method.
b. The movement in retained earnings as it would appear in the statement of changes in equity for the year ended 31 December 2020 and 2019; under WAC and FIFO.

9.12 Solution to examination type questions

1. Units unit cost total cost

₦

₦'000

Opening inventory	15,000	791	11,865
Cost of goods produces	<u>120,000</u>	815	<u>97,800</u>
Cost of goods available for sale	135,000		109, 665
Closing inventory	<u>(12,000)</u>	815	<u>(9,780)</u>
Cost of goods sold	123,000		99,885

Cost per unit of goods produced during the period

	₦
Raw materials (42,000,000 / 120,000)	350
Direct labour (21,000,000 / 120,000)	175
Variable overheads (14,040,000/ 120,000)	117
Fixed overheads (26,950,000 / 150,000)	<u>173</u>
Cost of plastic buckets produced during the period	815

i. Note that fixed overhead is absorbed into production at the normal units of output and not based on the actual units produced.

	₵	₵
Inventory at cost		971,040
Cost of damaged inventory	31,620	
NRV- selling price less cost of sale 8,160-1,156	<u>(7,004)</u>	
Amount written down on damaged inventory		<u>(24,616)</u>
Value of closing inventory		<u>946,424</u>

b.If the total cost has been recognised in the financial statements, then adjustment must be made for the amount written down

Dr. Cost of goods sold	24,616	
Cr. Inventory		24,616

Conclusion: Cost of goods sold will increase by ₵24,616 while the inventory to be reported in the statement of financial position will reduce by the same amount.

2. Statement of profit or loss for the years ended 31 December 2020 , using FIFO

	2020	2019
	₦'m	₦'m
Revenue	1,124	643
Cost of goods sold (See note 1)	(441)	(222)
Gross profit	683	421
Operating expenses	(300)	(120)
Profit before tax	383	301
Income tax expense	(135)	(59)
Profit for the period	248	242

Statement of changes in equity (extract) for the period ended 31 December 2020, using WAC

	2020	2019
	₦'m	₦'m
Balance b/d	297	163
Profit for the year	239	234
Dividend paid	(110)	(100)
Retained profits 31 December	426	297

Statement of changes in equity (extract) for the year ended 31 December 2020, using FIFO

	2020	2019
	₦'m	₦'m
Balance b/d	317	163
Change in accounting policy (See note 2)	----	12
Restated balance b/d	317	175
Profit for the year	248	242
Dividend paid	(110)	(100)
Retained profits 31 December	455	317

Tutorial Notes:

1. Higher closing inventory value under FIFO is a reduction in cost of sales. So, if the FIFO method had been used from year 2018 instead of the WAC method , then cost of sales could have reduced by the differences between the two valuations.
2. In year one (2018) the value of closing inventory increased by ₦12 million; in the same vein, it increased by ₦8million and ₦9 million in years 2 (2019) and 3 (2020) respectively.
3. These differences would be adjusted retrospectively; that is with effect from year 2018. Financial statements are produced for the current year with the comparative statements for the preceeding year, hence all adjustments were made in the 2019 and 2020.
4. The cumulative effect (₦12 million)of the change in accounting policies before 2019, (that is 2018), was made on the retained earnings of 2019. The other changes were adjusted in the statements of profit or loss of the year in which they occur.
5. The change to FIFO method increased retained earnings by a total of ₦29 million (₦455m-₦426m)

CHAPTER TEN

ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS –IAS 8

Chapter contents

a) Introduction
b) Explanation of changes in accounting policies**,** changes in accounting estimates and errors
c) Guidance for selection of accounting policies
d) Adjustments and disclose of accounting policies, accounting estimates and errors

10.0 Objectives

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

Identify and explain changes in accounting policies, changes in accounting estimates and errors

Explain the guidance on the selection of accounting policies
Adjust and disclose the effect on financial statements of changes in accounting policies, changes in accounting estimates and errors.

10.1 INTRODUCTION

IAS 8 deals with the selection and changes in policies and disclosure thereof. It also sets out the requirements and disclosure for changes in accounting estimates and correction of errors.

The objectives of the standard are:

i. To enhance relevance and reliability of financial statements
ii. To ensure comparability of the financial statements of an entity over time as well as with financial statements of other entities

What is accounting policies?
Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements, (IAS 8). Accounting policies are important for a better understanding of the financial statements prepared by the management of an entity. Under International Financial Reporting Standards (IFRS), alternative treatments are possible making it more important for an entity to state clearly which accounting policy it has used for the preparation of the financial statements

The following are Examples of accounting policies:

- **Valuation of inventory using FIFO, Average Cost or another suitable basis as per IAS 2**

- **Timing of recognition of assets, liabilities, expenses and income revaluation basis**

10.2 Circumstances for Change of accounting Policy

An entity can change an accounting policy only if:

i. **It is required by a standard e.g.an IFRS**
ii. **The change results in the financial statements providing reliable and more relevant information i.e. voluntary change.**

10.3 Selection of Accounting Policies

1. An entity is required to apply the standard that applies to a transaction, item or event so that the entity can identify trends in its financial performance or financial position.
2. If no standards exist presently for the item management shall develop and apply a policy that is reliable and relevant to the decision-making needs of the user.

   Generally, a change in accounting policy can be established where there is a change in recognition, measurement or presentation criteria of transactions and other events in the financial statements

   Accounting policy shall be considered reliable if it:

   represents faithfully the financial position, the performance and cash flows reflects the economic substance of transactions, other events and conditions

   is neutral

   is prudent

   is complete in all material respects

   comparable understandable

The entity may also consider the most recent pronouncement of other similar standards, accounting literature and accepted industry performance.

10.4 CONSISTENCY OF ACCOUNTING POLICIES

Entities are required to apply the accounting policies selected consistently for similar transactions, events and conditions.

If a standard permits categorisation of items, an accounting policy shall be selected and used consistently.

Once an accounting policy is selected it may be changed only if the change is required by the standard or it results in providing more reliable or relevant information in the financial statements.

10.5 Application or treatment of change of accounting policy:

When the change is required by a Standard, an entity shall account for the change in accordance with the specific transitional provisions, (that is, the standard may specify retrospective application or prospective application),

Where there are no specific transitional provisions in the Standard requiring the change in accounting policy or an entity changes an accounting policy voluntarily, it should apply the change retrospectively.

10.6 Retrospective Application

Where a change in accounting policy is applied retrospectively, an entity should adjust the
opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts for each prior period presented as if the new accounting policy had always been applied.
The impact of the new policy on the retained earnings prior to the earliest period should be adjusted against the opening balance of retained earnings.

If it is impracticable to determine the effects of the change, the entity shall apply the change prospectively from the start of the earliest period. The change and the reason for the change must be disclosed.

10.7 Disclosure of Accounting Policies

a. If the change in accounting policy is due to the initial application of standard, the entity must disclose the change when it has an effect on current and prior periods or it would have an effect in future periods. If it is impracticable to determine the impact, the entity must disclose the title of the standard and the nature of the change.

b. When the change is voluntary, and the entity is unable to determine the future or past impact, the entity shall also disclose the nature of the change and the reason for the new policy providing reliable and more relevant information.

10.8 Changes in Accounting Estimates

Definition of accounting estimates:

An accounting estimate is an approximation of the amount of a business transaction for which there are no precise means of measurement. Accounting estimates arise from inherent uncertainties in business activities, which means that many items in financial statements cannot be measured with precision but can only be estimated. Estimates are formed using judgements based on the latest available information.

10.8.1 Examples of accounting estimates

Common examples of accounting estimates are:

i. allowance for doubtful receivables
ii. useful lives of assets, or the expected pattern of consumption of the future economic benefits of an asset.
iii. Net relisable value of inventories
iv. warranty obligations

10.8.2 Treatment of changes in accounting estimates

A change in accounting estimate gives rise to adjustment of carrying amount of an asset or a liability or of the amount of periodic consumption of an asset.

A change in accounting estimate is accounted for prospectively. The effect of the change is recognized in the current period and future periods affected by the change.

This means that the change is recognized by including it

i. In the statement of profit or loss for the period in which the change is made, if the change affects that period only, or
ii. In the statement of profit or loss for the period of change and future periods, if the change affects both.
iii. The effect of the change will be recognized by adjusting the carrying amount of any affected asset or liabilities in the period of change.

Accounting estimates may change as a result of measurement uncertainties. Estimates are revised as more information becomes available. Such change in estimate does not require restating the financial statements of a prior period, because they neither amount to correction of prior year errors nor change in accounting policy.

Examples are:

- Estimating allowances for doubtful debts
- Inventory obsolescence
- Estimating the useful lives of PPE
- Determining the fair values of financial assets and financial liabilities
- Estimating the amount of warranty obligations

The effect of a change in accounting estimate shall be recognised prospectively by including it in the profit or loss in the period of the change or if it affects future periods in both the period and future periods.

The effect of the change (if any) on assets, liability and equity shall be adjusted on their carrying amount in the period of change.

10.8.3 **Disclosure of Accounting Estimates**

The active and financial effect of the change in accounting estimate of current and future periods.
Errors.

When the financial statements contain errors that are material, the entity shall correct errors retrospectively in the financial statements authorized for issue when the error is discovered.

10.9 Accounting for prior year error

The entity shall restate the comparative amounts for the period(s) presented for which the error occurred.

If the error occurred before earliest period presented, the entity shall restate the opening balances of assets, liabilities and equity of the earliest period presented.

10.9.1 Disclosure requirements of prior period errors.

i. The nature of the error
ii. The amount of the error and the line item affected in a financial statement
iii. Basic and diluted earnings per share
iv. The amount of the correction at the beginning of the earliest period presented.

ILLUSTRATION10.1
The financial Accountant of Bournvilla Ltd encountered the following during the process of preparing the financial statement of the company
In preparing the financial statement for year 31 December 2019 the Accountant discovers an error affecting the 31 December 2018 financial statement.
During the year 31 December 2020 the company changes its accounting policies

Required:

State how the accountant should treat the situation above while complying with the provisions of IAS 8 on Accounting policies, changes in accounting estimates and correction of errors.

Solution to Illustration 10.1

The error should be corrected in the 31 December 2019 financial statement by restating the comparative figures for 31 December 2018 at their correct amount.

Since there is a change in accounting policy, the company must also present a statement of financial position as 1 January 2019 the beginning of the earliest comparative period.

This means that the change should be applied to the balance as at 1 January 2019 as if the new policy had always been applied.

10.10 End of Chapter Questions

1. In accordance with IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors, which of the following is considered changes in accounting estimates?

i. Changing the useful life of an asset
ii. Changing from cost model to revaluation model
iii. Change in the allowances for doubtful receivables
iv. Change from FIFO to weighted average for valuation of inventory
A. I and II
B. I and III
C. II and III
D. II and IV

10.11 Solution to end of chapter questions

1. D

CHAPTER ELEVEN

PREPARATION OF FINANCIAL STATEMENT FOR CORPORATE ENTRIES

Chapter contents

a. Introduction
b. Type of financial instruments a company can issue
c. Share premium account
d. Bonus issues and right issues
e. Differences between current and non-curren
f. Components of financial statements
g. Preparation of simple financial statements in alliance with IAS1
h. Statements of cash flows
i. Statements of changes in equity

11.0 Objectives:

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

- Explain the types of financial instruments a company can issue
- Explain and illustrate the share premium account
- Explain rights issue and it advantages and disadvantages
- Define and record bonus shares in the financial statement
- Explain the differences between current and non-current items
- Identify the line-items in the statement in each of the following components of financial statement
- Prepare simple financial statement in accordance with IAS 1
- Explain and account for treatment of current tax

Capital structure of a company.
The capital structure of a company are in two broad categories, equity, in particular, ordinary share capital and debt instruments.

11.1 Types of shares

There are two main types of share capital ; ordinary share capital and preference share capital

Ordinary shares. These are the shares issued to members of the company who have rights to vote and receive variable returns from the company. Dividends vary according to the profits earned by the company vis-à-vis their dividend policy. Ordinary shareholders are entitled to dividends only after preference dividends have been settled. Dividends paid to ordinary shareholders are treated in the statement of changes in equity.

Preference shares: These are shares that earn a fixed rate of dividends. The holders have prior claim over ordinary shareholders, to any company's profits available for dividends and the capital of the company in the event of liquidation. Preference shares are mainly classified as non-current liabilities, except in rare occasions when companies issue irredeemable preference shares. Some countries do not permit companies to issue of irredeemable preference share capital. Dividends due on preference shares are treated as finance cost in the statement of profit or loss preference shares.

Types of preference share capital

Some categories of preference shares are participating preference shares, redeemable preference shares, irredeemable preference shares and convertible preference shares.

i. Participating Preference Shares: These are preference shares that are given the right to share out of surplus income of the company.
ii. Cumulative Preference Shares: These are preference shares that are given the right to make claims in future for dividend not paid due to insufficient profit.
iii. Redeemable Preference Shares: These are preference shares that are redeemable in future
iv. Convertible Preference Shares: These are preference shares in which the holder has the option of converting to equity or ordinary shares in future
Terminologies

Nominal Value

Shares are normally stated at their nominal value or par value. Nominal value is used as a means of calculating dividends to shareholders; dividends are paid as a percentage of nominal value. The nominal value is also the minimum price at which shares can be issued to shareholders. Companies are prohibited by law to issue shares at a discount (that is, price that is lower than the nominal value) but they can issue shares at a premium.

11.2 Share Premium

Definition

Share premium is a situation where the shares of a company are issued at a price, higher than the nominal price. Simply, share premium is the excess of the issued price of a share over the nominal price. The total excess amount arising on the shares issued is credited to a share premium account. The balance in the share premium account is not distributable as dividends to shareholders.

For instance if an entity issued 1000 shares of ₦1 each at ₦2.50 per share; ₦1000 (₦1 x 1000 shares) would be credited to ordinary share capital account while ₦1,500 (₦1.50 x 1000) would be credited to share premium account. The cash received of ₦2,500 would be debited to cash account.

11.2.1 Uses of the balance in the share premium account.
The share premium can be used by the entity as follows

i. To issue bonus shares as fully paid to existing shareholders.
ii. Writing off preliminary expenses of a newly incorporated company

iii. Writing off the expenses of, or the commission paid on any issue of shares of the company.
iv. Providing for the premium payable on redemption of any redeemable share of the company.
v. To purchase its own shares and other type of securities
vi. To provide for premium payable on redemption of redeemable preferences share/debentures

11.3 Share Capital

a) **Minimum share capital:**
This is the concept used in company law to stipulate the nominal value of share capital a company must hold as a minimum requirement. For instance, in the CAMA 2020 Nigeria's companies must have a minimum issued share capital of ₦100,000 for private companies and ₦2,000,000 for public companies.

b) **Authorized Share Capital:** This is the amount approved by the Memorandum and Articles of Association of a company which the company can legally raise by issue of shares (usually in the form of ordinary or preference shares). Some countries have removed the lid on the number of shares a company may legally raise; in such countries, the concept of authorized share capital does not apply. In Nigeria, CAMA 2020 has replaced authorized share capital with minimum share capital**.**

c) **Issued Share Capital**: This is the part of the authorised shares that have been issued and allotted whether or not they have been fully paid for. Issued share capital cannot exceed the authorized capital.

d) **Called- Up Share Capital**: This is the cumulative portion of the nominal value of shares called-up for payment within a specified period. This is usually including the amount which was due on application, allotment and any subsequent calls that have not been made.

e) Paid- Up Share Capital: This is the portion of called up share capital which has been received from the subscribers

11.3.1 Accounting for Issue of Shares.

When shareholders pay cash to subscribe for shares of a company, the company will debit cash account and credit deposit for shares account. When the company issue shares, usually at a premium, the company will transfer the amount in the deposit for shares account to both ordinary share capital account, at nominal value and share premium account, being the excess of the issued price over the nominal value. Issue cost will be deducted from share premium. In effect, the relevant entries are;
Debit cash account
Credit ordinary share capital account, with the nominal value
Credit share premium account, with the premium

Illustration 11.1 Owen PLC issued 140,000 shares of ₦20 each at a price of ₦120 per share. Show journal entries for the transaction.

Solution to illustration 11.1

Cash received ₦120 x140,0000 = <u>16, 800,000</u>

Nominal value = 140,000 x ₦20 2,800,000
Share premium = 140,000 x ₦100 = 14,000,000

Journal

	DR.	CR.
	₦'000	₦'000
Cash account	16,800	
Ordinary share capital		2,800
Share premium		14,000

When share are issued with transaction cost, the cost is deducted from share premium balance.

Illustration 11.2

Assume that the transaction cost in the Owen example above is ₦2,000,000, then the entries will be reflected as follows:

Journal

	DR.	CR.	
	₦'000	₦'000	
Cash account			16,800
Ordinary share capital		2,800	
Share premium		14,000	
Debit share premium account (share issue cost)		2,000	

Effectively, the balance in the share premium account is. ₦12,000,000
.

11.4 Bonus Issue

This is also referred to as capitalization issue or scrip issue. It is simply capitalization of reserves. These are shares issued to existing shareholders on a pro-rata basis without the shareholders making any payment for shares issued, hence there is no cash received in respect of bonus shares but there may be administrative costs.

Advantages of issuing bonus share.

i. Bonus share increases the liquidity of the company

ii. It a is a positive sign that the company committed to long-term growth

iii. It increases the issued share capital of the company, making it attractive to investors

Disadvantages of issuing bonus share.

i. The administration cost of making bonus issue is higher than the cost of paying cash dividends

ii. The company does not receive cash, hence overall investment of the company remains the same.

Bonus shares are funded from reserves, first from share premium and then other reserves.

Example: A company with 10 million ordinary capital of ₦1 each made a 1 for 4 bonus shares. At that date, the balance in the share premium account was ₦1,700,000 while the retained earnings were ₦7,800,000.Show the accounting journal for the transaction.

Solution

Value of bonus shares issued = (10m/4 x ₦1) = ₦2,500,000

Entries

Debit share premium account with ₦1,700,000

Debit retained earnings with ₦800,000

Credit Ordinary share capital with ₦2,500,000

11.5 Rights Issue

These are shares issued to existing shareholders at a price which is usually lower than the market price of the shares: The shareholders therefore have the following options,

- To take up the rights;
- To sell/take up part of the rights;
- Not to do anything at all.

Rights are also issued on pro rata basis to existing shareholders. For example; rights issue of 1 for 2 means that for every two shares held by existing shareholders one share would be issued to them.

Therefore, a shareholder that has 50,000 ordinary shares would be entitled to 25,000 ordinary shares as rights.

11.5.1 Advantages of rights issue

- **i.** Rights issue is the cheapest and fastest source of raising capital for a company; the shareholders will likely take up the right because it is offered at cheaper than the market price.
- **ii.** There are less rigorous rules for their issue compare with outright public issues.
- **iii.** Companies can make right issue to reduce debt/equity ratio and may help companies to avoid breaching of contracts.

11.5.2 Disadvantages of rights issue

- **i.** If the existing shareholders do not exercise their rights or sold their rights to the public, their shareholding percentage may be diluted
- **ii.** Rights issue is always an indication that the entity is facing liquidity crisis, this impression may affect the entity negatively.

Accounting treatment of rights issue:
Rights issue is accounted for the same way issue of ordinary share capital to the public is accounted for.

Loan notes
A company can raise fund by issuing debt instruments other than preference shares. A typical example is loan notes or loan stock. A loan is not a financial instrument. When loan is issued by a company, it is a contract that specify that a loan is owed by the company to be paid at a specified period in the future. Annual amount of interest would be paid or payable on the principal. The interest due whether paid or not would be recognised in the statement of profit or loss part of the statement of comprehensive income. In the statement of financial position, the amount of interest due but not yet paid is recognised as current liability while the principal is treated as non-current liability.

11.6 Company Income Tax

Only corporate entities pay tax on their profits. At the end of each year, the entity will estimate its tax liability after adjusting for certain items, in its accounting profits, to arrive at the taxable profit. The adjustments are done according to the tax laws of the jurisdiction. This taxable profit is multiplied by the tax rate to arrive at the current tax estimate for the period.

Adjustment for tax underestimate or overestimate.
When the tax estimate is agreed with the relevant tax authority, in the following year, the tax payable may not agree with the tax estimate, hence the need to adjust for under- or over- estimate in respect of the previous year.

Income tax expense
The tax expense to be recognised for each year in the statement of profit or loss is made up of:

i. Tax estimate for the current year minus previous year's underestimate; or
ii. Tax estimate for the current year minus previous year's overestimate.

In the trial balance, underestimate is on the debit side while overestimate is on the credit side.

Treatment of tax in the statement of financial position.
The current tax year's estimate is reported in the statement of financial position as current liability. Last year's estimate, including any adjustment made for under or over-estimate would have been settled in the current year.

11.7 Preparation of Financial statements

Preparation of financial statements must comply strictly to the laid down laws and relevant International Financial Reporting Standards (IFRS). The financial statements are general purpose financial statements; hence they are not prepared for specific users.

IAS 1- Presentation of Financial Statements prescribes the contents and presentation of financial statements. We shall discuss some of the requirements at this level of the examinations.

Components of Financial Statements

The components of financial statements are:

1. Statement of financial position at the end of the period
2. Statement of comprehensive income (presented as a single statement) or a statement of profit or loss and other comprehensive income for the period (made up of a separate statement of profit or loss and of other comprehensive income)
3. Statement of changes in equity for the period
4. Statement of cash flows for the period
5. Notes, comprising a summary of significant accounting policies and other

explanatory notes

The first three components' statements are prepared using the accrual basis of accounting, while the statement of cash flows in prepared on cash basis.

11.7.1 Additional requirements of IAS 1

IAS 1 requires the following details to be stated in respect of every component of financial statements

1. The name of the reporting entity or other means of identification and any change in that information from the end of the preceding period;
2. Whether the financial statements are of an individual entity or a group of entities:
3. The date of the end of the reporting period or the period covered by the set of financial statements or notes;
4. The presentation currency, as defined in IAS 21 The effects of Changes in Exchange Rates; and
5. The level of rounding used in presenting amounts in the financial statements.

   An entity may round up or round down amounts contained in its financial statements to the nearest whole number, thousands or millions etc.

11.7.2 Other requirements of IAS 1 are the disclosure of:

i. The domicile and legal form of an entity, its country of incorporation and the address of its registered office (or principal place of business, if different from the registered office),
ii. A description of the nature of the entity's operations and its principal activities
iii. Comparative information must generally be disclosed in respect of the preceding accounting period.

11.7.3 Contents of Financial Statements

IAS 1 prescribes the structure and contents of the following financial statements:

Contents of the Statement of Financial Position

It is statement which shows all the components of equity, assets and liabilities of an entity as at a particular date or as at the end of a particular period. The items listed below are generally presented as line items in the statement of financial position.

i. Property, plant and equipment
ii. Investment property
iii. Intangible assets
iv. Financial assets or investments
v. Trade and other receivables, and
vi. cash and cash equivalents
vii. Inventories
viii. Trade and other payables
ix. Current tax liability
x. Provisions
xi. Financial liabilities such as loan notes

Current and non-current assets and liabilities

It is necessary to know the distinction between current and non-current where assets and liabilities in statement of financial position are classified into their current or non-current nature.

Current Assets

Assets are classified as current if they meet any of the following criteria
A current asset is one which satisfies any of the following criteria:

i. It is expected to be realized, sold or consumed within the entity's normal operating cycle.
ii. It is held primarily for the purpose of being traded
iii. It is expected to be realized within 12 months after the reporting period
iv. It is cash or a cash equivalent.

An asset which satisfies none of these criteria is a non-current asset.

Operating Cycle

This is the time between the acquisition of assets for processing and their realisation in cash or cash equivalent. When the entity's normal operating cycle is not clearly identifiable, its duration is assumed to be twelve (12) months.

Current assets include inventories and trade receivables that are sold, consumed or realised as part of the normal operating cycle, even when they are not expected to be realised within twelve (12) months after the end of the financial year.

Examples of current assets are

- Inventories
- Accounts receivables
- Cash and cash equivalents
- short-term and highly liquid investments that are readily convertible into specific sum of cash
- Income tax asset

Examples of non-current assets

- Motor vehicles
- Plant and equipment
- Furniture and fittings
- Computer
- Land and building
- Motorcycle
- Development cost
- Brand name
- Goodwill
- Deferred tax asset

Current Liabilities:

i. It expects to settle the liability in its normal operating cycle;
ii. It holds the liability primarily for the purpose of trading;
iii. The liability is due to be settled within twelve months after the reporting period; or
iv. It does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period

Any liability that does not meet any of the four criteria above for current liability is classified as a non-current liability.

Examples of current liabilities are

- Trade payables
- Other payables
- Accruals
- Provisions
- Current tax payable
- Bank overdraft/short-term bank borrowing; and
- Current portion of long-term loan payable.

11. 8 Presentation of Statement of Profit or Loss and Other Comprehensive

Income

IAS 1 stipulates that statement of profit or loss can be prepared using the following methods:

- Single statement method: that is where the profit or loss part in merged with the other comprehensive income section
- Two statement method: where the profit or loss part is prepared as a separate part and the other comprehensive income part is also prepared separately

The statement of profit or loss part is made up of income and expenses which would finally result in a profit or loss for the year while other comprehensive income part lists other gains or losses that have arisen in the period.

The only **Other Comprehensive Income (OCI**) we shall deal with at this level is the revaluation reserves on property, plant and equipment.

Total comprehensive income, comprising the profit or loss for the period and other comprehensive income, is transferred to statement of changes in equity.

11.8.1 Content of Statement of Profit or Loss

IAS1, however permits the classification of expenses in the statement of profit or loss using **two** methods:

1. **Analysis of expenses by functions**: when expenses are analysed according to their function, the functions are
   i. Cost of sales: They include purchases, for a merchandising company or production cost for manufacturing company. Cost of sales is calculated the same way for a sole trader.
   ii. Distribution costs: These costs relate to advertisement, marketing and promotion as well as depreciation of distribution vehicles and salesman salary and commission.
   iii. Administrative expenses: These are expenses that are neither cost of sales nor distribution cost. They relate to general office administration.

This method of classifying expenses is more common with most entities.

Format of function of expenses method

	₦	₦
Revenue		X
Cost of goods sold		(X)
Gross profit		X
Other operating income		X
Distribution costs	X	
Administrative expenses	X	
Total operating expenses		(X)
Profit from operating activities		X

2. **Analysis of expenses by their nature:** when expenses are analysed according to their nature the categories of expenses will vary according to the nature of the business.
   i. Cost of raw materials and consumables used;
   ii. Changes in inventory
   iii. Personnel cost
   iv. Depreciation and amortisation cost
   v. Other expenses

Cost of goods sold is calculated by adding opening inventory and cost of goods purchased less closing inventory. For a manufacturing company, cost of good purchased will be replaced with cost of goods produced. The format of the statement of profit or loss, using the nature of expenses method is as follows:

	₦	₦
Revenue		X
Other operating income		X
Cost of raw materials and consumable used		X
Changes in the inventory of finished goods and work in progress		X
Personnel or staff costs		X
Depreciation and amortisation charges		X
Other operating expenses		X
Total operating expenses		(X)
Profit from operating activities		X

- Under the nature of expenses method, if the closing inventory is greater than the opening inventory of finished goods and work in progress the difference is an increase in income or a reduction in operating expenses.
- Raw materials and consumable used is obtained by adding opening inventory of raw materials to purchases of raw materials less closing inventory of raw materials

11.9 Statement of Changes in Equity

Purpose of Statement of Changes in Equity (SOCIE) The main purpose of a SOCIE is to show how each component of equity has changed during an accounting period. The statement contains the following:

i. Balances at the beginning of the period in respect of components of equity;
ii. Adjustment for the effect of changes in accounting policies and prior year error;
iii. The profit earned during the period
iv. The other comprehensive income for the year
v. Additional funds raised during the year, through issue of ordinary shares
vi. Dividends paid to holders of equity shares
vii. Balances at the end of the accounting period.

In the case of a company, these components are share capital and the company's reserves; such as share premium, revaluation reserves and retained earnings.

Illustration 11.2

You have been asked to prepare the financial statements of Brima Limited for the year ended 31 December 2021.

The trial balance as at that date is shown below.

	DR	CR
	Le 000	Le'000
Revenue		66,000
Purchases	32,200	
Property, plant and equipment (PPE) - cost	72,000	
PPE-accumulated depreciation, 1 January 2021		25,000
Inventories as at 1 January 2021	7,800	
Interest expense	200	
Income tax		400
Distribution expenses	8,900	
Administrative expenses	7,000	
Retained earnings		27,700
Dividend paid	1,200	
Trade receivables	9,000	
Cash at bank	3,200	
8% bank loan repayable in 2021		5,000
10 million ordinary share capital at N1 each		10,000
Share premium		5,000
Trade payables		2,400
		141,500
	141,500	

The following information is also available:

i. The revenue figure in the trial balance includes sales made on credit to Mr. Alusine amounting to Le3,100,000 on 30 October 2020.
ii. Closing inventory value was Le8,400,000. Included in this figure are inventories that cost Le500,000 but which can be sold for only Le250,000.
iii. Interest on bank loan for the past six months remained unpaid as at 31 December 2018. This was not included in the trial balance.

iv. Depreciation of property, plant and equipment, for the year was charged at 10% using straight line method.
v. Accrued distribution expenses amounted to Le 150,000 at 31 December 2021.
vi. Included in the ordinary share capital is additional 1 million shares of Le1 that were issue for Le2,500,000.
vii. Income tax represents overestimate in respect of current tax in the previous year. Income tax estimate for the current year is Le1800,000.

You are required to prepare:

a) Statement of profit or loss and other comprehensive income for the year ended 31 December 2021.
b) Statement of changes in equity for the year ended 31 December 2021.
c) Statement of financial position as at 31 December 2021.

SOLUTION TO ILLUSTRATION 11.2

Brima LIMITED
Statement of profit or loss and other comprehensive income for the year ended 31 December 2021

	Le'000	Le'000
Revenue	9,050	62,900
Cost of sales	14,200	(31,850)
Gross profit		31,050
Distribution costs		
Administrative expenses		(23,250)
Loss from operations		7,800
Finance costs (		(400)
Profit before tax		7,400
Tax expense		(1,400)
Profit for the year		6,000

Brima LTD
Statement of financial position as at 31 December 2021

Assets	Le'000		
Non-current Asset			Le'000
Property, plant and equipment			39, 800
Current Assets:			
Inventories		8,150	
Trade receivables		9,000	
Cash at bank		3,200	20,350

		60,150
Equity		
Share capital	10,000	
Share premium	5,000	
Retained earnings (23,500-4,457 + 3,100)	35,600	50,600
Liabilities		
Non-current liabilities		
8% bank loan		5,000
Current liabilities:		
Income tax payable	1,800	
Trade payables	2,400	
Other payables (200+150)	350	4,550
		60,150

Brima LTD

Statement of changes in equity for the year ended 31 December 2021

	Ordinary shares	Share premium	Retained earnings	Total
	Le'000	Le'000	Le'000	Le'000
Balance Jan 1, 2021	4,000	8,500	27,700	40,200
Prior year gain			3,100	3,100
Profit for the period			6,000	6,000
Dividend paid			(1,200)	(1,200)
Issue of shares	1,000	1,500		2,500
Balance Dec 31, 2021	5,000	10,000	35,600	50,600

Working notes:

		Le'000	Le'000
1.	Revenue		66,000
	Prior year gain		(3,100)
	Recognised in profit or loss		62,900
2.	**Cost of goods sold**		
	Opening inventory	7,800	
	Purchases		32,200
	Closing inventory at cost	8,400	
	Amount written off (500-250)	(250)	
	Net realisable value		(8,150)
	Recognised in profit or loss		31,850

3. Distribution costs

As per trial balance	8,900	
Accrued expenses	150	
Recognised in profit or loss		9,050

4. Administration expenses

As per trial balance	7,000	
Depreciation charge on PPE	7,200	
Recognised in profit or loss		14,200

5. Income tax

Income tax estimate	1,800	
Over-estimate in previous year		(400)
		1,400

6. Other payables

Accrued interest on loan	200	
Accrued distribution expenses		150
		350

7. Property, plant and equipment

Cost		72,000
Depreciation		
Accumulated depreciation January 1, 2021	(25,000)	
Charge for the year		(7,200)
Balance December 31,2021		32,200

Tutorials:

The illustration examines your ability to prepare financial statements in accordance with IAS 1, the relevant adjustments as prescribed by the relevant standards included in the notes, such as:

- Revenue of Le3,100,000 not recognised in 2020, now adjusted as prior year item in 2021 by debiting current year revenue and crediting prior year retained earnings.
- Adjustment for tax overestimate in previous year to arrive at tax expense for the year.
- The amounts in ordinary shares and share premium are the balances at the end of the year In order to obtain the balances at January 1, 2021, the amount raised from issue of shares during the year must be deducted.
  Ordinary shares (Le5,000,000 – Le1,000,000) = Le4,000,000
  Share premium (10,000,000 – Le1,500,000) = Le8,500,000
  Le'000

Total amount realised 1,000,000 shares **x** Le2.50	2,500
Credit to ordinary shares	1,000
Credit to share premium	1,500
	2,500

11. 10 Statement of Cash Flows Statement of Cash Flows

IAS 1 states that a complete set of financial statements should include a **statement of cash flows**. IAS 7- Statements of Cash Flows sets out the requirements for the format and content of the statement. The aim of IAS 7 is to provide information to users of financial statements about an entity's ability to generate cash and cash equivalents, as well as indicating the cash needs of the entity. The statement of cash flows provides historical information about cash and cash equivalents

A statement of cash flows categorizes inflows and outflows of cash, under three main headings namely:

- Cash flows from operating activities
- Cash used in or obtained from investing activities
- Cash paid or received in financing activities.

Statement of cash flows can be prepared using two methods, these are:

- Indirect method
- Direct method.

The statement of cash flows provides users with a basis to:

a) Assess the ability of the enterprise to meet its debt obligations as they fall due.
b) Assess the entity's ability to generate and utilize cash
c) Assess the ability of the enterprise to finance its current operations using its own cash or external sources of cash
d) Analyze the relationship between profit and cash flows overtime, in order to control costs by controlling cash flows
e) Estimate future cash flows.

11.10.1 Limitations of the Statement of Cash Flows

a) The statement may not be able to provide the required information for the future because it uses historical data.
b) Some non-cash transactions that are not disclosed on the face of the statement are of interest to users because they will impact on future cash flows.

11.10.2 Differences Between Statement of Cash Flows and Statement of Profits or loss.

a) The statement of comprehensive income is prepared on accrual basis; hence profit is only an indicator of performance. On the other hand, the statement of cash flows is prepared on cash basis, which is a useful indicator of a company's liquidity and solvency.
b) Cash flows is a better measure of the ability of the entity to meet its debt obligation, as they fall due, than the profit generated.

11.10.3 CLASSIFICATION OF CASH FLOWS- IAS7

The Statement of cash flows is prepare using standard headings as explained below:

1. Cash flows from operating activities: These are principal revenue-producing activities of the entity and other activities that are not investing or financing activities:

Common examples are:

a. Cash inflows
- Cash receipts from customers from sales of goods or rendering of service
- Royalties fees, commission and other revenue received in cash
- Income tax refunds received,

b. Cash outflows:
- Cash payments made to suppliers of goods and services
- Cash payments made to and on behalf of employees"
- Income tax paid, unless the payments can be specifically identified with financing or investing activities

2. Cash flows from investing activities: These are cash flows of the entity that relate to acquisition and disposal of property, plant and equipment, financial assets and investment properties and any other non-current assets.

Examples of inflows from investing activities are
- A proceed from sale of property, plant and equipment
- Proceed from sale of investments
- Collection of cash advances
- Dividend received
- Interest received

Examples of cash outflows from investing activities are:
- Purchase of property, plant and equipment
- Purchase of investment
- Cash advances made to third parties

3. Cash flows from financing activities: These are cash flows of the entity that relate to changes in the size and composition of the equity and borrowing of an entity.

Example of cash inflows from financing activities are
- Cash received on issue of shares
- Cash received from issuing debt instruments
- Proceeds from bank borrowings

Examples of cash outflows from financing activities are:
- Payment of dividends to shareholders
- Repayment of principal portion of debt, including lease obligations
- Repayment of bank borrowings

4. Cash and Cash Equivalents: Cash and cash equivalents comprise cash on hand and demand deposits, together with short-term, highly liquid investments that are readily convertible to a known amount of cash, and that are subject to an insignificant risk of changes in value. Cash equivalents include bank overdrafts and cash equivalents with short-term maturity; usually not more than three months maturity date.

5. Net increase or decrease in cash and cash equivalents is the overall increase or decrease in cash and cash equivalents during the period. The balance of cash and cash equivalents at the end of the year is obtained by adding the

cash and cash equivalent at the beginning of the period to the net increase or decrease in cash equivalent for the period. The net increase in cash and cash equivalent for the period is the sum of the cash flows from operating activities, investing activities and financing activities.

11 10.4 Presentation of the Statement of Cash Flows

Cash flows are divided into three parts, namely:

- Cash flows from operating activities.
- Cash flows from investing activities; and
- Cash flows from financing activities.

There are two methods for the preparation of cash flows from operating activities,

1. **Direct Method:** Direct Method shows all the receipts and payments for each class.

- Cash receipts from customers
- Cash paid to suppliers
- Cash paid to employees
- Cash paid for other operating expenses
- Interest paid
- Income taxes paid
- Net cash from operating activities

2. **Indirect Method**

Under this method the profits or loss is adjusted for the effects of transactions of non-cash nature. It derives net cash flows from operating activities from the net operating results for the year as reported in the statement of profit or loss.

Indirect Method Cash Flow Statement comprises of

- Profit before interest and income taxes

Add or deduct items not involving movement in cash

- Add back depreciation charged during the year
- Add back loss on sale of non-current assets
- Add back impairment loss of assets during the year
- Add back interest expense
- Deduct gains on sale of non-current assets

Adjust for changes in working capital items

- Deduct increase or add decrease in receivables
- Deduct increase or add decrease in inventories
- Add increase or deduct decrease in trade payables

Obtain a sub-total of all the above items, then

- Deduct interest paid
- Deduct tax paid

The result is, net cash from operating activities

Note that an increase in inventories or receivables means that it takes longer time to collect cash in respect of it, hence it is a deduction from cash from operating activities. An increase in payables means that it takes a longer time to pay cash to suppliers, hence it is an addition to cash flows from operating activities.

Working capital items.

Working capital items are current assets and current liabilities but for the purpose of cash flows, increase or decrease in the following working capital items are not adjusted under cash flows from operating activities, using indirect method.

- Tax: Tax paid is treated as a deduction from gross cash flows from operating activities
- Interest: Interest paid is treated as either cash outflows on operating activities or from financing activities. Interest received is treated as cash inflows from investing activities
- Dividend: Dividend paid is treated as cash flows from financing activities and interest receive is treated as cash inflows from investing activities
- Cash: Cash and cash equivalent
- Bank overdraft: Cash and cash equivalent
- Demand deposits: Cash and cash equivalent if it is easily convertible to cash

Illustration 11.3

Chuks Ltd is preparing it statement of cash flows using the direct method and has provided this information.

	₦'m
Credit sale	20,000
Trade and other receivable at year end	3,000
Trade and other receivable at beginning of the year	5,000
Purchase on credit	8,000
Trade payable at year end	3,800
Trade payable at beginning of year	4,000
Operating expenses incurred	6,000
Accrued expenses, beginning of the year	1,000
Accrued expenses, end of the year	800
Depreciation of property, plant and equipment	1,200
Tax paid	3,200

Required:

Prepare the cash flows from operating activities using the direct method.

Solution to illustration 11.3

Cash flows from operating activities

	₦'m
Cash received from customers (w1)	22,000
Cash paid to suppliers (w2)	(8,200)
Cash paid towards operating expenses (w3)	(5,000)
Tax paid	(3,200)
Net cash flows from operating activities	6,000

Working

Receivables Account

	Nm		Nm
Bal b/f	5,000	Bank received	22,000
Credit Sales	20,000	Bal c/f	3,000
	25,000		25,000
Bal b/d	3,000		

Suppliers Account

	Nm		Nm
Bank-paid	8,200	Bal b/f purchase	4,000
Bal c/f	3,800		8,000
	12,000	Balance b/d	12,000
		Balance b/d	3,800

Operation Expenses Account

	Nm		Nm
Bank-paid	5,000	Bal b/f	1,000
Depr. On PPE	1,200	Income statement	6,000
Bal c/f	800		
	7,000		7,000
		Balance b/d	800

Indirect method

Under this method the profits or loss is adjusted for the effects of transactions of non-cash nature. It derives net cash flows from operating activities from the net operating results for the year as reported in the statement of profit or loss.

Illustration 10.3

Ajileye Ltd has provided the following information

	₦'m
Profit before tax	800
Depreciation on PPE	400
Loss on sale of building	200
Interest paid	200
Interest expenses	300
Income tax paid	100
Account receivable year end	1,700
Account receivable beginning to the year	1,000
Account payable year end	1,000
Account payable beginning of the year	400
Inventory year end	800
Inventory beginning of the year	1,000

Required: prepare the statement of cash flow from operating activities using the indirect method.

Statement of cash flows- indirect method Cash flows from operating activities:

Ajayi Ltd

Statement of cash flows

	₦'m	₦'m
Profit before taxation		800
Adjustment for:		
Depreciation on PPE	400	
Loss on sale of building	200	
Interest expense	300	900
Movement in working capital:		
Increase in account receivable	(700)	
Increase in account payables	600	
Decrease in inventory	200	100
Cash from operation		1,800
Interest paid	200	
Tax paid	100	(300)
Net cash flows from operating activities		1,500

Illustration.

The statement of financial position of Alade Ltd as at 31 December 2020 and 2021 are given below:

	2021	2020
	₦''000	₦''000
Non-current assets		
Land and buildings	7,170	6,940
Plant and equipments	5,404	6,214
	12,574	13,154
Intangible assets		
Patents	1,704	1,570

Current assets

Inventory	11,434	11,470
Receivables and prepayments	9,870	9,394
Cash and bank balances	930	230
	36,512	35,818
Current liabilities		
Trade and other payable	(5,590)	(5,344)
Current taxation	(1,790)	(1,970)
Bank overdraft	(544)	(1,410)
	28,588	27,094
Non-Current Assets:		
Deferred taxation	(3,110)	(3,090)
	25,478	24,004
Equity and Liabilities:		
Ordinary share capital	8,800	8,800
Share premium	1,034	1,034
Accumulated profits	15,644	14,170
	25,478	24,004

Notes

a) Depreciation has been charged for the year ended 31 December 2021 as follows

	₦'000
Land and building	174
Plant & machinery	1,200
Patents	46

b) Plants sold during the year realized ₦80, 000. The cost of the plant when it was acquired was ₦304, 000, accumulated depreciation at date of disposal amounted to ₦264, 000.

c) The tax charge was ₦2,080,000

d) Dividend paid in the year amount to ₦1,854,000

e) The profit for the year before tax was ₦5,428,000

Required:

Prepare the statement of cash flows using the indirect method for the year ended 31 December 2021

Solution illustration 11.5

Alade LTD

Statement of cash flows for the year ended 31 December 2021

	₦'000	₦'000
Cash flow from operation activities:		
Profit before tax		5,428
Adjustment for:		
Depreciation	1,374	
Amortization of patents	46	
Profit on disposal of plant	(40)	1,380
Change in working capital		
Decrease in inventory	36	
Increase in receivables	(476)	
Increase in payables	246	(194)
Cash flow from operating activities		6,614
Tax paid		(2,260)
Net cash from operating activities		4,354
Cash flow from investing activities:		
Purchase of land and buildings	(404)	
Purchase of plant & machinery	(430)	
Purchase of patents	(180)	
Proceed from disposal of plant & machinery	80	
Net cash used in investing activities		(934)
Cash flow financial activities:		
Dividend paid	(1,854)	
Net cash flow used in financing activities		(1,854)
Net increase in cash and cash equivalents	1,566	
Net cash and cash equivalents Jan 1 (230-1,410)		(1,180)

Net cash and cash equivalents 31 December	386

Workings

Land and Building Account

	₦'000		₦'000
Opening balance	6,940	Depreciation charged	174
Bank purchase	404	Bal c/d	7,170
	7,344		7,344

Plant disposal

	₦' 000		₦ '000
Plant account cost	304	Plant account depreciation	264
Income statement	40	Bank sale proceed	80
	344		344

Taxation Account

	₦'000		₦'000
Bank (Paid)	2,260	Opening balance b/d	1,970
Closing balance c/d	1,790	Statement of profit or loss	2,080
	4,050		**4,050**

11. 11 End of Chapter Questions.

1. Which of the following cash transactions will result in cash outflow?
   A. Sale of a machine
   B. Increase in trade receivables
   C. Increase in trade payables
   D. Proceed from issue of debenture
   E. Receipts from customers

2. Which of the following is NOT a cashflow from operating activities?
   A. Cash payment of an insurance entity for premiums on claims, annuities and other policy benefits

B. Cash advances and loans made to other parties

C. Cash payments or payments from contracts held for dealing or trading purposes.

D. Cash receipts from the sale of goods and rendering of services

E. Cash receipts from royalties, fees, commissions and other revenue

3. Which of the following is/are correct?

I. A statement of cash flow prepared using the direct method produces same figure for operating cash flow from that produced if the indirect method is used

II. Rights issue of shares do not feature in the statement of cash flow

III. Revaluation surplus of a non-current asset is not recognised as an item in statement of cash flow

IV. A profit on the sale of a non-current asset is recognised as an item under cash flows from investing activities in a cash flow statement

A. I and IV

B. II and III

C. II and IV

D.I and III

E. I and III

4. When preparing statement of cash flows, which of the following items may NOT be classified as investing activities?

A. Proceeds from the issue of shares, debentures and loan stock

B. Dividends and interest received on investments

C. Purchase of non - current assets

D. Proceeds from sale of non-current assets

E. Purchase of investments

Use the following information to answer questions 5 and 6:

Opa Limited has the following capital structure:-

Ordinary share capital of 50k	₦100,000
Share Premium Account -	₦150,000

The company made a rights issue of 1 for 5 at N1.50 which were fully subscribed.

5. Determine the value of the rights issue

A. ₦40,000

B. ₦50,000

C. ₦60,000

D. ₦70,000

E. ₦75,000

6. What is the balance on the share premium account following the rights issue?

A. ₦140,000

B. ₦150,000

C. ₦160,000

D. ₦190,000

E. ₦200,000

7. Ale Limited has a gross profit of 11% and its sales are ₦150,000. What is the cost of sales?
   A. ₦131,460
   B. ₦133,135
   C. ₦133,500
   D. ₦142,500
   E. ₦160,000

11.12 SOLUTION TO END OF CHAPTER QUESTIONS

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

CHAPTER TWELVE

INTERPRETATION OF FINANCIAL STATEMENTS

Charter content

a. Users of financial statements and their information needs
b. Financial analysis
c. Tools of financial analysis
d. Summary of basic accounting ratios
e. Calculation of basic ratios and their interpretations
f. Limitations of ratio analysis

12.0 Objectives

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

a. Distinguish vertical and horizontal financial analysis
b. Identify different tools of financial analysis
c. Calculate basic financial ratios.
d. Analyse results over time or between entities.
e. Interpret such results
f. Produce reports based on the interpretation
g. Understand basic limitations inherent in such analysis.

12.1 Users of Financial Statements and Their Information Needs

Financial statements are produced not for their own sake but for different uses to which they can be put by various groups interested in different aspects of the report. These users and their information needs are considered below:

Employees (existing and potential, including management): They are interested in the overall profitability, financial soundness, growth and efficiency of the company.

Investors (existing and potential, including shareholders, takeover bidders, predator companies): These are interested in profitability, earnings potential, dividend policy, yields on investment, financial stability and risk exposure of the firm where they have committed or are intending to commit their fund.

Creditors (existing and potential, including debenture holders, loan providers, bankers, trade creditors, lessors): These are concerned about the company's solvency and ability to pay debt and interest as at when they fall due, asset backing for liability, their position vis-à-vis other stakeholders, etc.

Analysts and Advisors (including credit rating agencies, stockbrokers, investment advisors, insurance brokers, etc.): These are professionals interested in the overall performance of the firm relative to the industry or the whole market.

Government and Its Agencies (including VAT Service, CEPS, IRS and Local Government, Central bank, etc.): This group of users are interested in the profitability and growth prospects of companies within the economy, their ability to meet their tax liability, their ability to generate employment and fulfil their statutory obligation and corporate responsibilities, etc.

Business Contacts (including suppliers, bankers, insurance companies, consumers): This group of people are interested in different things. Suppliers are interested in the continued existence of their client company and its growth. Consumers are interested in quality of goods and/or service delivery, reasonableness of pricing and trade terms, etc. Bankers are interested in the cash flow and performance efficiency of the client. Insurance companies are also interested in the continued operation of the client, risk management policies and safety measures.

The General Public: would like to see corporate bodies living up to their social responsibilities

12.2 Financial Analysis

The process of reviewing and evaluating the financial statements of companies, thereby gaining an understanding of the financial health of the company and enabling more effective decision making is what is referred to as **Financial Statements Analysis** or simply **Financial Analysis**.

Financial Analysis is usually performed by professionals who prepare reports using ratios that make use of information taken from financial statements and other sources. Financial analysis is required for many financial managerial decisions such as:

- How to manage the finances to achieve the strategic goals of the institution
- How to increase profitability
- How to reach self-sufficiency/breakeven point

- How to increase efficiency especially reducing the cost per client
- How to manage the costs of human resources as part of overall human resource management
- How to deal with the effect of inflation
- How to manage liquidity
- How to manage the fixed assets, i.e. what should the asset structure be? How to finance them, are they insured and are they safe, what should be the depreciation policy?
- What is the best financing structure, i.e., how much debt?
- What is the optimum level of each different operational expense including the cost of funds?

12. 2.1 Tools of Financial Analysis

Analyzing the financial statement could be done in several ways; through horizontal, vertical or intercompany and ratio analysis.

Horizontal Analysis

Horizontal analysis is the comparison of financial information over a series of reporting periods; it is a form of inter-temporal analysis i.e. a comparison between accounting periods. Horizontal analysis compares two or more years of financial data in both monetary and percentage terms, which is the most straight forward method of analysing financial statements. The current year figures and information are compared with the previous year (s) to note and rationalize any significant changes. A variation of horizontal analysis is **Trend Analysis** where percentage changes are calculated for several successive years thus having a long run view of the analysis. In trend analysis a firm's present performance figure is compared with its past and expected future performance figure to determine whether the company's financial condition is improving or deteriorating over time.

Vertical Analysis

Vertical Analysis also known as common size financial statement is the proportional analysis of a financial statement, where each line item on a financial statement is listed as a percentage of another item. Typically, this means that every line item on an income statement is stated as a percentage of gross sales, while every line item on a statement of financial position is stated as a percentage of total assets. It is the review of the proportion of accounts to each other within a single period.

Intercompany Analysis

This relates to comparison of performance figure of two or more similar companies. In intercompany analysis, the performance figures of a firm are compared with those of similar firms or with industry averages or norms to determine how the company is faring relative to its competitors. Ideally the `benchmarked companies` should be operating under similar business and economic conditions and applying similar accounting policies. If these are lacking, then adjustments should be made to ensure fair and comparable bases.

Ratio Analysis

Ratio analysis provides relative measures of the firm's conditions and performance. It identifies meaningful statistical relationships between different components of the financial statements. Ratios are useful in evaluating a company's financial position and operations and in comparing financial data for several years or for many companies.

12.2.2 Comparisons and Basis of Comparisons in Financial Analysis

Our discussion of tools of financial analysis enumerated above reveals that comparisons are being made; either inter-temporal and/or intra or intercompany. A single performance indicator or ratio is not sufficient on its own but becomes more meaningful if a benchmark or yardstick is available against which to set the indicator. This call for benchmarking and possible yardsticks to use as a basis for comparisons includes the following:

- Company's own budgeted or targeted performance
- Company's own previous year(s) performance (trend analysis or intra-company analysis)
- Performance figures of similar entities
- Industrial average performance figures
- National economic targets

12.3 **Ratio Analysis as a Tool of Financial Analysis**

Ratio analysis is the most common form of financial analysis. There are different categories and types of ratios with each of them focusing and evaluating different areas of performance. Therefore, it is important to restrict the calculation by being selective. The ratios chosen should be the key ones relevant to the requirements of the situation. The main point is that there is no single group of ratios suitable for all purposes; specific ratios are required for specific purposes and the analysis must be developed accordingly.

12.3.1 Categories of Ratios

Different users of financial statements are interested in different ratios since their information needs and areas of interest in the company differ. Ratios can be grouped into categories such as:

a) Profitability,
b) Activity or Efficiency,
c) Liquidity (short-term financial stability),
d) Gearing (Long-term financial stability) and
e) Investment and Market Value Ratios.

a. Profitability Ratios

Profitability is the ratio that measures the ability to earn income and sustain growth in both short and long run. A company's degree of profitability is usually based on the income statement, which reports on the company's results of operations. These ratios measure the entity’s potential to earn income /revenue in excess of its operating costs.

The absolute figure of profit earned is not in itself significant since the size of the business earnings and profit may vary enormously. It is significant to consider the size of the profit relative to the size of the business; size being expressed in terms of the quantity of capital employed. This is why these ratios are of two types; those showing profitability in relation to sales and those showing profitability in relation to investment. Measures of profitability include the following:

i. Gross Profit Margin
ii. Net Profit Margin
iii. Return on Equity (ROE)
iv. Return on Assets (ROA)

v. Return on Capital Employed

Gross Profit Margin

Gross profit ratio expresses the relationship between gross profit and net sales. Gross profit is the difference between sales and cost of sales. Normally, a higher ratio is considered good. Gross profit ratio is a reliable guide to the adequacy of the selling prices and efficiency of trading activities.

$$\frac{\textit{Gross}\ \text{Profit x 100}}{\textit{Total}\ \text{Sale}}$$

This is the margin that the enterprise makes on its sales. Normally, this ratio is expected to remain reasonably constant. A change in this ratio over various accounting periods may be traced to a change in:

- Selling price – normally deliberate though sometimes unavoidable, for example, because of increased competition
- Sales mix (often deliberate)
- Purchase cost including carriage or discounts
- Production cost (material, labour, production overhead)
- Inventory (error in counting, valuing or cut off, inventory shortages)

Low margins usually suggest poor performance but may be due to expansion cost (e.g. launching a new product) or trying to increase market share. Above average margins are usually a sign of good management although unusually high margins may make the competition keen, whereby many will be willing to join the industry and enjoy the rich pickings.

Generally, industries with high volumes of sales and quick turnover rates like food retailing are able to support and sustain low margins while manufacturing industries with high operating overheads would normally have high margins.

Net Profit Margin

This ratio establishes the relationship between net profit and net sales. Net profit ratio indicates the overall efficiency of the business. The higher the net profit ratio, better the business.

$$\frac{\textit{Net}\ \text{Profit after tax}}{\textit{Total}\ \text{sales}} \text{ x 100}$$

Rate of Return on Equity (ROE)

This is the required rate of return on investment in shares. It varies from investor to investor, but should reflect the fact that investment in shares is having a higher level of risk than leaving the money in the bank.

$$\frac{\textit{Net}\ \text{Profit after tax - Preferred Stock Dividend}}{\textit{Shareholders}'\ \text{Equity}}$$

Return on Assets

This is an indication of how profitable a company is relative to its total **assets**. **It** gives an idea as to how efficient management is at using its **assets** to generate earnings.

$$\frac{\textit{Net}\ \text{Profits after Tax x 100}}{\textit{Total}\ \text{Assets}}$$

Return on Capital Employed (ROCE)

Return on Capital Employed or Return on Investment judges the overall performance of the enterprise. It measures how efficiently the sources entrusted to the business are being used. The return on capital employed is a fair measure of the profitability of any concern. This ratio also helps in judging performance of different departments as well. In practice, this ratio can be calculated in various ways depending on how capital employed is defined and which of the earnings figure is used, whether earnings before interest and tax (EBIT) or profit after tax (PAT).

In its simple form, this ratio is $= \frac{\text{Earnings}}{\text{Capital Employed}} \times 100\%$

Other versions of ROCE are as follows:

$$\frac{\text{EBIT (Net Profit before interest on long term loan and taxation)}}{\text{Shareholders Fund + Long term loan}} \times 100$$

EBIT means Earnings Before Interest and Tax

$$\frac{\text{Profit after Interest and Tax – preference dividends}}{\text{Ordinary share capital + reserves}}$$

b. Activity or Efficiency Ratios

These ratios show how well management have been able to utilize the resources of the business to generate income. They include:

i. **Sales to Assets Ratio**

$$\text{Sales to Assets Ratio} = \frac{\text{Sales}}{\text{Assets}}$$

The denominator (Assets) can be defined as Non-current Assets, total assets or various categories of assets; the choice of the appropriate base depends on the user of the information and the purpose of the analysis. The perceived performance of the company is good with a high figure from this ratio; therefore the higher this ratio, the better the performance.

ii. Sales to Capital Employed

This ratio suffers similar challenges like the ROCE because of the different ways of measuring capital employed by the business. Its interpretation is not different from that of Sales to Asset ratio.

$$\frac{\text{Sales}}{\text{Capital Employed}}$$

iii. Inventory Turnover Ratio/Period

Inventory turnover ratio establishes the relationship between the cost of goods sold during a given period and the average amount of inventory carried during that period. Higher ratio indicates that more sales are being produced by a unit of investment in inventory. The objective of computing inventory turnover ratio is to ascertain whether investment in stock has been efficiently used or not. A low inventory turnover may reflect dull business, over investment in stock or accumulation of inventory.

$$\frac{\text{Average Inventory } \times \text{ 365 days/52 weeks/12 months}}{\text{Cost of Sales}}$$

Receivables Turnover Ratio/period

This ratio is computed to establish the relationship between net credit sales and average Receivables. This ratio indicates the number of times the receivables are

turned over in a year in relation to sales. It shows how quickly receivables are converted into cash. It indicates the efficiency of the staff entrusted with collection of debts. A high ratio is better since it would indicate that debtors are being collected more quickly.

$$\text{Debt Collection Period} = \frac{\text{Average Receivables x 365 days/52 weeks/12 months}}{\text{Credit Sales}}$$

iv. Payable Payment Period

This ratio shows the relationship between net credit purchases and average Trade payables. The objective of computing this ratio is to determine the efficiency with which the creditors are managed and paid. A high ratio indicates that creditors are not paid in time while a low ratio gives an idea that the business is not taking full advantage of Trade payables period allowed by the creditors. A long payment period may be good. It represents a source of free finance. It may however indicate that the company is unable to pay more quickly because of liquidity problems. Note that if the payment period is long, then:

i. The company may develop a poor reputation as slow payer and may not be able to attract new suppliers.
ii. Existing suppliers may decide to discontinue supplies
iii. The company may be losing out worthwhile cash discounts.

$$\text{Trade payable Payment Period} = \frac{\text{Average Trade payables x 365 days/52 weeks/12 months}}{\text{Credit Purchases}}$$

It is usual to find the last three ratios 'iii' to' v' listed under liquidity or short-term financial stability ratios as well. This is because they are part of working capital components and determinants of cash operating cycle.

c). Liquidity or Short-term financial stability Ratio

Liquidity or short-term financial stability ratios measure the ability of a firm to maintain positive cash flow, while satisfying immediate obligations. The common ones are:

Current Ratio

Current Ratio = *Current* Assets abilcities

The current ratio measures the adequacy of current assets to meet short term liabilities. It reflects whether the entity is in a position to meet its liabilities as they fall due. Traditionally, a current ratio of 2 or higher was regarded as appropriate for most businesses to maintain credit worthiness. However in recent times, a figure of 1.5 may be regarded as the norm (In practice, what is an ideal ratio depends on the industry and the particular circumstance of the entity involved). A higher figure should be perceived with some suspicion as it may be due to high level of inventory and receivable or high cash levels which could be put to better use. The current ratio should be looked at in the light of what is normal for the business. For example, supermarkets tend to have low current ratio because there are no trade receivables and there is usually very tight cash control.

Quick Ratio or Acid Test Ratio

Quick ratio is also known as the acid test ratio because by eliminating inventories from current assets, it provides the acid test of whether the enterprise has sufficient resources (in terms of receivables and cash) to settle its current liabilities. The Norm is for the quick ratio to be between 1 and 0.7 (even though in practice what is an ideal ratio depends on the industry and the circumstance of the entity).

$$\text{Quick Ratio or Acid Test Ratio} = \frac{\textit{Current}\ \text{Assets less Inventory}}{\textit{Current}\ \text{Liabilities}}$$

Stock Turnover Period

$$\text{Stock Turnover Period} = \frac{\text{Average Inventory x 365 days/52 weeks/12 months}}{\text{Cost of Sales}}$$

Debt Collection Period

$$\text{Debt Collection Period} = \frac{\text{Average Trade Debtors x 365 days/52 weeks/12 months}}{\text{Credit Sales}}$$

Creditors Payment Period

$$\text{Creditors Payment Period} = \frac{\text{Average Trade creditors x 365 days/52 weeks/12 months}}{\text{Credit Purchases}}$$

Cash Operating Cycle/Working Capital Cycle

This indicates the length of times it takes a business to convert its Inventory into sales (stock turnover period), converts receivables into cash (receivable collection period) and mobilizes cash to pay its trade payables (payable payment period).

Inventory turnover period	xx
Receivable Collection Period	xx
	xx
Less payables payment period	xx
Cash operating cycle	xx

The longer the period, the worse it is for the business because the longer the period, the higher the working capital requirement. It is therefore essential that under normal circumstances, a company works towards reduction of the Inventor turnover period and the Trade receivable collection period and expansion of the Trade payables payment period.

12.4 The Concept of Overtrading

Overtrading arises when a company expands its sales revenue fairly rapidly without securing additional long term capital adequate for its needs. The symptoms of overtrading are:

i. Inventory increasing, possibly more than proportionately to revenue

ii. Receivables increasing, possibly more than proportionately to revenue

iii. Cash and liquid assets declining at a fairly alarming rate

iv. Payables increasing rapidly

The symptoms imply that the company has expanded without giving proper thought to the necessity to expand its capital base. It has consequently continued to rely on its suppliers and probably its bank overdraft to provide the additional finance required. It will reach a stage where suppliers will withhold further goods and bankers will refuse to honour further cheques until borrowings are reduced. The problem is that borrowings cannot be reduced until sales revenue is earned which in turn cannot be achieved until production is completed which in turn is dependent upon materials being available and wages paid. Overall result is deadlock and rapid financial collapse.

12.5. Gearing or Long- term Financial Stability Ratios

These ratios assess the ability of the entity to fulfil its obligation to creditors and other third parties in the long-run. They measure the relationship between equity capital and debt capital of the company and also indicate financial risk and stability of the company.

Ratios computed under this sub-heading include the following:

i. Total Debts to Shareholders Fund = $\dfrac{\textit{Total debts}}{\text{Shareholders' equity}}$

ii. Long Term Debts to Shareholders Fund

This ratio measures the relationship between equity fund and debt capital. Within this context, preference shares are considered as debt capital (probably because they normally attract fixed rate of dividends and also they are cumulative). It is also known as the gearing or leverage ratio.

Gearing is the relationship between fixed interest bearing long term loans plus fixed dividend bearing shares on one hand and equity share capital or equity fund on the other. The objective of companies is to obtain favourable or positive leverage. This means that the business raises fund at a relatively low fixed servicing cost (in terms of interest and dividends) and uses these funds to earn a much higher returns than their servicing cost. This strategy is known as trading on the equity and is evidenced by improvement in earnings per share.

Long Term Debt to Shareholders Fund =

$$\frac{\text{Long Term Loan + Preference Shares}}{\text{Shareholders Fund}}$$

The Concept of Financial Balance

The capital leverage of a company brings into focus the concept of *'financial balance'* It is the balance between the various forms of available funds. A business must have a sufficient level of long term capital to finance its long term investments in non-current assets. Part of the investment in current assets will also be financed by relatively permanent capital with the balance being provided by credit from suppliers and other short- term borrowings.

Any expansion in activity will normally require a broadening of the long capital base, without which overtrading may develop.

Suitability of finance is also a key factor. A permanent expansion of a company's activities should not be financed by temporary, short term borrowings. On the other hand a

short term increase in activity such as the ***December Christmas Sales'*** for a company retailing children's wear would ideally be financed by short-term borrowing e.g. bank overdraft.
A major addition to Property Plant & Equipment fixed assets such as the construction of a new factory would not normally be financed on a long term basis.

iii. Proprietary Ratio

Proprietary ratio is also known as Equity Ratio or Net worth to total assets. It establishes relationship between proprietor's funds to total resources of the firm. It is the inverse of debt ratio and is not very widely used.

$$\text{Proprietary Ratio} = \frac{\text{Shareholders Fund}}{\text{Total Tangible Assets}}$$

iv. Fixed Interest Cover

Interest cover shows how many times interest payments are covered by operating profits, or the ability of a company to pay for the cost of its long term borrowing out of profit is measured by its interest cover. A low interest cover is a warning to ordinary shareholders that their dividend may be endangered if profits are not maintained.

$$\text{Fixed Interest Cover} = \frac{\text{Net Profit before Interest and Tax}}{\text{Fixed Interest paid or payable}}$$

v. Fixed Dividend Cover

This is the relationship between available profits and the ordinary dividends payable out of those profits, reflecting how sustainable the dividend level is likely to be in the future

$$\text{Fixed Dividend Cover} = \frac{\text{Net Profit before Interest and Tax}}{\text{Preference Dividend paid or payable}}$$

Investment or Market Value Ratios

These are ratios that measure potential and actual growth of a shareholder's investment

The Earnings Per Share (EPS)

The EPS is used primarily as a measure of profitability and so an increasing EPS is a good sign.

$$\text{Earnings per Share i.e. EPS} = \frac{\textit{Earnings} \text{ after Taxes}}{\textit{Total} \text{ Number Shares}}$$

The limitations of EPS are as follows:

i. In times of rising prices, EPS will increase as profits increase. Thus any improvement in EPS should be viewed in the context of the effect of the price level changes on the company's profits

ii. Earnings Per Share is dependent on an earnings figure, which is a subjective measure. Some elements of the earnings figure are particularly subjective such as depreciation charges.

iii. EPS is a historical figure based on historical accounts. This is a disadvantage where it is used for a forward-looking figure such as the price earnings ratio\

iv. EPS cannot be used as a basis of comparison between companies, as the number of share in issue in any particular company is not related to the amount of capital employed.

Dividend Per Share (DPS)

This indicates the amount payable as dividend per ordinary share. It is usually recommended by the directors and approved by the shareholders. When compared with EPS, it indicates the retention policy of the Company.

$$\text{Dividend per Share} = \frac{\textit{Dividend}}{\textit{Total}\ \text{Number of Shares}}$$

Earnings Yield

This measure relates EPS to the market price per share and it is a very important stock market performance indicator.

$$\text{Earnings yield} = \frac{\text{Earnings per share}}{\text{Market price per share}} \times 100$$

Price Earnings Ratio

This ratio is the reciprocal of earnings yield and it indicates the payback period of the investment made in the shares. It is the most widely referred to stock market ratio. It is also commonly referred to as *Earnings Multiple* and it represents the market`s consensus of the future prospects of that share. The higher the P/E ratio, the faster the growth the market is expecting in the company`s future EPS; and the lower the P/E ratio, the lower the expected future growth.

$$\text{Price/Earnings Ratio} = \frac{\textit{Share}\ \text{Price}}{\textit{Earning}\ \text{per Share}}$$

Dividend Yield

This is the percentage of the gross dividend to the market price. The dividends are grossed up to show the amount including tax where applicable**.**

$$\text{Dividend Dividend yield} = \frac{\textit{Dividend}\ \text{Per Share}}{\textit{Share}\ \text{Price}} \times 100$$

Dividend Pay-Out Rate

This ratio indicates the percentage of the earnings for the year (available to equity shareholders) that is actually declared as dividend.

$$\text{Dividend Pay-Out Ratio} = \frac{\text{Dividend per share}}{\text{Earnings per share}} \times 100$$

12.6 Calculation of Basic Ratios and Their Interpretation

A number of worked examples showing how basic accounting ratios are calculated are given below.

ILLUSTRATION 12.1

The capitals employed by two different companies operating in the same industry are as follows

	Glory Ltd	Praise Ltd
	¢	¢
Equity Shares (issued at ¢2)	600,000	1,800,000
Preferences Shares (issued at ¢2)	600,000	-
	1,200,000	1,800,000
Retained earnings	800,000	1,200,000

Total equity	2,000,000	3,000,000
18% Debentures	2,000,000	1,000,000
Capital Employed	4,000,000	4,000,000

The preference shares is irredeemable

Required

i. Calculate the gearing ratios of each company, stating in each case whether the gearing is high or low.

ii. Calculate the maximum dividend per share on equity dividend which each company could declare, without utilizing, or adding to, surplus. if net profits before interest and tax for 2021 were Glory ¢1,000,000 and Praise ¢1,000,000. The preference shares attract a fixed dividend of 24 pesewas per share per annum. Assume corporation profit tax to be at the rate of 30%.

iii. What conclusions can you draw from your calculation in (ii) above?

Solution 12.1

b) (i) Gearing = $\frac{\text{Long Term Loan + Preference Shares}}{\text{Total equity}}$

	Glory Ltd	Praise Ltd
	$\frac{¢2,600,000}{¢1,400,000}$ =185%	$\frac{¢1,000,000}{¢3,000,000}$ =33.3%
	Highly geared	Lowly geared
	=	
b) ii	Glory Ltd	Praise Ltd
Net Profit before Interest and Tax	₵1,000,000	₵1,000,000
Less Interest	360,000	180,000

Net Profit before tax	640,000	820,000
Less Tax	192,000	246,000
Net Profit after tax	448,000	574,000
Preference dividend (600,000 x 24p)	144,000	-
Profit available for equity shareholders	304,000	574,000

Maximum dividend per share ₵304,000 = ₵0.51 ₵600,000
₵574,000 ₵1,800,000
=₵0.31

iii. It can be seen that in Glory Ltd, the highly geared company, EPS is substantially better than in Praise Ltd which is lowly geared, although both companies have the same net profit before interest and tax. This is due to the fact that the return on capital employed

earned was higher than the fixed interest rate and fixed dividend rate.

Illustration 12.2

The figures below relates to QRS Ltd For the year ended 31 December 2016
Dalasi (D)

Gross profit	3,985,000
Net Profit	1,275,000
Turnover	13,715,000

As at 31 December 2016 D

Shareholders' Fund	6,675,000
Total Tangible Assets	10,040,000
Total Current Assets	160,000
Current Liabilities	125,000
Long term loans	3,240,000
Inventories	95,000

Required:

Using the above figures and what can be derived there from, calculate profitability and financial stability ratios discussed above.

Solution 12.2

Some ratios that can be used to measure profitability are

- Net Profit to Total asset % (Return On Assets or ROA)
- Net Profit to Non-current assets %
- Net Profit to capital Employed (ROCE)
- Gross Profit to Sales %
- Net Profit to sales %

Some ratios that can be used to measure financial stability are

- Shareholders‟ funds to total tangible assets (Proprietary ratio)
- Long term external finance to shareholders funds
- Total external finance to shareholders‟ funds
- Current ratio
- Quick ratio or acid test ratio

b) **Profitability**

i)	Net profit on Total Assets %	= D1,275,000/D10,040	=12.7%
ii)	Net Profit to Noncurrent Assets %	=D1,275,000/(D10,040,000–D160,000)	=12.9%
iii)	Net Profit to Capital Employed	=D1,275,000/(D6,675,000 +D3,240,000)	= 12.86%
iv)	Gross Profit to sale%	=D3,985,000/D13,715,000	=29.1%
v)	Net Profit to Sales %	=D1,275,000/D13,715,000	=9.3%

Financial Stability

i)	Proprietary Ratio	=D6,675,000/D10,040,000	= 66.5%
ii)	Long Term External Finance to SF	=D3,240,00/D6,675,000	= 48.5%
iii)	Total External Finance to SF	= (D3,240,000+D125,000)D6,675,000	= 50.4%
iv)	Current Ratio	= D160,000/D125,000 :1	= 1.28:1
v)	Quick Asset Ratio	= (D160,000 – D95,000) /D125,000	= 0.52 :1

Illustration 12.3

The summarized final accounts for the year ended 31 December 2006 for two retailing companies in the same industry are as follows:

Income statement for the year ended 31 December 2016

	Adom Ltd		Grace Ltd	
		L$		L$
Sales		400,000		400,000
Cost of sales		280,000		292,000
Gross profit		120,000		108,000
Expenses	94,800		84,960	
Net Profit	25,200		23,040	

Statement of Financial Positions as At 31 December 2016

		Adom Ltd (L$)	Grace Ltd (L$)
Non-Current Assets		260,000	160,000
Current Assets:			
Inventory	96,000	96,000	24,000
Receivables	34,000		8,500
Cash	10,000		39,500
		140,000	72,000
Current Liabilities		(40,000)	(4,000)
Net Current Liabilities		100,000	32,000
		360,000	192,000
Financed by			
Stated Capital		160,000	160,000
Income Surplus		200,000	32,000
		360,000	192,000

Notes:			
Opening Inventory were as follows		64,000	16,000

Required:

a) Calculate the following ratios for the respective companies:

- Current Ratio
- Acid Test Ratio
- Rate of Inventory Turnover
- Gross Profit to Turnover %
- Net Profit to Turnover %
- Net Profit to Capital Employed %

b) One of the companies had adopted the policy of selling goods as cheaply as possible to increase the volume of sales. The other company gives special attention to customer service and charges top prices for its goods.

Required

State with reasons, which of these companies, Adom Ltd or Grace Ltd, is better using ratios in part (a) of the question

Solution 12.3

		Adom Ltd		**Grace Ltd**	
a)	Current Ratio	<u>L$140,000</u> L$40,000	=3.5:1	<u>L$72,000</u> L$40,000	=1.8:1
	Acid Test	<u>L$44,000</u> L$40,000	=1.1:1	<u>L$48,000</u> L$40,000	=1.2:1
	Rate of Inventory Turnover	<u>L$280,</u>000 80,000	=3.5times	<u>L$292,000</u> 20,000	=14.<u>6</u>

Gross Profit %	L$120,000 -------------- =30% L$400,000	L$108,000 ------------- = 27% L$400,000
Net Profit %	L$25,200 ------------ = 6.3% L$400,000	L$23,040 ------------ = 5.8% L$400,000
Net Profit to Capital Employed	L$25,200 ------------ = 7.0% L$360,000	L$23,040 ------------ = 12% L$192,000

Adom Ltd carries a wider range of expensive Inventory, consequently inventory turnover is slower. More substantial investment in non-current assets, stemming from ownership of a prime prestigious site and luxurious premises has accounted for a relatively low return on capital employed.

Grace Ltd charges lower prices which encourage sales. The faster Inventory turnover is the result of the company operating on a Inventory figure of about one quarter of that of its competitor.

Illustration 12.4

The financial information provided below is for two companies, which operate in similar retail fields, using the same business and accounting policies.

Statement of financial position at 30 june 2016

	GODSON LTD	**ALLASON LTD**
	¢	¢
Assets		
Non-current	11,260	15,700

Current Assets

Inventories	2,440	1,940
Trade Receivables	2,480	3,320
Cash	120	160
	5,040	5,420
Total assets	16,300	21,120

Share Capital	7,000	9,400
Capital reserves	1,300	700
Retained earning	3,700	5,740
Equity	12,000	15,840
10% loan notes	1,100	1,280
Current Liabilities		
Bank overdraft	420	400
Trade payables	1,940	2,640
Other payables	840	960
	3,200	4,000
Total equity and liabilities	13,100	17,120

Statement of income for the year ended 31 december 2006

	GODSON LTD	**ALLASON LTD**
	¢	¢
Sales	14,940	11,400
Cost of sales	11,360	7,540
Gross Profit	3,580	3,860
Less: Expenses		
Selling and Distribution	1,280	1,200

Administration and General	620		580
Financial	180		160
	2,080		1,940
Net Profit before	1,500		1,920
Taxation	740		900
Net Profit after tax		760	1,020
Dividends		480	740
Retained Profit		280	280

You are required to:

a. Calculate for each company six ratios which you consider to be most appropriate for indicating the efficiency of operation and shor term financial strength of the two firms showing the figures you have used and pointing out any weakness in the figures, and alternatives that might be taken had more information been available.

b. Using the financial information provided above and the ratios you have calculated, prepare a report which analyses and compares the efficiency of operations and short term financial strength of the two companies.

Solution 12.4

The question requires only six ratios to be calculated out of the many which can be calculated. The main feature of the question is that there should be a judicious selection of ratios. Different accountants would make different choices.

	Godson Ltd	Allason Ltd
Efficiency of Operation		
Sales/non-current assets	¢14,940	¢11,400
	¢11,260- =1.33times	¢15,700 =0.73times

Profit before Tax/Capital employed	$\frac{¢1,500}{¢13,100}$ =11.45%	$\frac{¢1,920}{¢17,120}$ =11.54%
Sale/Capital employed.	$\frac{¢14,940}{11,420}$ =1.4 times	$\frac{11,400}{17,120}$ =0.67 times
Debts collection period	$\frac{2480}{14,940}$ x 365days =61days	$\frac{3320}{11,400}$ x 365days = 106days

The main weakness in the figures is that the ratios have been calculated on the figures prepared under historic cost convention. Consequently, if one of the companies is much older than the other, it will have better efficiency ratios, all other things being equal, by reason of its total assets and capital employed being less than those of other company since a greater number of years‟ depreciation would have been accumulated.

If more information had been available, figure on current cost accounting basis could have been used. This would not only have taken inflation into account, but also would have the effect of making the two companies‟ figures time comparable.

b. **Report on Inter-Company Performance Comparison Efficiency of Operation**

In absolute terms, Allason has achieved a greater net profit (¢1,920) on a lower turnover figure of ¢11,400) compared with ¢14,940m for Godson Ltd. This represents net profit to sales of 16.85% for Allason Ltd as against 10% for Godson Ltd.

This situation is mainly attributable to the Gross Profit Ratio of 33.86% and 23.96% for Allason and Godson respectively. Bearing in mind that these are similar businesses, this disparity is remarkable. From the evidence which follows, there might be good reasons for saying that Godson Ltd is under-pricing its goods and that Allason Ltd is over-pricing them and that both companies might improve profits and profitability by remedying this situation.

Godson's lower Gross profit margin of 33.86% seems to be responsible for its faster Inventory turnover of 5.07 times compared with Allison's rate of Inventory turnover of 4 times. The lower turnover (¢11,400) and slower Inventory turnover (4 times) of Allason are reflected in its poor sales to capital employed ratio of 0.67 times or 67% compared with 1.14% for Godson Ltd. Overall profitability

(ROCE) is consistent with the above findings.

Short-term Financial Strength

At both 1.56:1 and 1.36:1, the working capital positions of both companies seem weak. The Receivable collection and Payable settlement periods of Godson are evenly balanced (about 61/62 days) while those for Allason are about 106 days and 128 days respectively.

If those for Godson are on the high side, Allason's figures are incredibly high. Considering the similarity of the businesses, the disparities between the two companies is surprising. The liquidity problem could be overcome by issuing share capital or debentures.

12.7 Limitations of Ratio Analysis

Ratios are meaningless on their own unless they are interpreted to bring out their intended meaning and to tell the intended stories to aid management decisions. The following points should serve as a checklist

i. What does the ratio literally mean?
ii. What does a change in the ratio mean?
iii. What is the norm?
iv. What are the limitations of the ratio?

Computing financial ratios are merely one way of conducting financial analysis and financial ratios face several theoretical challenges among which are:

1. Financial statements themselves have limitations, e.g. they contain arbitrary estimates and figures which are based on personal decisions. Another limitation of financial statement is window dressing. To give a better picture of the company, accounting figures may be manipulated.

2. The application of accounting policies in the preparation of financial statements must be understood when attempting to interpret financial ratios. Inter firm comparison is possible provided these firms follow the same accounting policies regarding the method of depreciation, valuation of stock, etc. But this is very rare to see.

3. The effect of inflation: The problem of interpreting data in a period of changing prices is can only be catered for if prior year(s) figures are adjusted to constant values. The interpretation and comparison of ratios are rendered invalid by the changing value of money.

4. A few simple ratios do not provide an automatic means of evaluating a company. Business problems usually involve complex patterns which cannot be solved by the use of ratios.

5. Ratios must not be used as the sole test of efficiency. Concentration of ratios may inhibit the incentive to grow and expand, to the detriment of the long-term interests of the company.

6. The earning power of a business may well be affected by factors which are not reflected in the financial statements. Thus, these do not necessarily represent a complete picture of a business, but only a collection of those parts which can be translated into money terms e.g. the size of the order book and the existence of a highly trained workforce are normally ignored in financial statements.
7. Ratios say little about the firm's prospects in an absolute sense. Their insights about relative performance require a reference point from other time periods or similar firms.
8. One ratio holds little meaning. As indicators, ratios can be logically interpreted in at least two ways. One can partially overcome this problem by combining several related ratios to paint a more comprehensive picture of the firm's performance.
9. Seasonal factors may prevent year-end values from being representative. A ratio's values may be distorted as account balances change from the beginning to the end of an accounting period. Use average values for such accounts whenever possible.
10. Financial ratios are no more objective than the accounting methods employed. Changes in accounting policies or choices can yield drastically different ratio values.
11. They fail to account for exogenous factors like investor behaviour that are not based upon economic fundamentals of the firm or the general economy (fundamental analysis).
12. Many large companies actually operate a number of different divisions in quite different industries making it difficult to develop a meaningful set of industry averages for comparison purposes.
13. At times, even for those companies operating in one industry it is difficult to decide on a proper basis for comparison. Ratios of a company have meaning only when they are compared with some standards. Generally there is no standard ratio for the purpose of the comparison, because conditions of one concern differ significantly from another concern. For example, an ideal current ratio is 2: 1. But if a firm is able to procure additional funds easily and immediately, in that case current ratio of less than 2 may be considered good.
14. The differences in definitions of items in the statement of financial position and income statements make the interpretation of ratio difficult. In practice, differences exist as to the meaning of certain term e.g. capital employed. Terms used to calculate accounting ratios have no standard and precise

15. Definition. For example, net profit ratio is calculated by different ways like net profit before tax or net profit after tax.

16. Ratios calculated at a point in time are less informative and effective as they suffer short-term changes and qualitative factors like skill of employees, quality of product/ service, competitions, industrial relations, etc. are ignored.

17. Life cycle of the business, such as type of firm, stage of development, objectives of owners are not considered. For example low profitability ratios may be accepted during early stages of growth.

18. Ratios indicate past performance only. Ratios are calculated on the basis of past figures. Thus, ratios indicate past performance and not expected future performance. Since past is quite different from what is likely to happen in future, it is difficult to use ratios for forecasting purposes. The financial analyst is more interested in what will happen in future. The management of a company has information about the company's future plans and, policies and is, therefore, able to predict future to a certain extent. But an outsider analyst has to rely only on the past ratios.

19. Unless ratios are calculated in a uniform manner, from uniform data, comparisons can be very misleading.

    The accounting periods covered by the financial statements may not reflect representative financial positions. Many businesses produce financial statements to a date on which there are relatively low amounts of trading activities. If trade is seasonal, the items in the statement of Financial Position may not be representative of values throughout the accounting period.

12.8 Chapter Summary

Users of financial statements can best appreciate the contents if they can interpret the statements and make meaning out of them. Horizontal or intra-company analysis involves comparing the current year with the previous year(s) and noting any significant changes. Intercompany analysis involves comparing an entity's performance with another entity of comparable standard

Ratios are one means of analyzing financial statements. Ratios can be grouped into categories such as Profitability, Liquidity (short term financial stability), Efficiency, Gearing (Long term financial stability) hand Investor ratios. Different users of financial statements are interested in different ratios. Ratios are only as good as the underlying information and this must therefore be considered as to its reliability and the degree to which it may have been manipulated.

12.9 END OF CHAPTER QUESTIIONS

1. During a year, a business sold inventory which had cost N120,000. The inventory held at the beginning of the year was N12, 000 and at the end of the year was N20,000. What was the annual rate of inventory turnover?
   A. 12times
   B. 10 times
   C. 7.5 times
   D. 7 times
   E. 6 times

2. Given a selling price of Le350, 000 and a gross profit mark up of 40%, the cost price would be

   A. Le300,000

   B. Le250,00

   C. Le210,000

   D. Le140,000

   E. Le100,000

3. A business operates on a gross profit margin of $33^{1}/_{3}$%. Gross profit on sale Was L$1,600 and expenses were L$1,360. The net profit percentage is

   A. 22.67%

   B. 11.25%

   C. 18.5%

   D. 5.0%

   E. 3,75%

4. In 2006, a company's current ratio was 2.5:1 and its acid test ratio was 0.8:1. By year 2007, the ratios are expected to be 3:1 and 0.6:1 respectively. These changes are most likely to be due to which ONE of the following

   A. Increased bank balance

B. Decreased bank balance
C. Increased Inventories
D. Increased receivable and payable
E. Decreased Inventories

12.10 SHORT ANSWER QUESTIONS

1. State the formulae for computing inventory turnover ratio
2. State how to compute quick Asset ratio.
3. State the formulae for debt collection period
4. (Long term loan + Preference shares)/Equity is equal to
5. Which user group would be most interested in the gearing ratio?

12.11 SOLUTION TO MULTIPLE CHOICE QUESTIONS

1. C
2. B
3. D
4. D

12.12 solution to short answer questions

1. Inventory turnover ratio= $\dfrac{\text{Average Inventory x 365 days/52 weeks/12 months}}{\text{Cost of Sales}}$

2. Quick Ratio or Acid Test Ratio **=** $\dfrac{\textit{Current}\text{ Assets less Inventory}}{\textit{Current}\text{ Liabilities}}$

Debt Collection Period = $\dfrac{\text{Average Receivables}}{\text{Credit Sales}}$ x 365 days/52 weeks/12 months

Gearing

3. Debenture Holders

12.13 Examination Type Question

a) It is widely recognized that in order to succeed, a business must pay regard not only to its profitability but also to its financial stability.

Required

i. State briefly what you understand to be the meaning of the terms `profitability" and "financial stability"
ii. Name three ratios which can be used for measuring profitability and three ratios for measuring financial stability.

SOLUTION 12.13

Profitability

This is the measure of relationship between profit and the resources employed in earning it: the resultant figure is usually expressed as a percentage. The resources aspect of the relationship may comprise total assets or fixed assets plus working capital or equity fund.

For other businesses which are not asset reliant, an alternative suitable measure might be adopted.

Thus in a profession such as that of an accountant or a solicitor, profit would be more appropriately related to fee income. A subsidiary measure of profitability is in the relationship between gross profit and net profit to sales.

Financial Stability

This measures the degree of safety of a business from failure due to inability to pay its way. It is necessary to consider stability in both the long and short term. Thus, in assessing financial stability, important relationships include e.g. those subsisting between total resources owned and external obligations (that is, solvency) and between short term resources owned and external obligations which have to be met in the near future (that is, liquidity). Stability is the firm's ability to remain in business in the long run, without having to sustain significant losses in the conduct of its business. Assessing a company's stability requires the use of both the income statement and the statement of financial position, as well as other financial and non-financial indicators.

Ratios that can be used to measure profitability are

- Net Profit to Total asset % (Return On Assets or ROA)
- Net Profit to Non-current assets %
- Net Profit to capital Employed (ROCE)
- Gross Profit to Sales %
- Net Profit to sales %

Ratios that can be used to measure financial stability are

- Shareholders" funds to total tangible assets (Proprietary ratio)
- Long term external finance to shareholders funds
- Total external finance to shareholders" funds
- Current ratio
- Quick ratio or acid test

CHAPTER THIRTEEN

ETHICS AND COMPUTERISED ACCOUNTING SYSTEM

Chapter contents

a) Introduction
b) Explanation of professional ethics
c) Principles of honesty and integrity
d) Way by which financial reports can be manipulated
e) Threats that may affect professional accountants behaviuor
f) How to resolve ethical issues
g) Consequences of unethical financial behaviour
h) Components and making of computerised Accounting
i) Explanation of coding of accounts
j) Type of accounting software packages
k) Preparation of accounting tally software package

13.0 Objectives

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

- Explain the need for professional ethics
- Identify the principles of honesty and integrity sets out in the professional codes of ethics
- Explain the various way by which financial reports can be manipulated
- Explain the motivation for unethical behaviours in financial reporting
- Identify and explain threats that may affect professional accountants from compliance with ethical behaviour
- Explain how to resolve ethical issues
- State consequences of unethical financial behaviours
- Identify and explain the components and workings of the computerised accounting system
- Explain coding of accounts
- Identify and explain the types of accounting software packages
- Prepare accounts using Tally.

13.1 Professional Ethics

The Need for Professional Ethics in Financial Reporting
Professional accountants are faced with series of ethical pressures and influences from employers, individual clients, chief executive and politicians in the course of their duties. The professional accountant's responsibility is not to satisfy the needs of their client or employer only but must act in the public interest.

Existing and potential shareholders need financial reports for decision making on the investment and financial aspect of the organisation. The financial reports produced by the accountant should be based on certain fundamental qualities for various users to understand the content of the report. Accountants have obligations to shareholders, creditors, employees, suppliers, the government, the accounting profession and the public at large. In other words, their obligations go beyond their immediate client, hence behaving ethically is an essential and expected trait.

Ethics and ethical behaviour refer more to general principles such as honesty, integrity, and morals. The code of professional conduct, however, is a specific set of rules set by the governing board of professional accounting bodies. The rules set out by different bodies around the world are unique, but some rules are universal.

13.2 Fundamental principles set out in the Professional code of ethics are:

i. Integrity Professional accountants should be honest and straightforward in their professional and business dealings. They must be seen to be honest. Integrity implies not just honesty but also fair dealings and truthfulness;
ii. Objectivity ICAN members should not allow bias, conflicts of interest or undue influence of others to override their professional or business judgments;
iii. Professional competence and due care Members have a duty to maintain their professional knowledge and skills at such a level that a client or employer receives a competent service, based on current developments in practice, legislation and techniques. They should act diligently and in accordance with applicable technical and professional standards;
iv. Professional behaviour Members must comply with relevant laws and regulations, always behave with courtesy and should avoid any action which can put the profession to disrepute; and
v. Confidentiality Members should not disclose any information of their clients or employers to third parties without the consent of such or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.

13.3 Ways by which financial statements information can be compromised

i. Keeping liabilities off the statement of financial position or classification of liability as equity. Keeping liabilities off the financial statement of financial position, has the impact of increasing the net assets and reducing gearing. This could be done by the company to avoid breaching of debt covenants on borrowings that require the maintenance of certain ratios such as gearing or interest cover. A typical example is when preference share is treated as equity, instead of being classified as debt instrument, according to its substance..
ii. Manipulating revenue: Companies may lower their revenue by not recognising all invoices received for good sold towards the end of the year in order to reduce tax liability. They may also recognise fictious revenue in order to attract investor or retain existing investors
iii. The company may raise invoices before the end of the accounting year to inflate its sales figures and, but the actual transaction occurs after the reporting date. It is an example where the company attempts to boost up revenue figures.
iv. A company may record amount received from loan as revenue.
v. Manipulate depreciation rates and methods: The management may set an arbitrary life span, usually more than expected or may increase the salvage of a depreciable asset, it thus can have a less deprecation calculated on the asset.
vi. Arbitrary revaluation of non-current assets in order to reduce debt/equity ratio.
vii. Selling off assets that is not yet fully depreciated in order to earn one-off high gain
viii. Capitalising operating costs in order to reduce expenses.
ix. Failing to recognise impairment losses or failing to write down inventory to its net realisable value when it is expected that the net realisable value is lower than the cost.

x. Inadequate disclosure in order to hide some information that may affect the credibility of the financial information.

xi. Failure to write-off undoubtful receivables to avoid reporting losses, in order to maintain an equal level of earnings over the years.

13.4 What are the motivations for unethical financial reporting by companies?

Management has the tendency to focus on short-term gains in order to achieve the following objectives:

i. Bonuses for management are often tied to performance level hence they violate generally accepted accounting principles in the preparation of financial statements, in order to meet earnings target and receive annual bonus.

ii. Increase the market indicators in order to increase the market capitalisation of the company, thereby attracting investors.

iii. In order to achieve reduction in tax liabilities

iv. As a result of increasing pressure from the company's competitors.

v. By employees to cover up assets misappropriated

vi. Self -review threats, which relate to attempt by management to depict healthy financial picture in order to conceal material losses.

vii. Lack of strong and efficient internal control system in place

13.5 Threats that may affect professional accountants from compliance with ethical behaviour

The following five threats are identified by the International Federation of Accountants (IFAC).

i. Self-interest threats, or conflicts of interest: These occur when the financial and other interests of the professional accountant, or a close family member, inappropriately affect the accountant's decisions or actions.

ii. Self-review threats: This is the threat that a professional may not review appropriately some work done previous by him or by another individual within the same firm. A typical example is a situation where a professional accountant prepares the annual financial statements for a client and then is appointed to do the audit.

iii. Advocacy threats: This type of threat can occur when an accountant promotes the point of view of a client, for example by acting as a professional witness in a legal dispute. This may impair the objectivity of the accountant

iv. Familiarity threats: The is the threat that result from long or close relationship with the client such that an accountant might become too sympathetic to client and more willing to accept the client's point of view.

v. Intimidation threats: A professional accountant might find that his objectivity and

independence is threatened either real or perceived pressures

13.6 How to resolve issues of ethical conflict

Professional accountants responsible for the preparation of financial reports need to adhere to

the codes of ethical accounting standards to produce reliable, relevant, timely, accurate, understandable and comprehensive financial reports.
Therefore, the professional accountant should consider the following steps in the resolution of ethical conflicts with client or employer.

i. State the relevant facts of the case and examine the ethical issues involved;
ii. Explain the fundamental principles relating to the matter;
iii. Explain the GAAP and standards that is appropriate in the circumstance and the consequences of adopting the unethical approach;
iv. Establish internal procedure to resolve the issue;
v. Where this fails, the accountant should explore alternative course of action, which should be consistent with the fundamental principles identified;
vi. The professional accountant may consider consulting with the governing board of the company or the audit committee;
vii. The professional accountant should document the substance of the issue and details of discussions held or decision taken in respect of the issue
viii. If the conflict cannot be resolved internally, the accountant may wish to obtain advice from professional body or seek legal advice without breaching confidentiality; and
ix. In the final analysis, if all these steps failed, the accountant may wish to disengage from the assignment or resign.

13.7 Consequences of unethical financial reporting:

The following are some of the consequences of unethical financial reporting:
i. Lack of investors' confidence and low participation in the stock market leading to substantial fall in stock market price of shares;
ii. The company may face lawsuit from lenders and other creditors;
iii. Integrity and reliability of financial statements will be in doubt;
iv. The going concern of the company may be threatened, leading to liquidation of the company, consequently stakeholders will suffer; such as
    - Loss of investment by shareholders,
    - Loss of revenue to the government,
    - Loss of jobs by employees, and
    - Loss source of patronage by suppliers
v. The general economic climate of the country's economy will be depressed if the unethical practice are pervasive.
vi. High cost of obtaining capital

13.8 How does accounting profession tend to ensure quality financial reporting?

i. The conceptual framework for financial reporting: The IASB Conceptual Framework clearly defines and sets out guidance for measurement, recognition, derecognition, presentation and disclosure of elements of financial statements. These definitions and guidance if properly applied may reduce the cases of poor-quality financial reporting.
ii. Issue of principle-based accounting standards rather than rule based: The adoption of International Financial Reporting Standards is believed to be principled based as against the previous accounting standards. IFRSs also require more disclosures
iii. The professional accountants' codes of ethics.

iv. Companies codes of ethics: Companies now have codes of ethics stating their commitment to integrity, healthy and safe business environment, employees welfare etc
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13.9 Computerised Accounting System

Computerised accounting system refers to the processing of accounting transaction through the use of hardware and software in order to produce accounting records and reports.

Components of Computerised Accounting System
The components of computerised accounting system comprises computer hardware and software while the software comprises mainly system and application software.

Workings of the Computerised Accounting System
The computerised accounting system works under the Generally Accepted Accounting Principles (GAAP) to process accounting transactions as inputs through Accounting Software to generate reports. The following reports may be generated through the processing;

- Day books or journals
- Ledger
- Trial balance
- Statement of financial position
- Statement of profit or loss and other comprehensive income.
- Statement of changes in equity
- Statement of cash flows

Computerised accounting system is based on the concept of database. A database is implemented using a database management system, which is a set of computer software that may be organised effectively and provide access to data by the application software. The user operates on such database using the required and desired interface and also takes the desired reports by suitable transformation of stored data into information.

Basic requirements of computer database application
The phases of computer database application are:

i. Front-end interface: This refers to the user interface. The user enters a request through the interface. It is then verified and communicated to the server, which pulls the data from the database and sends it to the user
ii. Back-end database: It is the data storage system that is hidden from the user and responds to the requirement of the user to the extent the user is authorised to access.
iii. Data processing: It is the sequence of actions that are taken to transform the data into decision useful information
iv. Reporting system: It is an integrated set of objects that constitute the report

13.10 Coding and Grouping of accounts

After classification of accounts into various groups and allotting codes to each account these are programmed into the computer system.

A proper codification requires a systematic grouping of accounts. The major groups or heads could be assets, liabilities, income and expenses. Each major group may be divided further to the line-items required to be presented in the financial statements under IAS 1; Presentation of

Financial Statements. For instance, assets may be divided further as follows:

Non-current assets

i. Property, plant and equipment;
ii. Investment property;
iii. Intangible assets;
iv. Financial assets or investments

Current assets

v. Inventories
vi. Trade receivables
vii. other receivables
viii. cash and cash equivalents

There is a hierarchical relationship between the groups and its sub-groups. In order to maintain the hierarchical relationships between a group and its sub-groups, proper codification is required to ensure correct application of the codes. For instance, unique code should be assigned to assets, liabilities, income, expenses and equity and each subgroup of these major groups should also be assigned different codes that are unique to each sub-group. Modern accounting software systems use a generic system of accounting codes to codify the various ledgers that make up your full accounts.

1.11 Type of coding

Sequential codes

A common application of numeric sequential codes is the prenumbering of source documents. These codes are applied primarily to source documents such as purchases order, cheques, invoices, etc. A sequential code can facilitate document searches. Errors can easily be detected and corrected.

Block-coding: Assigned to

Features of computerised accounting system.

i. Recording: Data content is recorded in customised database
ii. Calculation: Only data input is required, the calculations are performed by computer system
iii. Correction of errors: No ratification of errors if input data are done correctly
iv. Backup: Entries of transactions can be saved and backed up
v. Instant trial balance and financial statements provided, when required. Reports can be generated based on codes.

It is to be noted that the fundamentals of accounting do not change whether books of accounts are maintained manually or computerised. The same principles of debit and credit are equally applicable in a computerised environment

Accounting software

There are three types of software, namely,

i. Readymade software,

ii. Customised software and
iii. Tailormade software

i. Readymade software

These packages are standardised or readymade packages which can be used by the business enterprises immediately on procurement. These software packages are used by those enterprises where financial transactions are simple, uniform and routine in nature. Few examples of such type of software are **Tally, Busy, Marg, Profitbooks**.

ii. Customised packages

Customised packages can be modified according to the need of the enterprise. These packages are used by medium or large business enterprises. Cost of installation, maintenance and training is relatively higher than that of ready-to-use packages. These software packages are used by those enterprises where financial transactions are somewhat peculiar in nature.
Tailormade packages: These are used by large companies to process large information frequently to meet the company's needs. They are usually expensive and users will require training to use them.

1.12 How to prepare accounts in Tally

a. Prepare Trial Balance
Gateway of Tally → A/c information → ledger → create → Enter detail → Press yes

Show Trial Balance
Gateway of Tally → Display → Trail Balance

b. Preparation of ledgers

Create Ledger
Gateway of Tally → A/c information → ledger → create → Enter detail → Press Yes

Alter Ledger
Gateway of Tally → A/c information → ledger → Alter → choose ledger → Alter ledger name → Press Yes

Delete Ledger
Gateway of Tally → A/c information → ledger → Alter → choose ledger → Alt + D → Press Yes

c. Preparation of financial statements

Statement of Financial Position
Gateway of Tally → Click statement of financial position → Change period (F2) → Click print option → Enter Yes

Profit & Loss Account
Gateway of Tally → Click **Profit or Loss** → Change period (F2) → Click print option → Enter Yes

Ratio Analysis
Gateway of Tally → Click **Ratio analysis** → Change period (F2) → Click print option → Enter Yes

Statement of cash flows
Gateway of Tally → Click Display → Click Cash/ Fund flow → Click Cash Flow → Enter Ye

13. 13 Advantages of Computerised Accounting System

The advantages of Computerised Accounting System are:

i. Timely generation of reports and information in desired format.
ii. Efficient record keeping.
iii. Ensures effective control over the system.
iv. Economy in the processing of accounting data.
v. Confidentiality of data is maintained.

The limitations of Computerised Accounting System are:

i. Faster obsolescence of technology necessitates investment in shorter period of time.
ii. Data may be lost or corrupted due to power interruptions.
iii. . Data are prone to hacking.
iv. Un-programmed and un-specified reports cannot be generated.:

13.14 End of chapter questions

1. Identify the ethical issues an accountant may likely encounter
2. Discuss the role of accountant in the issue of ethics.
3. Why should a company develop its own code of ethics?