



Financial Accounting

Study Text

**The Institute of Chartered
Accountants of Nigeria**



Financial accounting

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Foreword

The business environment has been undergoing rapid changes caused, by globalisation and advancement in Information Technology. The impact of these changes on the finance function and the skills set needed by professional accountants to perform their various tasks have been profound. These developments have made it inevitable for the Institute's syllabus and training curriculum to be reviewed to align its contents with current trends and future needs of users of accounting services.

The Institute of Chartered Accountants of Nigeria (ICAN) reviews its syllabus and training curriculum every three years, however, the syllabus is updated annually to take cognisance of new developments in the national environment and the global accountancy profession. The Syllabus Review, Professional Examination and Students' Affairs Committees worked assiduously to produce a 3-level, 15-subject ICAN syllabus. As approved by the Council, examinations under the new syllabus will commence with the November 2021 diet.

It is instructive to note that the last four syllabus review exercises were accompanied with the publication of Study Texts. Indeed, when the first four editions of Study Texts were produced, the performances of professional examination candidates significantly improved. In an effort to consolidate on these gains and to further enhance the success rates of students in its qualifying examinations, the Council approved that a new set of learning materials (Study Texts) be developed for each of the subjects. Although, these learning materials may be regarded as the fifth edition, they have been updated to include IT and soft skills in relevant subjects, thereby improving the contents, innovation, and quality.

Ten of the new learning materials were originally contracted to Emile Woolf International (EWI), UK. However, these materials were reviewed and updated to take care of new developments and introduced IT and soft skills in relevant subjects. Also, renowned writers and reviewers which comprised eminent scholars and practitioners with tremendous experiences in their areas of specialisation, were sourced locally to develop learning materials for five of the subjects because of their local contents. The 15 subjects are as follows:

Foundation Level		
1.	Business, Management and Finance	EWI/ICAN
2.	Financial Accounting	EWI/ICAN
3.	Management Information	EWI/ICAN
4.	Business Law	ICAN

Skills Level		
5	Financial Reporting	EWI/ICAN
6	Audit and Assurance	EWI/ICAN
7.	Taxation	ICAN
8.	Corporate Strategic Management and Ethics	EWI/ICAN
9.	Performance Management	EWI/ICAN
10.	Public Sector Accounting and Finance	ICAN

Professional Level		
11.	Corporate Reporting	EWI/ICAN
12.	Advanced Audit and Assurance	EWI/ICAN
13.	Strategic Financial Management	EWI/ICAN
14.	Advanced Taxation	ICAN
15.	Case Study	ICAN

As part of the quality control measures, the output of the writers and reviewers were subjected to further comprehensive review by the Study Texts Review Committee.

Although the Study Texts were specially produced to assist candidates preparing for the Institute's Professional Examination, we are persuaded that students of other professional bodies and tertiary institutions will find them very useful in the course of their studies.

Haruna Nma Yahaya (Mallam), mni, BSc, MBA, MNIM, FCA
Chairman, Study Texts Review Committee



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The Institute is deeply indebted to the underlisted locally-sourced rewriters, reviewers and members of the editorial board for their scholarship and erudition which led to the successful production of these new study texts. They are:

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1. Ogunniyi, Olajumoke

Management Information

1. Adesina, Julius Babatunde
2. Ezeribe, Chimenka

Financial Accounting

1. Adeyemi, Semiu Babatunde

Financial Reporting

1. Okwuosa, Innocent

Performance Management

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Corporate Strategic Management and Ethics

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1. Amadi, Nathaniel

Corporate Reporting

1. Adeadebayo, Shuaib

Advanced Audit and Assurance

1. Okere, Onyinye

Strategic Financial Management

1. Omolehinwa, Ademola

The Institute also appreciates the services of the following:

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Syllabus

FOUNDATION LEVEL

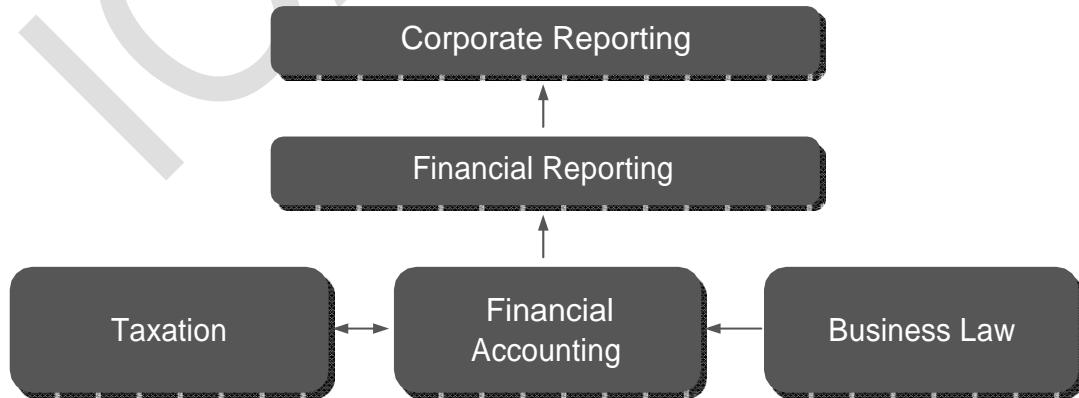
FINANCIAL ACCOUNTING

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Linkage with other subjects

This diagram depicts the relationship between this subject and other subjects. Financial accounting as a subject is a pre-requisite to Financial Reporting and Corporate Reporting.



Main competencies

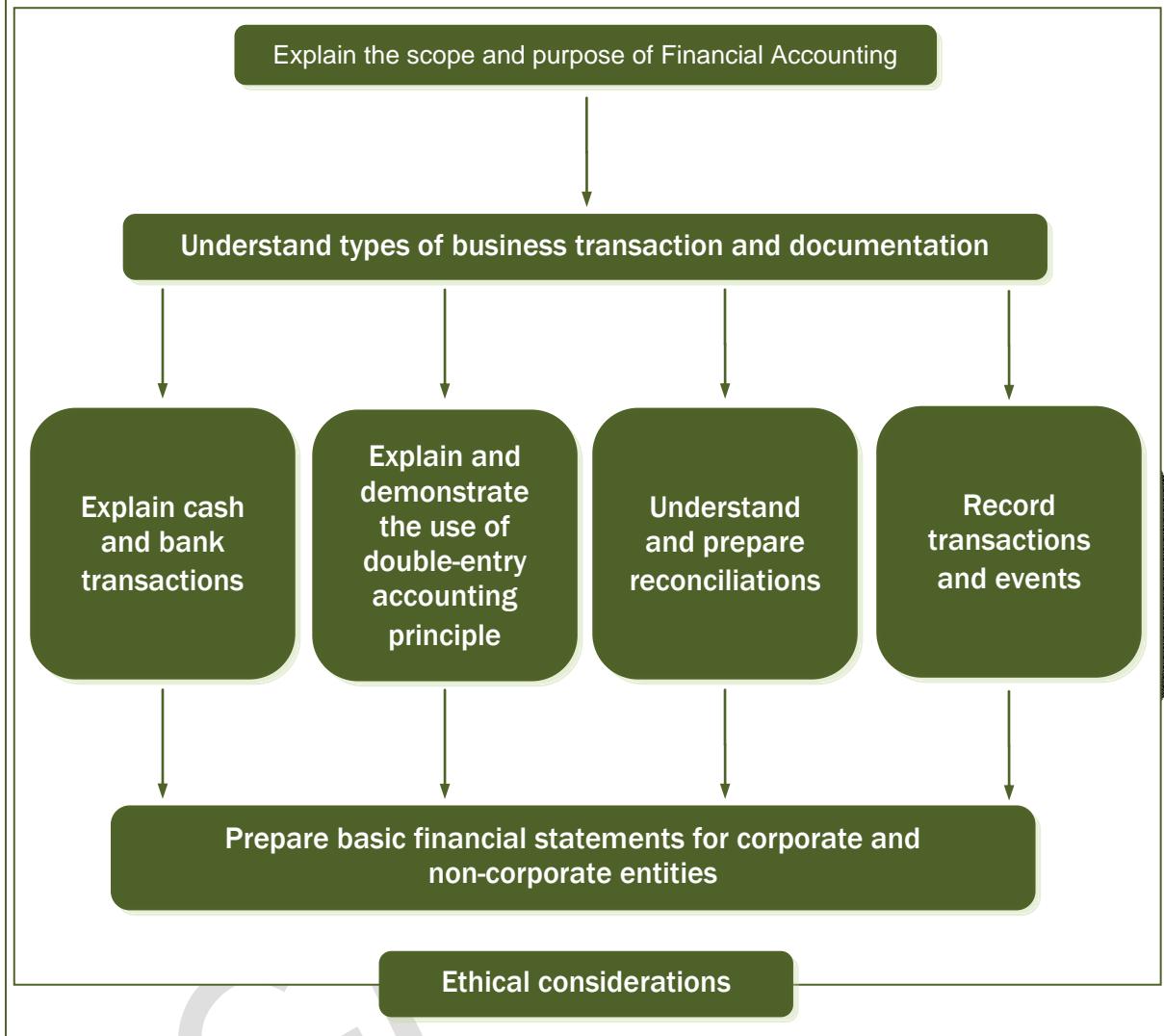
On successful completion of this paper, candidates should be able to:

- Explain the scope and purpose of accounting;
- Explain types of business transaction and documentations;
- Explain cash and bank transactions;
- Explain and demonstrate the use of double-entry accounting principle;
- Prepare reconciliation statements;
- Record transactions and events;
- Prepare basic financial statements for corporate and non-corporate entities; and
- Explain current trends and concepts in virtual accounting.

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Linkage of the main competencies

This diagram illustrates the linkage between the main competencies of this subject and is to assist candidates in studying for the examination.



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	b	Identify the sources of regulation of accounting practice.	1
8	State the roles of accountants in business and the economy.		1

Detailed syllabus			Chapter
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An introduction to business and accounting

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- 1 Types of business
- 2 Introduction to financial accounting of business entities
- 3 Bases of accounting
- 4 The need for financial statements
- 5 Components of financial statements
- 6 Business transactions
- 7 Chapter review

Introduction

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

A Accounting framework		
1	Scope and purpose of accounting	
	a	Define accounting and state the objectives of accounting.
	b	Differentiate between accounting and book-keeping.
	c	Discuss the different types of accounting.
2	Identify the users of accounting information and their information needs.	
5	Explain the following accounting concepts:	
	b	Accruals;
	e	Business entity concept;
6	Bases of accounting	
	a	Discuss accrual, cash and break-up bases of accounting.
7	The regulatory environment of accounting	
	a	Explain the need for regulation of accounting practice.
	b	Identify the sources of regulation of accounting practice.
8	State the roles of accountants in business and the economy.	
F Financial statements		
1	State and explain the purpose, nature and relationships among the main components of financial statements.	

Exam context

This paper requires you to be able to prepare financial statements of different types of entity. This chapter explains differences between different types of business entity and explains what financial statements are.

It also explains other fundamental concepts which provide a foundation to understanding what follows in later chapters.

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

- Explain the characteristics of a business
- Describe the key features of sole proprietorship, partnership and limited company
- Describe the accruals, cash and break up bases of accounting
- Explain the importance of financial information to different types of users
- Explain the characteristics and purpose of the statement of financial position and the statement of comprehensive income.
- List the components of a set of financial statements.
- Describe the basic presentation layout of statements of financial position and statements of profit or loss and other comprehensive income.
- Classify transactions that fall under the definition of business transactions

1 Types of business

Section overview

- Business
- Types of business entity
- Advantages and disadvantages of different types of business entity

1.1 Business

The word **business** is used in different contexts. It is used to describe an economic process and to describe entities that participate in that process.

There is no single definition of a business. Some possible definitions include the following.



Definitions: Business

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

A business entity is a commercial organisation that aims to make a profit from its operations.

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return to investors or other owners.

An organisation or enterprising entity engaged in commercial, industrial or professional activities.

Characteristics of business

All businesses share certain characteristics.

- Businesses exist to make profits.
- Businesses make profit by supplying goods or services to others (customers).
- Businesses that supply goods might make those goods or buy them from other parties (for example, food retailers buy food off food producers and sell it to their customers).
- Profit is the reward for accepting risk. For example, a food retailer might buy 100 kgs of bananas but might not be able to sell them all. In other words, he runs the risk of paying for bananas that he will have to throw away. He is willing to run the risk because if he does not buy bananas he has no chance of selling them for a profit.
- The profit of a business belongs to its owners. A share of the profits might be paid to the owners periodically.

1.2 Types of business entity

There are three main types of business entity:

- a sole proprietorship;
- a business partnership;
- a company (a limited liability company).

Sole proprietor (or sole trader)

The business of a sole trader is owned and managed by one person. Any individual, who sets up in business on his/her own, without creating a company, is a sole trader.

Important features of a sole trader business are as follows.

- There is no legal distinction between the proprietor and the business.
 - The owner of the business is personally liable for any unpaid debts and other obligations of the business.
 - The profits of a sole proprietor business are treated as income of the owner, for the purpose of calculating the amount of tax payable on income.
 - When a sole proprietor dies the business ceases to exist (there is no perpetual succession as the business does not exist independently of the owner).
- The profits of the business belong to the sole proprietor.
- The assets of the business belong to the sole proprietor.
- The sole proprietor can extract cash and other assets from the business (known as drawings).
- The business may be financed by a mixture of owner's capital (including retained earnings) and loans.
- A sole proprietor business might employ many people but it is usual for the proprietor to take a very active role in the business exercising a high degree of control.
- A sole proprietorship business can be sold as a going concern by its owner.



Example:

If a business owes a supplier ₦1,000 for goods it has purchased, but does not have the money to make the payment, the owner of the business is personally liable to make the payment out of his/her other assets.

Partnership

A business partnership is an entity in which two or more individuals (partners) share the ownership of a business. Each partner contributes funds ('capital') to set up the business.



Definition: Partnership

The relationship between persons who have agreed to share the profits of a business carried on by all or any of them, acting for all.

Important features of a partnership are as follows:

- There must be an association of two or more persons to carry on a business.
- The owners of the business are personally liable as individuals for the unpaid debts and other obligations of the business.
- The profits of a partnership are shared between the partners in an agreed way, and each partner's share of the profits is treated as personal income, for the purpose of calculating the amount of tax payable on his or her income.
- When a partner dies the partnership comes to an end (there is no perpetual succession).
- The profits of the business belong to the partners in an agreed ratio.
- The assets of the business belong to the partners in an agreed ratio.
- The partners can extract cash and other assets from the business (known as drawings).
- The business may be financed by a mixture of partners' capital (including retained earnings) and loans.
- A partnership might employ many people but it is usual for the partners to take a very active role in the business exercising a high degree of control.
- A partnership can be sold as a going concern by its owner.



Example:

If a partnership owes a supplier ₦1,000 for goods it has purchased, but does not have the money to make the payment, the partners are personally liable to make the payment.

Company (limited liability company)

A company is a special form of business entity. Nearly all companies in business are limited liability companies with liability limited by shares.

- Ownership of the company is represented by ownership of shares.
 - A company might issue any number of shares, depending largely on its size. A very small company might have just one share of ₦1, whereas a large stock market company will have millions of shares in issue.
 - If a company has issued 100 shares, ownership of 40 shares would represent 40% of the ownership of the company.
 - Large companies usually have a large number of shares in issue, and a large number of shareholders. This means that the owners (the shareholders) do not manage the business. Managers are employed (the executive directors of the company) to run the company on behalf of the shareholders. This is sometimes referred to as the 'separation of ownership from control'.
- Unlike a sole trader or a partnership, a company has the status of a 'legal person' in law.
 - A company can be the legal owner of business assets, and can sue or be sued in its own right in the law.
 - A company is also taxed separately from its owners (the profits of a sole trader and business partners are taxed as personal income of the business owners).
 - A company is liable for its own debts. If a company owes a supplier ₦1,000 for goods it has purchased, but does not have the money to make the payment, the company alone is liable for the debt. The owners (shareholders) are not personally liable to make the payment. The liability of shareholders is limited to the amount of capital they have invested or agreed to invest in the company.

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.

However, there might be a risk that the managers of a company would make false reports to shareholders about the financial position and performance of the company. To reduce this risk, the laws on financial reporting and auditing are generally much stricter for companies than for other types of business entity.

1.3 Advantages and disadvantages of different types of business entities

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

Business structure	Sole trader	Partnership	Company
Owned by...	One person	Several individuals working together	Shareholders
Liability for the unpaid debts and other obligations of the business	Personal liability of owner	Personal liability of partners	Limited
Management	Business managed by its owner	Business managed by its owners	Larger companies are managed by professional managers
Raising capital	Capital for the business is provided by its sole owner. Often limited in amount.	Capital for the business is provided by its owners. Likely to be limited in amount.	Capital for the business is provided by its shareholders. Public companies can raise new capital from investors in the stock market. Most very large businesses are companies.
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.

2 Introduction to financial accounting by business entities

Section overview

- Introduction to accounting
- The purpose of financial accounting
- Accounting systems
- Financial statements
- Regulation of financial reporting

2.1 Introduction to accounting

There are many definitions of accounting



Definitions: Accounting

Accounting is a systematic and comprehensive recording of financial transactions pertaining to a business and the process of summarising, analysing and reporting these transactions.

A systematic process of identifying, recording, measuring, classifying, verifying, summarising, interpreting and communicating financial information.

The process of identifying, measuring, and communicating economic information to permit informed judgements and decisions by users of the information.

The main purposes of accounting are to:

- provide a record of the financial value of business transactions, and in doing so to establish financial controls and reduce the risks of fraud;
- assist with the management of the financial affairs of an entity; and
- provide information - mainly information of a financial nature.

Accounting information is provided for:

- Management, so that managers have the information they need to run the company. (This is known as management accounting).
- Other users of information, many of them outside the entity. For example, a company produces accounting information for its shareholders in the form of financial statements, and financial statements are also used by tax authorities, investors, trade union representatives and others. (This is known as financial accounting).

Types of accounting

In view of the fact that there are several users of accounting information with differing needs, accounting can be classified into several aspects as follows:

1. Financial Accounting: This involves the process of recording, classifying, preparation, interpretation of financial statements so that both internal and external users can make informed decisions.

2. Cost Accounting

Cost Accounting is the procedure for accumulating cost data to provide information for planning, control and decision making by management.

3. Performance Management

Performance Management is a continuous process where managers and employees combine efforts in planning, monitoring and reviewing the effectiveness of the workforce towards the achievement of the overall objectives of the entity.

4. Auditing

An independent examination of the financial statements of an entity by a professional called *an auditor*. This professional accountant after gathering various forms of audit evidence forms an opinion on the financial statements.

The auditor expresses this opinion in a report, asserting the fairness of the financial statements and the scope of work carried out before arriving at this opinion.

5. Government Accounting

Government Accounting is a part of public sector accounting that records revenue and expenditure of government ministries, departments and agencies (MDAs). The government uses this information for appropriate decision making, planning, control and appraisal of government activities, and in compliance with the laws regulating government finances.

6. Taxation

The accounting profits generated in the financial statements provide the basis for determining the taxable profits of an entity. The taxable profits are different from the accounting profits because certain expenses and income are allowable for accounting purpose but disallowed for tax purpose. A good understanding of the knowledge of these taxable and non-taxable incomes and expenses would help an entity in its tax management.

7. Financial Management

Financial Management is the process by which the resources of an organisation are efficiently and effectively procured, utilised and accounted for by the owners of the business in such a way to maximise the wealth of the owners.

8. Forensic Accounting

Forensic Accounting refers to the application of accounting skills to investigate and probe frauds, deliberate misrepresentations (falsifications and misappropriations) or embezzlements of an entity's resources with a view to recovering such funds, usually through legal proceedings.

9 Social and Environmental Accounting

Social and Environmental Accounting is the branch of accounting that deals with accounting for and reporting of the social and environmental impact of an entity's activities upon the stakeholders (investors, management, employees, customers, suppliers, local community where the entity operates, etc).

10. Bookkeeping

Bookkeeping is the process of recording financial transactions in the accounting records (the 'books') of an entity. It incorporates posting of transactions and extracting a trial balance.

This text is about financial accounting.

2.2 The purpose of financial accounting

Financial accounting is a term that describes:

- maintaining a system of accounting records for business transactions and other items of a financial nature; and
- reporting the financial position and the financial performance of an entity in a set of financial statements.

The term **entity** is used to describe any type of organisation. Business entities include companies, business partnerships and the businesses of 'sole traders'.

2.3 Accounting systems

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

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

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

Difference between bookkeeping and accounting

This might be best explained by comparing the work of a bookkeeper and an accountant.

Bookkeeping is the first step in an accounting process. Bookkeepers are responsible for maintaining a record of all transactions entered into by a business. Bookkeepers enter the transactions into the accounting system to produce an accurate and complete record of the financial transactions of a business.

Accountants use the information recorded by the bookkeepers to help them produce financial statements (or other reports as required by management).

Bookkeeping is part of accounting but accounting is much wider in scope. An accountant could easily perform a bookkeeping function but a bookkeeper would require a lot more education and training before becoming an accountant.

Role of accountants in business

Qualified accountants have considerable knowledge and expertise about all aspects business with a particular focus on the numbers that reflect the position and performance of the business.

An accountant may fulfill or contribute to a large number of roles and functions. These include:

- Financial reporting – Accountants generate financial reports. This involves using information from the accounting system, adding to it, analysing it and presenting it in accordance with the accounting rules followed in the jurisdiction in which the business operates.

- Compliance – Accountants are involved in ensuring that a business complies with certain aspects of company law (e.g. a company must prepare financial statements in a given form).
- Strategy – Accountants provide analysis and insight during the formulation of a business's strategy.
- Planning – accountants are involved in providing information used when businesses plan their future activities.
- Control – accountants assist in setting targets and monitoring and reporting on performance.
- Decision making – accountants are involved in providing information used for decision making purposes.
- Taxation – Accountants might prepare taxation computations or provide relevant information to tax specialists for the preparation of taxation computations.
- Systems – accountants can be involved in helping to design accounting systems.

Role of accountants in the economy

Accountants contribute to the success of businesses and that success is of vital importance to the economy.

Successful businesses provide employment and generate profit. Wages and salaries are taxed and businesses pay tax on their profits thus providing revenue to governments who use it to the benefit of society at large.

The role of accountants in financial reporting is particularly important. Businesses need capital. This might involve asking external parties to invest in the business. These parties will want to be able to monitor their investment and will use accounting information to do this. Accountants provide high quality information that investors are able to rely on in making investment decisions.

There is a legal requirement that the financial statements of companies should be audited. An audit is a review carried out by an independent accounting firm who express an opinion on those financial statements.

The existence of high quality financial reports (prepared by accountants) which are then independently audited (by other accountants) help capital markets to function by providing information that investors can rely upon when making investment decisions.

2.4 Financial statements

Double entry bookkeeping is used to record transactions in systems designed to allow the management of the business to monitor its progress and produce periodic financial statements and performance reports.

The information recorded in the book-keeping system (ledger records) is analysed and summarised periodically (typically each year) and the summarised information is presented in financial statements. Typically these might include:

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

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

The information explains the financial position of an entity at the end of a period (usually a year) and the financial performance of the entity over that period.

Financial statements relate to a given period of time, known as the 'financial year', 'accounting period' or 'reporting period'. They are prepared from information held in the financial accounting records (the **books, ledgers or accounts**), although some adjustments and additions are required to complete the financial statements, especially for companies.

The financial statements are often referred to as **a set of accounts** of the business.

The business entity concept

Financial reports are constructed as if the business entity is separate from its owners. In other words, the business entity and its owners are different. This is known as the **business entity concept**.

This concept has legal 'reality' in the case of companies. A company by law is a legal person, separate from its owners (the shareholders). However, the concept is also applied to sole traders and partnerships.



Illustration:

Imran Khan sets up a sole trader business as a builder, and he calls the business 'IK Builders'.

Legally, IK Builders does not have a separate legal personality. The debts of IK Builders are debts of Imran Khan.

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

Responsibility for preparing financial statements

Type of entity	Responsibility
Sole trader	<p>There may be no obligation to prepare financial statements (other than for tax purposes) but if so the owner of the business is responsible.</p> <p>The owner might employ a person or persons to maintain the accounting records and prepare financial statements.</p>
Partnership	<p>There may be no obligation to prepare financial statements (other than for tax purposes) but if so the partners are responsible.</p> <p>They might employ a person or persons to maintain the accounting records and prepare financial statements.</p>
Company	<p>Companies must prepare financial statements for shareholders and for filing with relevant regulatory bodies.</p> <p>It is the responsibility of the directors to ensure that this is done. Usually the work is delegated to employees.</p>

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 business partnership are private and do not have to be disclosed.

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 that 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 web site.

The financial statements of a company are subject to more regulation than those of a sole trader or a partnership.

2.5 Regulation of financial reporting

Generally accepted accounting principles

Financial reporting is regulated and controlled. Regulations help to ensure that information reported in financial statements has the required qualities and content.

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**.

The main sources of GAAP in a jurisdiction are:

- Company Law; and
- Accounting standards.

GAAP varies from country to country, because each country has its own legal and regulatory system. For example, there is Nigerian GAAP, US GAAP, etc.

Accounting standards

The accountancy profession has developed a large number of regulations and codes of practice that professional accountants are required to use when preparing financial statements. These regulations are **accounting standards**.

Accounting standards are applied by companies rather than sole traders and partnerships though they are written for all entities.

Nigeria, in common with many other countries, has adopted **International Financial Reporting Standards** or **IFRS**. These are issued by the International Accounting Standards Board (IASB).

Accounting standards provide guidance on four issues:

- Recognition:** This concerns when an item should be included in the accounting records;
- Measurement:** This concerns the value at which an item is recorded in accounting records. There are rules about how to measure transactions when they are first recorded (referred to as initial recognition) and how they should be measured subsequently (referred to as subsequent measurement);
- Presentation:** This refers to the different types of statements that an entity must prepare and how items are presented in those financial statements; and
- Disclosure:** This refers to extra information that must be provided in order that those parties that use the financial statements are able to better understand the financial position and financial performance of an entity.

Other regulations that guide the preparation and presentation of financial reporting in Nigeria include:

a. Finance Acts 2019 and 2020

The amendments introduced by the Acts are in connection with the Federal Government of Nigeria's (FGN's) tax policy reforms, financial management and public revenue goals. The Acts also recognise the challenges experienced by the country during the first wave of COVID-19 pandemic and attempt to create a structure that ameliorates some of the effects. The Acts amended 14 tax and fiscal legislations including: Capital Gains Tax Act (CGTA); Companies Income Tax Act (CITA); Industrial Development (Income Tax Relief) Act (IDITRA); Personal Income Tax Act (PITA); Tertiary Education Trust Fund (Establishment etc.) Act; Customs and Excise Tariff, etc. [Consolidation] Act (CETA); Value Added Tax Act (VATA); Stamp Duties Act (SDA); Federal Inland Revenue Service (Establishment) Act (FIRSEA); Nigeria Export Processing Zones Act (NEPZA); Oil and Gas Export Free Zone Act (OGEFZA); Companies and Allied Matters Act (CAMA); Fiscal Responsibility Act (FRA); and Public Procurement Act (PPA).

b. Companies and Allied Matters Act (CAMA) 2020

The Companies and Allied Matters Act 2020, ensures conformity with current global trends in company administration and regulation. The Act made elaborate provisions for the protection of shareholders', employees', directors', auditors' and other stakeholders' rights. It effectively covers annual audits, powers to sanction erring directors, mechanism for effective oversight of the audit function, convening of annual and extra ordinary general meeting, mechanism and structure for prudent management of shareholders assets, transfer shareholders' ownership and enforcement rights, measures for secure shareholder share registration, shareholder voting and proxy rights and minority shareholders' rights among others.

c. The Financial Reporting Council of Nigeria (FRCN) Act 2011

Some of the responsibilities of the FRCN as given by the Financial Reporting Council of Nigeria Act, include:

- (a) develop and publish accounting and financial reporting standards to be observed in the preparation of financial statements of public interest entities;
- (b) review, promote and enforce compliance with the accounting and financial reporting standards adopted by the Council;
- (c) receive notices of non-compliance with approved standards from preparers, users, other third parties or auditors of financial statements; and
- (d) receive copies of annual reports and financial statements of public interest entities from preparers within 60 days of the approval of the Board.

3 Bases of accounting

Section overview

- Introduction
- Accruals basis of accounting (matching concept)
- Cash basis of accounting
- Break-up basis of accounting
- Modified cash basis of accounting

3.1 Introduction

There are three bases of accounting which go to the heart of how transactions are recognised and measured:

- accruals basis;
- cash basis; and
- break-up basis.

In practice, the accruals basis is by far the most important of these three.

3.2 Accruals basis of accounting (matching concept)

Accruals basis accounting (accruals accounting, the accruals concept) recognises transactions and other events and circumstances in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

- Revenue from sales and other income should be reported in the period when the income arises (which might not be the same as the period when the cash is received).
- The cost of sales in the statement of profit or loss and other comprehensive income must be matched with the sales. Income and 'matching' expenses must be reported in the same financial period.
- Other expenses should be charged in the period to which they relate, not the period in which they are paid for.



Illustration: Statement of comprehensive income

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



Example: Accruals basis

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

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

Accruals basis

The sale is recognized as income in the year to 31 December Year 2, though the cash is not received until after the end of this financial year.



Example: Accruals basis

A company starts in business on 1 September Year 1. It acquires an office for which it pays one year's rent in advance, to 31 August Year 2.

The cost of the annual rental is ₦120,000. The company prepares its financial statements for a financial period ending on 31 December each year.

Accruals basis

The office rental cost in the period to 31 December Year 1 is the cost of just four months' rent.

The expense is therefore ₦40,000 ($\text{₦120,000} \times \frac{4}{12}$) in Year 1, and there has been a prepayment for ₦80,000 that relates to the next financial period, the year to 31 December Year 2.



Accruals and prepayments

Definitions

Accrued expense or accrual.

An accrued or accrued expense is an amount that an entity owes in respect of a benefit it has received in a period but for which it has not yet been invoiced. An accrual is an estimate of the cost of the benefit received.

Prepayment.

A prepayment is an amount of money paid in advance for benefits that will be received in the next accounting period.

A prepayment in Year 1 of some expenses relating to Year 2 should not be charged as an expense in Year 1, but should be treated as an expense in Year 2.



Example: Accrual

A company rents office space at a cost of ₦6,000,000 per year paid 12 months in arrears (this means that the company pays the rent at the end of the year).

The first payment is due on 30 June Year 2.

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

Accruals basis

The company will not have received an invoice for the rent when it is preparing its financial statements for 31 December Year 1.

However, it knows that it has occupied the office space for six months. The company would recognise a liability for rental costs for six months (₦3,000,000) and also include this as an expense in profit and loss for Year 1.

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

3.3 Cash basis of accounting

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

- Revenue from sales and other income would be reported in the period when the cash is received (which might be in a later period than when the income arose).
- Expenses are charged in the period to which they are paid not the period in which they are incurred.

Example: Cash basis

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

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

Cash basis

The sale is recognised as income in Year 3, though sale was made in year 2.



Example: Cash basis

A company starts in business on 1 September Year 1. It acquires an office for which it pays one year's rent in advance, to 31 August Year 2.

The cost of the annual rental is ₦120,000. The company prepares its financial statements for a financial period ending on 31 December each year.

Cash basis

The entire cost is recognised in the year to 31 December Year 1.

Over time the accruals based accounting and cash based accounting result in recognising the same amounts. However, transactions might be recognised in different periods under each system.

Example: Cash basis

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

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

Accruals basis

The sale is recognized as income in the year to 31 December Year 2, though the cash is not received until after the end of this financial year.

Cash basis

The sale is recognized as income in Year 3, though sale was made in year 2.

₦50,000 is recognised as revenue under each basis but in different periods.

3.4 Break-up basis of accounting

Both the accruals basis and the cash basis assume that a business is a going concern. That means that the business is expected to continue into the future. This may not always be the case.

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

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

Example: Break-up basis

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

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

Break-up basis

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

Modified cash basis

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

4 The need for financial statements

Section overview

- The objective of financial reporting
- Informational needs of those who use financial statement

4.1 The objective of financial reporting

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

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

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

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

4.2 Informational needs of those who use financial statements

Investors

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

In the case of shareholders in a company, these decisions will often involve whether to buy, hold or sell shares in the company. Their decision might be based on an analysis of the past financial performance of the company and its financial position, and trying to predict from the past what might happen to the company in the future. Financial statements also give some indication of the ability of a company to pay dividends to its shareholders out of profits.

Lenders

Lenders, such as banks, are interested in financial information about businesses that borrow from them. Financial statements can help lenders to assess the continuing ability of the borrower to pay interest, and its ability to repay the loan principal at maturity.

Suppliers and other trade creditors

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

Government

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

The public

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

Employees

Employees need information about the financial stability and profitability of their employer. An assessment of profitability can help employees to reach a view on the ability of the employer to pay higher wages, or provide more job opportunities in the future.

Customers

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

Managers

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

5 THE COMPONENTS OF FINANCIAL STATEMENTS

Section overview

- Financial statements
- The statement of financial position
- The statement of comprehensive income
- Relationship between the statement of comprehensive income and the statement of financial position
- Statement of changes inequity

5.1 Financial statements

A full set of financial statements would include the following:

- a statement of financial position;
- a statement of profit or loss and other comprehensive income;
- a statement of changes inequity;
- a statement of cash flows; and
- notes to the financial statements.

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

5.2 The statement of financial position

A statement of financial position is a list of the assets and liabilities of an entity as at a particular date. It also shows the equity (capital) of the entity. Each of these is explained more fully in later sections.

A statement of financial position (formerly called a balance sheet) reports the financial position of an entity as at a particular date, usually the end of a financial year. The financial position of an entity is shown by its assets, liabilities and equity (owners' capital).

Assets

An asset is something that an entity owns, a resource that it controls or something that it is owed. (This is not a strictly accurate definition but will do at this point. A detailed technical definition of an asset is given in the next chapter).

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

- Current assets:** assets that are expected to provide economic benefit in the short term.
- Non-current assets:** assets that have a long useful life and are expected to provide future economic benefits for the entity over a period of several years.



Example: Current assets

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

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

Liabilities

A liability is an amount that the entity owes to another party. (This is not a strictly accurate definition but will do at this point. A detailed technical definition of a liability is given in the next chapter).

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

- Current liabilities:** Amounts payable by the company within 12 months
- Non-current liabilities:** Amounts not payable within the next 12 months



Example: Liabilities

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

Equity

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

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

This can be represented as the accounting equation.



Formula: Accounting equation

Assets – Liabilities = Equity **or** Assets = Liabilities + Equity

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

Format of a statement of financial position

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

- The top half of the statement shows the assets of the business, with non-current assets first, and current assets below the non-current assets.
- The lower half of the statement shows equity, followed by liabilities. The liabilities are shown with non-current (long-term) liabilities first, and then current liabilities.

The figure for total assets in the top part of the statement must always equal the total of equity plus liabilities in the bottom half.



Illustration: Statement of financial position

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

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

The statement of financial position is not a statement of value.

The value of a business is determined by the profits that the business is expected to generate using the assets that it owns. There is no way of telling what a business is worth by looking at the financial statements. (Further analysis would be required to arrive at a valuation).

5.3 The statement of profit or loss and other comprehensive income

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

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

Transactions that would appear in the statement of other comprehensive income are not in your syllabus. Statements of profit or loss and other comprehensive income in this syllabus include only those items which would be recognised in the statement of profit or loss part of the statement.

A detailed technical definition of income and expense is given in the next chapter. For the time being the text provides simple examples of these.

Income

Income consists of:

- revenue from the sale of goods or services
- other items of income such as interest received from investments
- gains from disposing of non-current assets for more than the amount at which they are carried in the records (carrying amount). For example, if a machine is sold for ₦ 15,000 when its value in the statement of financial position is ₦ 10,000, there is a gain on disposal of ₦5,000.

The term '**revenue**' means income earned in the course of normal business operations. In a statement of comprehensive income, revenue and 'other income' are reported as separate items.

Expenses

Expenses consist of:

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

Format of a simple statement of profit or loss

The order of presentation is usually as follows:

- revenue (sales)
- the cost of sales
- gross profit (sales minus the cost of sales)
- other income, such as interest income and gains on the disposal of non-current assets
- other expenses, which might be itemised in some detail. (There is no rule about the sequence of expenses in the list, but it is usual to show expenses relating to administration, followed by expenses relating to selling and

distribution, and finally expenses relating to financial matters, such as interest charges, bad debts and audit fees.)

- net profit (gross profit plus other income and minus other expenses).

A company's statement of profit or loss would also include the tax charge on the company's profits.



Illustration: Statement of profit or loss

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

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

Gross profit and net profit

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

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

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

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

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

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

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



Illustration: Statement of financial position (with comparatives)

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

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

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

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



Illustration: Change in equity and net assets

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

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

The statement of profit or loss links last year's statement of financial position to that constructed at the end of this year.

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

5.5 Statement of changes in equity

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



Illustration: Statement of changes in equity

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

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

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

6 BUSINESS TRANSACTIONS

Section overview

- Introduction
- The difference between capital transactions and revenue transactions
- Capital and revenue expenditure
- Revenue income and capital receipts

6.1 Introduction

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

There are many different types of business transaction including:

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

There are many more examples.

Classification of business transactions

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

- Simple transactions and complex transactions
- One-off transactions and ongoing transactions
- Capital transactions and revenue transactions

Simple or complex

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

One-off transactions and ongoing transactions

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

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

6.2 The difference between capital transactions and revenue transactions

A business entity normally operates over many years, but prepares financial statements annually (at the end of each financial year).

- It spends money for both the long term, by investing in machinery, equipment and other assets. It also spends money on day-to-day expenses, such as paying for supplies and services, and paying wages or salaries to employees.
- It receives income from its business operations. It might also receive income from other sources, such as a new bank loan, or new capital invested by its owner.

A distinction is made between 'capital' and 'revenue' items:

- Items of a long-term nature, such as property, plant and equipment used to carry out the operating activities of the business, are 'capital items'.
- Items of a short-term nature, particularly items that are used or occur in the normal cycle of business operations, are 'revenue items'.

As a rough guide (but which is not strictly accurate):

- capital items will be reported in the statement of financial position, because they are of a long-term nature
- revenue items are at some stage reported as income or expenses in the statement of comprehensive income.

6.3 Capital and revenue expenditure

Capital expenditure is expenditure made to acquire or improve long term assets that are used by the business:

Examples include:

- purchase of property, plant and equipment, office equipment; and motor vehicles;
- installation costs associated with new equipment;
- improvements and additions to existing non-current assets (for example, building extensions, installation of air-conditioning, etc.)

Fees paid to raise long term finance are also deemed to be capital in nature.

- To pay fees associated with raising long term finance

A 'capital asset' is a '**non-current asset**'

The IASB defines '**capitalisation**' as recognising a cost as an asset or part of the cost of an asset. So when an item of cost is '**capitalised**' it is treated as an asset rather than an expense.

Revenue expenditure is expenditure on day-to-day operating expenses.

Examples include:

- Purchase of goods meant for resale in the normal course of business;
- Purchase of raw materials and components used to manufacture goods for resale in the normal course of business;
- Expenditures made to meet the day to day running costs of a business (for example, rent, energy, wages, etc.)
- Expenditures made to repair non-current assets.
- Expenditures made to distribute goods to customers.
- Costs of administering a business (for example, accounting services, licence fees, etc.)

Revenue expenditure is reported as expenditure in the statement of comprehensive income.

It is not always easy to distinguish between capital and revenue transactions.



Illustration:

A business has two identical vehicles each with engine problems.

Vehicle A engine is repaired – costs associated with the repair are revenue expenditure

Vehicle B engine is replaced – this is capital expenditure.

6.4 Revenue income and capital receipts

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

Examples include:

- Revenue from the sale of goods.
- Commissions and fees received and receivable from the provision of a service.
- Interest received and receivable from savings.
- Rent received and receivable from letting out property.

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

Capital receipts are receipts of 'long term' income, such as money from a bank loan, or new money invested by the business owners (which is called 'capital').

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



Illustration:

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

The loan is an on – current liability (and part of the long-term 'capital' of the business – a capital receipt) but the interest is an expense (revenue expenditure). A business has two identical vehicles each with engine problems.

The engine of one is repaired – costs associated with the repair are revenue expenditure

The engine of the second is replaced – this is capital expenditure.

7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- (a) Explain the characteristics of a business
- (b) Describe the key features of sole proprietorship, partnership and limited company
- (c) Describe the accruals, cash and break up bases of accounting
- (d) Explain the importance of financial information to different types of user
- (e) Explain the characteristics and purpose of the statement of financial position and the statement of comprehensive income.
- (f) List the components of a set of financial statements.
- (g) Describe the basic presentation layout of statements of financial position and statements of comprehensive income.
- (h) Classify transactions that fall under the definition of business transactions.

The IASB's Conceptual Framework

Contents

- 1 A conceptual framework for financial reporting
- 2 The IASB Conceptual Framework
- 3 Qualitative characteristics of useful financial information
- 4 The elements of financial statements
- 5 Recognition in financial statements: IASB Conceptual Framework
- 6 Other accounting concepts
- 7 Fair presentation
- 8 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

A	Accounting framework
2	Identify the users of accounting information and their information needs.
3	Explain the qualitative characteristics of useful financial information.
4	List and explain the elements of financial statements.
5	Explain the following accounting concepts:
	a Going concern;
	c Materiality and aggregation;
	d Substance over form;
	f Fair presentation;
	g Offsetting;
	h Consistency of presentation; and
	i Prudence.

Exam context

This paper requires knowledge of the essential framework of assumptions that underpin reliable reporting.

Many of these are set out in the **IASB's Conceptual Framework for Financial Reporting** which is an examinable document.

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

- Explain the meaning of GAAP
- Describe the purpose of the IASB's Conceptual Framework
- Describe users and their informational needs
- State the objective of financial statements
- Describe the qualitative characteristics of financial information
- List and define the elements of financial statements
- State the recognition criteria for elements of financial statements
- Explain materiality, offsetting and consistency
- Explain the meaning of fair presentation

1 A CONCEPTUAL FRAMEWORK FOR FINANCIAL REPORTING

Section overview

- The meaning of GAAP
- The meaning of a conceptual framework
- The purpose of a conceptual framework
- The alternative to a conceptual framework

1.1 The meaning of GAAP

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

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

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

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

1.2 The meaning of a conceptual framework

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

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

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

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

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

The new document is made up of the following sections:

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

1.3 The purpose of a conceptual framework

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

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

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

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

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

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

1.4 The alternative to a conceptual framework

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

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

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

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

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

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2 THE IASB CONCEPTUAL FRAMEWORK

Section overview

- Introduction
- Users and their information needs
- Chapter 1: Objective of general purpose financial statements
- Chapter 4: Financial statements and the reporting entity

2.1 Introduction

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

The Conceptual Framework deals with:

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

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

- assist the IASB to develop IFRS Standards (Standards) that are based on consistent concepts;
- assist preparers to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when IFRS allows a choice of accounting policy; and
- assist all parties to understand and interpret IFRS.

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

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

2.2 Users and their information needs

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

- General purpose financial reports cannot provide all the information needed and users also need to consider pertinent information from other sources.
- General purpose financial reports do not show the value of a reporting entity; but they provide information to help users estimate a value.

- Individual primary users have different information needs. The aim of IFRSs is to provide information that will meet the needs of the maximum number of primary users.

Other users

- Regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful but these reports are not primarily directed to these groups.
- A company's management is often interested in financial information but the management do not need to rely on general purpose financial reports.

2.3 Chapter1: Objective of general purpose financial statements

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

The objective

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

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

- In order to make these decisions the users need information to help them assess the prospects for future net cash inflows to an entity.
- In order to assess an entity's prospects for future net cash inflows, users need information about:
 - the resources of the entity;
 - claims against the entity; and
 - how efficiently and effectively the entity's management have discharged their responsibilities to use the entity's resources. (This information is also useful for decisions by those who have the right to vote on or otherwise influence management performance).

Information provided

General purpose financial statements provide information about:

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

Economic resources and claims

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

- identify the financial strengths and weaknesses of a reporting entity;

- to assess a reporting entity's liquidity and solvency and its needs for additional financing;

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

Changes in economic resources and claims – Financial performance

Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.

This is important because such information provides a better basis for assessing the entity's past and future performance than information solely about cash receipts and payments during that period.

Importance of information about a reporting entity's financial performance:

- It helps users to understand the return generated from its economic resources. This in turn provides an indication of how well management has discharged its responsibilities to make efficient and effective use of these resources.
- It shows the capacity of a reporting entity to generate net cash inflows through its operations rather than by obtaining additional resources directly from investors and creditors.
- It gives an indication of the extent to which events such as changes in market prices or interest rates affect its ability to generate net cash inflows.
- Information about the variability and components of return is also important, especially in assessing the uncertainty of future cashflows.
- Information about past financial performance is helpful in predicting the entity's future returns on its economic resources.

Another aspect of performance is management of cash flow. Information about a reporting entity's cash flows during a period helps users to assess the entity's ability to generate future net cash inflows. It indicates how the reporting entity obtains and spends cash, including information about its borrowing and repayment of debt, cash dividends or other cash distributions to investors, and other factors that may affect the entity's liquidity or solvency. Information about cash flows helps users understand a reporting entity's operations, evaluate its financing and investing activities, assess its liquidity or solvency and interpret other information about financial performance.

Changes in economic resources and claims – Other events and transactions

Information about this type of change is necessary to give users a complete understanding of why the reporting entity's economic resources and claims changed and the implications of those changes for its future financial performance.

Objectives of financial statements: summary

The objectives of financial statements are met by:

- the main financial statements (statement of financial position, statement of profit or loss and other comprehensive income (or statement of profit or

- loss and statement of other comprehensive income), statement of cash flows, and statement of changes in equity), and
- supporting notes to the accounts, which provide additional details.

2.4 Chapter4: Financial statements and the reporting entity

Objective and scope of financial statements

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

That information is provided:

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

Reporting period

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

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

Going concern assumption

Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future.

It is assumed that the entity does not intend or need to enter liquidation or to cease trading. If that is not the case, the financial statements may have to be prepared on a different basis and the basis used must be described.

3 QUALITATIVE CHARACTERISTICS OF USEFUL FINANCIAL INFORMATION

Section overview

- Introduction
- Relevance
- Faithful representation
- Enhancing qualitative characteristics
- Cost constraint on useful information

3.1 Introduction

This is covered by chapter 2 of *The IASB Conceptual Framework*.

Information must have certain characteristics in order for it to be useful for decision making. The *IASB Conceptual Framework* describes:

- fundamental qualitative characteristics; and
- enhancing qualitative characteristics

Fundamental qualitative characteristics:

- relevance; and
- faithful representation

The qualitative characteristics that enhance the usefulness of information that is relevant and a faithful representation are:

- comparability;
- verifiability
- timeliness; and
- understandability

"If financial information is to be useful, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable".

Emphasis

Information must be both relevant and faithfully represented if it is to be useful.

The enhancing qualitative characteristics cannot make information useful if that information is irrelevant or not faithfully represented.

3.2 Relevance

Information must be relevant to the decision-making needs of users. Information is relevant if it can be used for predictive and/or confirmatory purposes.

- It has **predictive value** if it helps users to predict what might happen in the future.
- It has **confirmatory value** if it helps users to confirm the assessments and predictions they have made in the past.

The relevance of information is affected by its materiality.

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

- Materiality is an entity-specific aspect of relevance based on the nature or magnitude (or both) of the items to which the information relates in the context of an individual entity's financial report.
- Therefore, it is not possible for the IASB to specify a uniform quantitative threshold for materiality or predetermine what could be material in a particular situation.

3.3 Faithful representation

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

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

A perfectly faithful representation would have three characteristics. It would be:

- complete – the depiction includes 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 – where there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process.

3.4 Enhancing qualitative characteristics

Comparability

Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items

Information about a reporting entity is more useful if it can be compared with similar information about other entities and with similar information about the same entity for another period or another date.

Consistency is related to comparability but is not the same. Consistency refers to the use of the same methods for the same items, either from period to period within a reporting entity or in a single period across entities. Consistency helps to achieve the goal of comparability.

Verifiability

This quality helps assure users that information faithfully represents the economic phenomena it purports to represent.

- Verifiability means that different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.

- Quantified information need not be a single point estimate to be verifiable. A range of possible amounts and the related probabilities can also be verified.

Timeliness

This means having information available to decision-makers in time to be capable of influencing their decisions.

Understandability

Information is made understandable by classifying, characterising and presenting it in a clear and concise manner.

Financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently.

3.5 Cost constraint on useful information

Reporting financial information that is relevant and faithfully represents what it purports to represent helps users to make decisions with more confidence. This results in more efficient functioning of capital markets and a lower cost of capital for the economy as a whole. An individual investor, lender or other creditor also receives benefits by making more informed decisions. However, it is not possible for general purpose financial reports to provide all the information that every user finds relevant.

The benefits obtained from financial information should exceed the cost of obtaining and providing it. Information should not be provided if the cost is not worth the benefit.

Since it is difficult to measure the benefits of financial information, the setters of accounting standards must use their judgement in deciding whether certain items of information should be provided in the financial statements (and if so, in how much detail).

4 RECOGNITION IN FINANCIAL STATEMENTS: IASB CONCEPTUAL FRAMEWORK

Section overview

- Recognition criteria
- Recognition criteria
- Commentary on the new recognition criteria
- Measurements of elements of financial statements

4.1 Recognition

This is covered by chapter 5 of *The IASB Conceptual Framework*.

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

Recognition involves depicting the item in words and by a monetary amount.

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

Recognition links the elements as the recognition of one item (or a change in its carrying amount) requires the recognition or derecognition of another item. For example, revenue is recognised at the same time as the corresponding receivable.

4.2 Recognition criteria

Only items that:

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

However, not all items that meet the definition of one of those elements are recognised.

An asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful, i.e. with:

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

Information about an asset or liability may not be relevant when there is uncertainty about its existence or when there is only a low probability of an inflow or outflow of economic benefits in respect of that asset or liability.

Whether a faithful representation can be provided may be affected by the level of measurement uncertainty associated with the asset or liability or by other factors.

4.3 Commentary on the new recognition criteria

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

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

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

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

4.4 Measurements of elements of financial statements

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

- Historical cost. Assets are measured at the amount of cash paid, or at the fair value of the consideration given to acquire them. Liabilities are measured at:
 - the amount of proceeds received in exchange for the obligation (for example, bank loan or a bank overdraft), or
 - the amount of cash that will be paid to satisfy the liability.
- Current cost or current value. This is the basis used in current value accounting/current cost accounting. Assets are measured at the amount that would be paid to purchase the same or a similar asset at the current time. Liabilities are measured at the amount that would be required to settle the obligation at the current time.
- Realisable value (or settlement value). This method of measurement is relevant when an entity is not a going concern, and is faced with liquidation and a forced sale of its assets. Assets are measured at the amount that could be obtained by selling them. Liabilities are measured at the amount that would be required to settle them at the current time.
- Present value. Assets might be measured at the value of the future net cash inflows that the item is expected to generate, discounted to a present value. Similarly, a liability might be measured at the discounted present value of the expected cash outflows that will be made to settle the liability.

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

5 OTHER ACCOUNTING CONCEPTS

Section overview

- Materiality and aggregation
- Offsetting
- Consistency of presentation
- Prudence

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

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

5.1 Materiality and aggregation

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

The relevance of information is affected by its materiality.

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

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

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

Magnitude

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



Example: Materiality

Two similar businesses prepare financial statements that show that each has non-current assets of ₦10,000,000 and each has a profit for the year of ₦100,000.

Each business discovers a ₦20,000 error.

Error	Comment
1 This relates to how Business A arrived at the total of non-current assets which are now overstated by ₦20,000.	This is immaterial. ₦20,000 is a small error in the context of the non-current asset figure and its omission would not be misleading.
2. This relates to how Business B arrived at the profit for the year which is now overstated by ₦20,000.	This is material. Omitting this amount means that profit is misstated by 20%



Example: Materiality

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

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

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

Nature

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

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

5.2 Offsetting

IAS 1 states that:

Assets and liabilities should not be offset against each other.

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

Instead they should be reported separately.

The exceptions to this rule are when:

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

Net

This refers to the result of adding a positive and negative number together. The result might be a net asset, net liability, net income or net expense. In other words a net asset is the result of offsetting an asset with a liability.

5.3 Consistency of presentation

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

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

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



Example: Consistency

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

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

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

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

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

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

5.4 Prudence

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

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

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



Example: Prudence

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

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

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

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

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

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

Other accounting concepts include:

- a. Going concern:** Unless otherwise stated, it is always assumed that a business entity will continue in operation for the foreseeable future. It is assumed that the entity has neither the intention nor the necessity of liquidation or curtailing significantly the scale of its operation.
- b. Accruals:** This can be called either accrual or matching concept. The accrual concept states that income should be recognised when they are earned and not when they are received in cash. Expenses should also be recorded when they are incurred and not when paid.

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

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

6 Fair presentation

Section overview

- What is meant by fair presentation (or a true and fair view)?
- Fair presentation and compliance with IFRSs

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

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

Under 'international GAAP' (specifically IAS 1 *Presentation of Financial Statements*) financial statements are required to present fairly the financial position, financial performance and cash flows of the entity.

The IASB Conceptual Framework does not deal directly with this issue. However, it does state that if an entity complies with international accounting standards, and if its financial information has the desirable qualitative characteristics of information, then its financial statements 'should convey what is generally understood as a true and fair view of such information'.

IAS 1 states that: 'Fair presentation requires the faithful representation of the effects of transactions, other events and conditions in accordance with the definitions and recognition criteria for assets, liabilities, income and expenses set out in the IASB Framework.'

The use of the term faithful representation means more than that the amounts in the financial statements should be materially correct. It implies that information should present clearly the transactions and other events that it is intended to represent. To provide a faithful representation, financial information must account for transactions and other events in a way that reflects their substance and economic reality (in other words, their true commercial impact) rather than their legal form. If there is a difference between economic substance and legal form, the financial information should represent the economic substance.

Faithful representation also implies that the amounts in the financial statements should be classified and presented and disclosures made in such a way that important information is not obscured and users are not misled.

6.2 Fair presentation and compliance with IFRSs

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

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

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

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

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7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the meaning of GAAP
- Describe the purpose of the IASB's Conceptual Framework
- Describe users and their information needs
- State the objective of financial statements
- Describe the qualitative characteristics of financial information
- List and define the elements of financial statements
- State the recognition criteria for elements of financial statements
- Explain materiality, offsetting and consistency
- Explain the meaning of fair presentation

The accounting equation

Contents

- 1 The accounting equation
- 2 Preparing a simple statement of financial position and statement of profit or loss
- 3 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

B Recording financial transactions		
3	Apply double entry principles to:	
	a	Accounting equation

Exam context

This chapter explains the accounting equation. This is essential background to understanding double entry bookkeeping. Furthermore, the accounting equation can be used to produce financial information in situations where accounting information is incomplete. This latter application is covered in detail in a later chapter.

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

- Apply, the accounting equation ($\text{Assets} = \text{Liabilities} + \text{Equity}$) in simple practical and common scenarios
- Explain links between financial statements
- Prepare simple financial statements

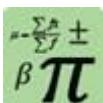
1 THE ACCOUNTING EQUATION

Section overview

- A simple representation of the statement of financial position
- The effect of financial transactions on the accounting equation
- Drawings
- Links between the statement of profit or loss and the statement of financial position
- Using the accounting equation

1.1 A simple representation of the statement of financial position

The accounting equation is a simplified way of showing a statement of financial position. The equation is:



Formula: Accounting equation

$$\begin{array}{rcl} \text{Assets} & = & \text{Equity} + \text{Liabilities} \\ \mathbf{A} & = & \mathbf{E} + \mathbf{L} \end{array}$$

Each new financial transaction affects the numbers in the accounting equation, but the accounting equation must always apply. Total assets must always be equal to the combined total of equity plus liabilities.

The accounting equation is a useful introduction to the preparation of a simple statement of profit or loss and statement of financial position. It is also a useful introduction to the principles of double-entry book-keeping, and the **duality concept** that every transaction has two aspects that must be recorded.

The accounting equation and the business entity concept

The use of the accounting equation is based on the business entity concept, that a business is a separate entity from the person or persons who own it. The owner puts capital into the business, and the business 'owes' this to the owner.



Illustration:

George sets up a business 'George's Security Services' and puts some capital into the business.

The accounting system of the business would consider that 'George's Security Services' is an entity on its own, separate from George, and that George is an owner to which the business owes the capital.

1.2 The effect of financial transactions on the accounting equation

The effect of financial transactions on the accounting equation will be explained by looking at a series of business transactions for a newly-established sole trader's business.



Example : Adeyemi – Transaction 1

Setting up a business by introducing capital

Adeyemi has decided to set up in business selling football shirts from a stall in the market place.

He begins by putting ₦30,000 into a bank account for the business.

This transaction is recorded in the accounting equation as follows:

Assets	=	Equity	=	Liabilities
₦		₦		₦
Cash	30,000	Capital	30,000	

30,000 = 30,000 +

Capital has been introduced into the new business. This is recorded as the owner's capital.

The new business also has cash in the bank, which is an asset.

Assets and equity have both increased by ₦30,000.



Example : Adeyemi – Transaction 2

Borrowing money

Adeyemi borrows ₦40,000 from his brother to purchase a motor van for the business.

The business acquires a new asset – a motor van – but has also acquired a liability in the form of the loan.

After the van has been purchased, the accounting equation changes to:

Assets	=	Equity	=	Liabilities
₦		₦		₦
Cash	30,000			
Van	40,000	Capital	30,000	Loan

70,000 = 30,000 + 40,000

Assets and liabilities have both increased by ₦40,000.



Example : Adeyemi – Transaction 3

Buying an asset for cash

Adeyemi buys a market stall and pays ₦5,000 in cash.

The business has used one asset (cash) to acquire a different asset (a stall). There is no change in the total assets, simply a change in the make-up of the assets.

After the stall has been purchased, the accounting equation changes to:

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	25,000		
Stall	5,000		
Van	40,000	Capital	30,000
	<u>70,000</u>	<u>=</u>	<u>30,000</u>
			<u>+ 40,000</u>



Example : Adeyemi – Transaction 4

Buying assets (inventory) on credit

Adeyemi now buys some football shirts for ₦18,000. He buys these on credit, and does not have to pay for them immediately.

The business has acquired more assets (shirts = inventory). In doing so, it has created another liability, because it now owes money to its supplier, who is recorded as a 'trade payable'.

Both assets and liabilities have increased by the same amount.

After the shirts have been purchased, the accounting equation changes to:

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	25,000		
Inventory	18,000		
Stall	5,000		Loan 40,000
Van	40,000	Capital	30,000
	<u>88,000</u>	<u>=</u>	<u>30,000</u>
			<u>+ 58,000</u>



Example : Adeyemi – Transaction 5

Making a cash payment to settle a liability

Adeyemi pays ₦10,000 to his suppliers for some of the shirts he purchased.

The payment reduces the liabilities of the business, but also reduces its assets (cash) by the same amount.

After the payment has been made the accounting equation changes to:

Assets	=	Equity	+	Liabilities
	₦		₦	₦
Cash	15,000			
Inventory	18,000			
Stall	5,000			Loan 40,000
Van	40,000	Capital 30,000		Payables 8,000
	<u>78,000</u>	=	<u>30,000</u>	+ <u>48,000</u>



Example : Adeyemi – Transaction 6

Cash sales (leading to recognising cost of sales and profit)

Adeyemi sells 50% of the shirts (cost = ₦9,000) for ₦12,000 in cash.

The business has sold assets that cost ₦9,000. It has received ₦12,000 in cash, and the difference is the profit on the sales.

Profit is added to the owner's capital.

After the sale, the accounting equation changes to:

Assets	=	Equity	+	Liabilities
	₦		₦	₦
Cash	27,000	Capital:		
Inventory	9,000	Original	30,000	
Stall	5,000	Profit	3,000	Loan 40,000
Van	40,000			Payables 8,000
	<u>81,000</u>	=	<u>33,000</u>	+ <u>48,000</u>



Example : Adeyemi – Transaction 7

Credit sales (leading to recognising cost of sales and profit)

Adeyemi sells shirts for ₦9,000, to a shop owner in another town. These shirts originally cost ₦5,000. He sells the shirts on credit, giving the purchaser one month to pay.

The business has sold for ₦9,000 assets that cost ₦5,000. The difference is the profit of ₦4,000 on the sale. Profit adds to the owner's capital, taking the total profit earned so far from ₦3,000 to ₦7,000. With this transaction, however, the business is still owed money from the customer for the sale.

Money owed by a customer for a sale on credit is called a 'trade receivable'. A trade receivable is an asset.

After the sale, the accounting equation changes to:

Assets	=	Equity	+ Liabilities
		₦	₦
Cash	27,000	<u>Capital:</u>	
Inventory	4,000	Original	30,000
Receivable	9,000	Profit	7,000
Stall	5,000		Loan 40,000
Van	<u>40,000</u>		Payables 8,000
	<u>85,000</u>	=	<u>37,000</u> + <u>48,000</u>



Practice question

1

Continuing the Adeyemi example construct an accounting equation after each of the following transactions

- 1 Transaction 8: Adeyemi repays ₦10,000 of the loan.
- 2 Transaction 9: Adeyemi pays his trade suppliers ₦6,000.
- 3 Transaction 10: Adeyemi receives ₦8,000 of the money owed to him by the customer (trade receivable).
- 4 Transaction 11: Adeyemi purchases another ₦2,500 of shirts, on credit.

1.3 Drawings

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

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

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



Example : Adeyemi – Transaction 12

Suppose that the accounting equation of Adeyemi is as follows:

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	19,000	<u>Capital:</u>	
Inventory	6,500	Original	30,000
Receivable	1,000	Profit	7,000
Stall	5,000		Loan 30,000
Van	40,000		Payables 4,500
	<u>71,500</u>	<u>=</u>	<u>37,000</u> + <u>34,500</u>

Adeyemi decides to take ₦4,000 in cash out of his business, and he also takes inventory with a value of ₦2,000.

The assets of the business are reduced by ₦6,000 (cash + inventory), and capital is reduced by the same amount.

The accounting equation now changes as follows:

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	15,000	<u>Capital:</u>	
Inventory	4,500	Original	30,000
Receivables	1,000	Profit	7,000
Stall	5,000	Drawings	(6,000) Loan 30,000
Van	40,000		Payables 4,500
	<u>65,500</u>	<u>=</u>	<u>31,000</u> + <u>34,500</u>

1.4 Links between the statement of profit or loss and the statement of financial position

A statement of financial position shows the financial position of a business at a given point in time and is a representation of the accounting equation.

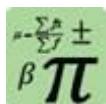
A statement of profit or loss shows the profit or loss for a period of time.

However, there are links between the two financial statements.

- Profit in the statement of profit or loss affects the statement of financial position, by adding to the owner's capital.
- Drawings out of profits also affect the statement of financial position, by reducing the owner's capital.

1.5 Using the accounting equation

The accounting equation is:



Formula: Accounting equation

$$\begin{array}{lcl} \text{Assets} & = & \text{Liabilities} + \text{Equity} \quad \text{or} \quad \text{Assets} - \text{Liabilities} = \text{Equity} \\ \text{A} & = & \text{L} + \text{E} \qquad \qquad \qquad \text{A} - \text{L} = \text{E} \end{array}$$

Assets minus liabilities is usually called **net assets**.

A change on one side of an equation must be matched by a change on the other. Therefore, an increase in net assets means a matching increase in equity capital and a fall in net assets means a matching fall in equity capital.

Movements in equity are caused by:

- profit being added to capital or losses deducted from capital; and
- the introduction of more capital into the business (perhaps by providing it with additional cash or other assets);
- payments to the owners in the form of drawings (or dividends in the case of a company).

In other words, net assets will change in value between the beginning and end of a financial year by the amount of profit (or loss) in the period, new capital introduced and drawings or dividends taken out.



Illustration:

	₦
Opening equity/net assets (ONA)	X
Profit (P)	X
Capital introduced (CI)	X
Drawings (D)	(X)
Closing equity/net assets (CAN)	<u>X</u>

The value of any term can be calculated if the others are known.

**Example:**

Olayode operates a business as a sole trader.

On 1 July 2019 the net assets of the business were ₦670,000.

During the year to 30 June 2020, the business made a profit of ₦250,000 and Olayode took out ₦220,000 in drawings.

Due to a shortage of cash in the business, he paid in additional capital of ₦40,000 in early June 2020.

The net assets of the business at 30 June 2020 can be calculated as follows:

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

**Example:**

Adamma operates a business as a sole trader. On 31 March 2019 the net assets of the business were ₦950,000.

During the year to 31 March 2019, the business made a loss of ₦20,000 and Adamma took out ₦150,000 in drawings during the year. She was also required to invest a further ₦290,000 during the year.

The opening net assets of the business at 1 April 2018 can be calculated by working backwards to identify what they need to be in order to make the sum work.

	₦		₦
Opening equity (net assets)	?	Therefore	830,000
Loss	(20,000)		(20,000)
Capital introduced	290,000		290,000
Drawings	<u>(150,000)</u>		<u>(150,000)</u>
Closing equity (net assets)	<u>950,000</u>		<u>950,000</u>

A missing figure identified in this way is described as a balancing figure.

A balancing figure is a number identified to make a sum work.

The opening assets could also be identified using an equation based approach:

$$ONA - L + CI - D = CNA.$$

$$ONA - 20,000 + 290,000 - 150,000 = 950,000.$$

$$ONA = 950,000 + 20,000 - 290,000 + 150,000 = 830,000$$

This technique can be used in situations where the accounting records are incomplete for some reason. It is covered again in a later chapter.

2 PREPARING A SIMPLE STATEMENT OF FINANCIAL POSITION AND STATEMENT OF PROFIT OR LOSS

Section overview

- Identifying the elements for a statement of financial position or statement of profit or loss
- Useful guidelines
- Exercise

2.1 Identifying the elements for a statement of financial position or statement of profit or loss

To prepare a statement of financial position and statement of profit or loss, several adjustments must be made to the accounting records at the end of the financial year. These adjustments (such as adjustments for the depreciation of non-current assets, for accruals and prepayments, for bad and doubtful debts and for opening and closing inventory values) are explained in later chapters.

At this stage, however, it is a useful exercise to test your ability to prepare a simple statement of financial position and statement of profit or loss from lists of assets, liabilities, equity, income and expenses.

2.2 Useful guidelines

The data for preparing financial statements comes from the accounting records, which are described in a later chapter.

A list of 'balances' is obtained from the accounting records, for assets, liabilities, capital, expenses and income.

In the example below, the list of balances is used to prepare a statement of profit or loss for the period and a statement of financial position as at the period end.

Opening and closing inventory and the cost of sales

The cost of sales in the statement of profit or loss is not the cost of goods purchased or the cost of goods produced. It must be the cost of the goods sold. The accruals or matching concept must be applied.

When there are differences between the quantity of materials purchased or made, and the quantity of materials used or sold, there is an increase or decrease in inventory during the period.

To calculate the cost of sales for a statement of profit or loss, it is necessary to make an adjustment for changes in the amount of inventory.

**Illustration: Cost of sales**

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

**Example: Cost of sales**

	₦	
Opening inventory	5,000	
Purchases	45,000	
	<hr/>	
	50,000	
Less: Closing inventory	(12,000)	
	<hr/>	
Cost of sales	38,000	

The statement of profit or loss will provide a figure for profit or loss for the period.

The statement of financial position and the statement of profit or loss can be prepared in any order but the statement of financial position can only be completed after the profit or loss for the period is known because this figure becomes part of the equity capital.

2.3 Exercise

This is an introductory example to illustrate the basic principles. In practice there would always be adjustments to make in order to arrive at the corrected figures for inclusion in the financial statements. These are explained in later chapters.

The first step is to identify which balances are income and expenses for inclusion in the statement of profit or loss and which balances are assets, liabilities and equity for inclusion in the statement of financial position.



Practice question

2

Joseph began trading on 1 January 2019.

The following information has been extracted from his accounting records at 30th June 2019.

	₦
Sales	184,620
Purchases	146,290
Salaries	21,500
Motor expenses	5,200
Rent	6,700
Insurance	1,110
General expenses	1,050
Premises	15,000
Motor vehicles	12,000
Trade receivables	19,500
Trade payables	15,380
Cash	16,940
Drawings	8,950
Capital	54,240

Inventory as at 30th June 2019 was ₦25,480.

Prepare a statement of profit or loss for the six months ended 30th June 2019 and a statement of financial position as at that date.

Remember that the capital at the beginning of the year is adjusted for the profit and drawings during the year, to obtain the owner's capital at the end of the year.

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Apply the accounting equation (Assets = Liabilities + Equity) in simple practical and common scenarios
- Explain links between financial statements
- Prepare simple financial statements

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

1. After transaction 8 (Cash falls by 10,000; Loan falls by 10,000)

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	17,000	<u>Capital:</u>	
Inventory	4,000	Original	30,000
Receivable	9,000	Profit	7,000
Stall	5,000		Loan Trade payables
Van	<u>40,000</u>		30,000
	<u>75,000</u>	<u>=</u>	<u>37,000</u> +
			<u>38,000</u>

2. After transaction 9 (Cash falls by 6,000; Trade payables falls by 6,000)

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	11,000	<u>Capital:</u>	
Inventory	4,000	Original	30,000
Receivable	9,000	Profit	7,000
Stall	5,000		Loan Trade payables
Van	<u>40,000</u>		30,000
	<u>69,000</u>	<u>=</u>	<u>37,000</u> +
			<u>32,000</u>

3. After transaction 10 (Cash increases by 8,000; Receivables fall by 8,000)

Assets	=	Equity	+ Liabilities
	₦		₦
Cash	19,000	<u>Capital:</u>	
Inventory	4,000	Original	30,000
Receivable	1,000	Profit	7,000
Stall	5,000		Loan Trade payables
Van	<u>40,000</u>		30,000
	<u>69,000</u>	<u>=</u>	<u>37,000</u> +
			<u>32,000</u>

Solutions**1**

4. After transaction 11 (Inventory increases by 2,500; Trade payables increase by 2,500)

Assets	=	Equity	+	Liabilities
	₦		₦	
Cash	19,000	<u>Capital:</u>		
Inventory	6,500	Original	30,000	
Receivable	1,000	Profit	7,000	
Stall	5,000			Loan 30,000
Van	<u>40,000</u>			Trade payables 4,500
	<u><u>71,500</u></u>	=	<u><u>37,000</u></u>	<u><u>34,500</u></u>

Solution: Joseph: Statement of profit or loss for the six months ended 30th June 2019. **2**

Sales	₦	₦
Inventory at 1 January 2019		184,620
Purchases		0
		146,290
Inventory at 31 December 2019		146,290
		(25,480)
Cost of sales		120,810
Gross profit		63,810
Salaries	21,500	
Motor expenses	5,200	
Rent	6,700	
Insurance	1,110	
General expenses	1,050	
		(35,560)
Net profit		28,250

Solution: Joseph: Statement of financial position as at 30th June 2019.**2**

	₦	₦
Non-current assets:		
Premises	15,000	
Motor vehicles	<u>12,000</u>	
	27,000	
Current assets:		
Inventory	25,480	
Trade receivables	19,500	
Cash at bank	<u>16,940</u>	
	61,920	
Total assets	<u>88,920</u>	
Capital at 1st January 2019	54,240	
Net profit for the year	28,250	
	82,490	
Less: Drawings	(8,950)	
Capital at 30th June 2019	<u>73,540</u>	
Current liabilities:		
Trade payables	15,380	
Total capital and liabilities	<u>88,920</u>	

Double entry bookkeeping

Contents

- 1 Introduction to accounting systems
- 2 Basic rules of double-entry book keeping
- 3 Account balances and the trial balance
- 4 General journal
- 5 General ledger
- 6 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

B	Recording financial transactions	
3	Apply double entry principles to:	
	B	Basic rules of double entry bookkeeping;
	C	Ledger accounts entry principle; and
	D	Balancing ledger accounts and extracting trial balance.
4	State the usefulness and limitations of trial balance.	

Exam context

This chapter explains basic double entry bookkeeping. This skill is fundamental to the work of an accountant.

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

- Apply the concept of double entry accounting to business transactions;
- Explain the purpose of establishing a chart of accounts;
- Close off and strike a balance from T accounts;
- Extract a trial balance from T accounts;
- Prepare journals for business transactions;
- Describe the main features of the general ledger;
- Post entries in the general ledger; and
- Explain the interaction between the general ledger balances and the trial balance.

1 INTRODUCTION TO ACCOUNTING SYSTEMS

Section overview

- The dual nature of transactions
- Overview of accounting

1.1 The dual nature of transactions

The previous chapter explained the accounting equation. It illustrates the most important concept in accounting. That is that every transaction must be entered in two places or the equation would fail.

There is no exception to this rule. Every transaction that affects assets, liabilities, capital, income or expenses must have an offsetting effect to maintain the accounting equation. Every transaction must be recorded (entered) in two places. The process of doing this is called ***double entry bookkeeping***.

The accounting equation is useful to give an overview of the accounting process but it is not very practical as a tool to account for the transactions of a business. A business might enter into many thousands of transactions and it would be very time consuming to redraft the equation after each of them. A system is needed to allow large numbers of transactions to be recorded and then summarised to allow the production of financial statements on a periodic basis.

All transactions are analysed into different types and are then recorded in a series of individual records called accounts. There is a separate account for each different type of transaction, or that is to say, for each type of asset, liability, income, expense, and owners' capital.

Accounts are kept together in a ***ledger***. A ledger is a term meaning a collection of related accounts.

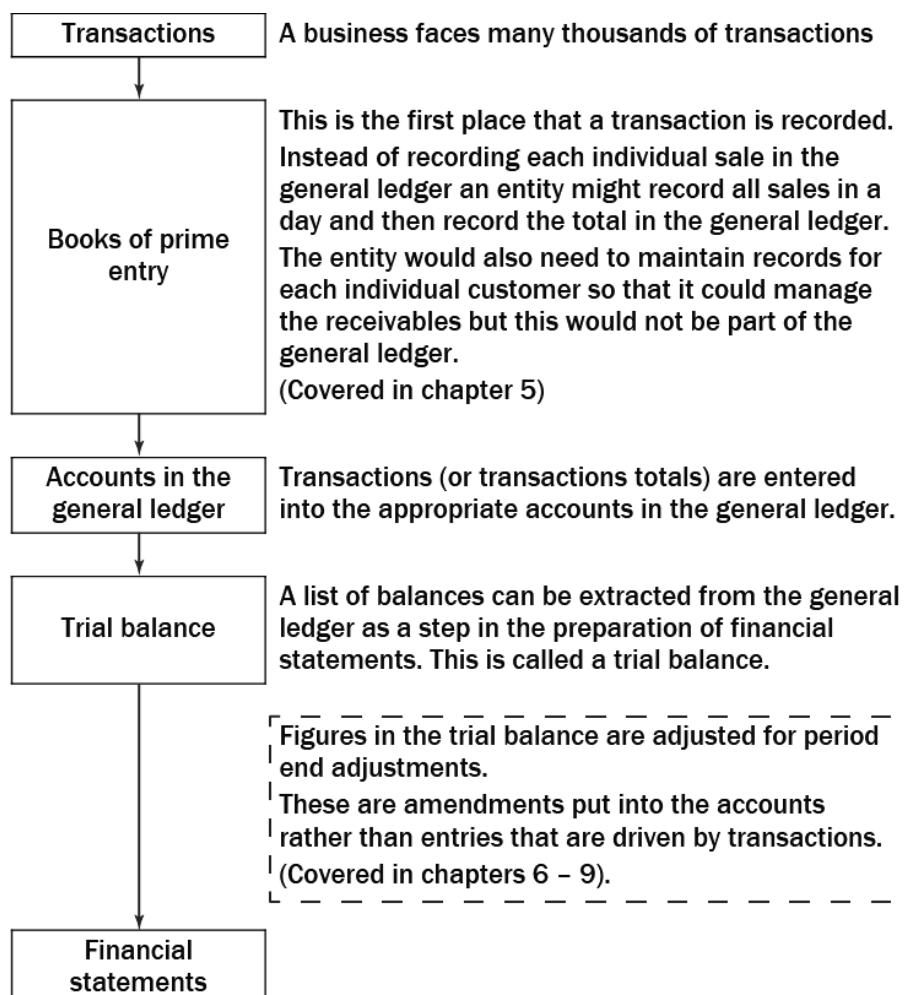
There are different types of ledgers in an accounting system but the accounts that record the double entries for each transaction are kept in the ***general ledger***, (also known as the ***nominal ledger*** or the ***main ledger***)

This section will continue to explain the process of double entry bookkeeping but before that there is an overview of the accounting process. Later sections and chapters will add to this in detail.

1.2 Overview of accounting



Illustration:



A trial balance can be extracted at anytime, but the rest of this book will assume it to be at the end of an accounting year.

Any adjustments made to the trial balance must also be reflected in the general ledger accounts. In other words, if something is added in after the trial balance is extracted it must also be added into the general ledger.

There is a large exercise to tidy up the general ledger once the year-end financial statements are produced. It involves clearing all of the income and expense accounts into a statement of profit or loss account. The balance on this account is then transferred to equity. This is to prepare the general ledger for the next accounting period.

2 BASIC RULES OF DOUBLE ENTRY BOOKKEEPING

Section overview

- Debit and credit entries, and T accounts
- The rules of debits and credits
- Double entry bookkeeping and the cash account

2.1 Debit and credit entries, and T-accounts

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

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

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

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

Illustration:



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

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

Alternative presentation

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

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

2.2 The rules of debits and credits

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



Illustration:

Account name	
Debit side(Dr)	Credit side(Cr)
Record as a debit entry:	Record as a credit entry:
An increase in an asset	A reduction in an asset
An increase in an expense	A reduction in an expense
A reduction in a liability	An increase in a liability
A reduction in income	An increase in income
A reduction in capital (drawings, losses)	An increase in capital (capital introduced profit)

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



Example

A purchase invoice is received for electricity charges for ₦2,300

The double entry is:

Debit: Electricity charges (= increase in expense)

Credit: Total trade payables (= increase in liability)

Electricity expense	
₦	₦
Trade payables	2,300
Expenses payables	
₦	₦
	Electricity expense
	2,300

This can be written as:

Dr Electricity expense 2,300

Cr Expenses payables 2,300

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

2.3 Double entry book keeping and the cash account

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

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

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



Illustration:

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

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

The transactions are repeated on the next page for convenience.



Example: Adeyemi revisited

- 1** Adeyemi introduces ₦30,000 cash as capital.
- 2** Adeyemi borrows ₦40,000 to purchase a van.
- 3** Adeyemi buys a market stall for ₦5,000 cash.
- 4** Adeyemi buys inventory for ₦18,000 on credit.
- 5** Adeyemi pays his supplier ₦10,000.
- 6** Adeyemi sells inventory for ₦12,000 cash.
- 7** Adeyemi sells inventory for ₦9,000 on credit.
- 8** Adeyemi repays ₦10,000 of the loan.
- 9** Adeyemi pays his trade suppliers ₦6,000.
- 10** Adeyemi receives ₦8,000 of the money owed to him by the customer (trade receivable).
- 11** Adeyemi purchases another ₦2,500 of shirts, on credit.
- 12** Adeyemi drew ₦4,000 cashout of the business and also took inventory which cost ₦2,500 for his own use.

Post all transactions to ledger accounts.



Example: Adeyemi – Transaction 1

Adeyemi sets up a business by putting ₦30,000 into a bank account. This increase the cash of the business, and its capital.

The double entry is:

Dr Bank (or cash)	30,000
Cr Capital	30,000

Capital		
₦		₦
	(1)Bank	30,000
Bank		
(1) Capital	₦ 30,000	₦

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



Example: Adeyemi – Transaction 2

Adeyemi borrows ₦40,000 to purchase a van.

There are two separate transactions, the loan of cash and the purchase of the van. The double entries are:

Dr Bank	40,000	Dr Van	40,000
Cr Loan	40,000	Cr Bank	40,000
Bank			
	₦		₦
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000		
Loan			
	₦		₦
		(2a) Bank	40,000
Van			
	₦		₦
(2b) Bank	40,000		



Example: Adeyemi – Transaction 3

Adeyemi buys a market stall for ₦5,000.

The double entry is:

Dr Stall	5,000	Dr Bank	5,000
Cr Bank	5,000		
Bank			
	₦		₦
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
Stall			
	₦		₦
(3) Bank	5,000		

The next transaction is a purchase of inventory. This is reflected in an account called purchases rather than inventory. You will see why later.



Example: Adeyemi – Transaction 4

Adeyemi purchases inventory for ₦18,000 on credit. The double entry is:

Dr Purchases 18,000
Cr Bank 18,000

Purchases		
	₦	₦
(4) Trade payables	18,000	
Trade payables		
	₦	₦
		(4) Purchases 18,000

Note on purchases of inventory

Notice that in this type of bookkeeping system, there is no separate account for inventory.

Purchases of materials and goods for re-sale are recorded in a purchases account, which is an expense account.

Inventory is ignored until such time as when the business wishes to calculate profit (usually the end of an accounting period) when it is counted and valued. This value is then used in a calculation of a cost of sale figure. (This will be demonstrated a little later in this chapter and the full inventory double entry explained in chapter 9).



Example: Adeyemi – Transaction 5

Adeyemi pays ₦10,000 to the supplier. The double entry is:

Dr Trade payables 10,000
Cr Bank 10,000

Bank		
	₦	₦
(1) Capital	30,000	(2b) Van 40,000
(2a) Loan	40,000	(3) Stall 5,000
		(5) Trade payables 10,000
Trade payables		
	₦	₦
(5) Bank	10,000	(4) Purchases 18,000



Example: Adeyemi – Transaction 6

Adeyemi sells inventory for ₦12,000 cash. The double entry is:

Dr	Bank	12,000
Cr	Sales	12,000

		Bank
	₦	₦
(1) Capital	30,000	(2b) Van
(2a) Loan	40,000	(3) Stall
(6) Sales	12,000	(5) Trade payables

		Sales
	₦	₦
(6)	Bank	12,000



Example: Adeyemi – Transaction 7

Adeyemi sells inventory for ₦9,000 on credit. The double entry is:

Dr	Trade receivables	9,000
Cr	Sales	9,000

		Trade receivables
	₦	₦
(7) Sales	9,000	

		Sales
	₦	₦
(6)	Bank	12,000
(7)	Trade receivables	9,000



Example: Adeyemi – Transaction 8

Adeyemi repays ₦10,000 of the loan. The double entry is:

Dr Loan	10,000
Cr Bank	10,000

Bank	
₦	₦
(1) Capital	30,000
(2a) Loan	40,000
(6) Sales	12,000
(2b) Van	40,000
(3) Stall	5,000
(5) Trade payables	10,000
(8) Loan	10,000

Loan	
₦	₦
(8) Bank	10,000
(2a) Bank	40,000



Example: Adeyemi – Transaction 9

Adeyemi pays ₦6,000 to the supplier.

The double entry is:

Dr Trade payables	6,000
Cr Bank	6,000

Bank	
₦	₦
(1) Capital	30,000
(2a) Loan	40,000
(6) Sales	12,000
(2b) Van	40,000
(3) Stall	5,000
(5) Trade payables	10,000
(8) Loan	10,000
(9) Trade payables	6,000

Trade payables	
₦	₦
(5) Bank	10,000
(4) Purchases	18,000
(9) Bank	6,000



Example: Adeyemi – Transaction 10

Adeyemi receives ₦8,000 from a customer. The double entry is:

Dr Bank	8,000
Cr Trade receivables	8,000

Bank

	₦		₦
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000

Trade receivables

	₦		₦
(7) Sales	9,000	(10) Bank	8,000



Example: Adeyemi – Transaction 11

Adeyemi purchases inventory for ₦2,500 on credit. The double entry is:

Dr Purchases	2,500
Cr Bank	2,500

Purchases

	₦		₦
(4) Trade payables	18,000		
(11) Trade payables	2,500		

Trade payables

	₦		₦
(5) Bank	10,000	(4) Purchases	18,000
(9) Bank	6,000	(11) Purchases	2,500



Example: Adeyemi – Transaction 12

Adeyemi draws ₦4,000 cash and took inventory which cost ₦2,000 for his own use.

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

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

Dr Drawings	6,000		
Cr Bank	4,000		
Cr Purchases	2,000		
Bank			
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
Purchases			
(4) Trade payables	18,000	(12b) Drawings	2,000
(11) Trade payables	2,500		
Drawings			
(12a) Bank	4,000		
(12b) Bank	2,000		



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

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

3 ACCOUNT BALANCES AND THE TRIAL BALANCE

Section overview

- Closing off an account (and bringing down the balance)
- Trial balance
- Preparing accounts from a trial balance

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

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

- If total debit entries in an account exceed total credits, there is a debit balance on the account.
- If total credit entries in an account exceed total debits there is a credit balance on the account.

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

- Balances on expense accounts and income accounts are transferred to the statement of profit or loss. (**Note:** There might be some accruals and prepayments on expense accounts. These are explained in a later chapter.)
- Balances on the asset, liability and capital accounts are carried forward as closing balances at the end of the period, and become opening balances at the beginning of the next period.



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

Step 1: Add up both sides of the account

		Bank	
	₦		₦
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000		75,000


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

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

Bank			
	₦	₦	
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
	90,000	(9) Trade payables	6,000
	90,000	(12a) Drawings	4,000
	90,000	75,000	
	90,000		

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

Bank			
	₦	₦	
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
	90,000	(9) Trade payables	6,000
	90,000	(12a) Drawings	4,000
	90,000	75,000	
		15,000	
		90,000	



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

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

		Bank	
	₦		₦
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000	75,000	
		Balance c/d	15,000
	90,000	90,000	
Balance b/d	15,000		

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

The full working in that case would look like this:



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

		Bank	
	₦		₦
(1) Capital	30,000	(2b) Van	40,000
(2a) Loan	40,000	(3) Stall	5,000
(6) Sales	12,000	(5) Trade payables	10,000
(10) Trade receivables	8,000	(8) Loan	10,000
		(9) Trade payables	6,000
		(12a) Drawings	4,000
	90,000	Balance c/d	15,000
Balance b/d	15,000		90,000

In this example, there is a debit balance on the bank account at the end of the period. The debit balance of ₦15,000 is brought forward as the opening balance on the account at the beginning of the next period.

This indicates that the business has an asset (a debit balance) of cash in the bank account totalling ₦15,000.

Note

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

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

Returning to Adeyemi.....



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

Capital		
	₦	₦
		(1) Bank 30,000
Balance c/d	30,000	<hr/>
	30,000	30,000
		Balance b/d 30,000
		<hr/>
Loan		
	₦	₦
(8) Bank	10,000	(2a) Bank 40,000
Balance c/d	30,000	<hr/>
	40,000	40,000
	<hr/>	Balance b/d 30,000
Van		
	₦	₦
(2b) Bank	40,000	Balance c/d 40,000
	<hr/>	40,000
Balance b/d	40,000	<hr/>
Stall		
	₦	₦
(3) Bank	5,000	Balance c/d 5,000
	<hr/>	5,000
Balance b/d	5,000	<hr/>

**Example: Adeyemi – All accounts closed off****Purchases**

	₦		₦
(4) Trade payables	18,000	(12b) Drawings	2,000
(11) Trade payables	2,500		
	<hr/>	Balance c/d	<hr/>
	20,500		18,500
Balance b/d	<hr/>		<hr/>
	18,500		20,500

Trade payables

	₦		₦
(5) Bank	10,000	(4) Purchases	18,000
(9) Bank	6,000	(11) Purchases	2,500
Balance c/d	<hr/>		<hr/>
	4,500		20,500
	<hr/>		<hr/>
	20,500	Balance b/d	4,500

Trade receivables

	₦		₦
(7) Sales	9,000	(10) Bank	8,000
	<hr/>	Balance c/d	<hr/>
	9,000		1,000
Balance b/d	<hr/>		<hr/>
	1,000		9,000

Sales

₦		₦
		(6) Bank
		12,000
		(7) Trade receivables
		9,000
Balance c/d	<hr/>	
	21,000	
	<hr/>	
	21,000	Balance b/d
	<hr/>	21,000
	21,000	21,000

Drawings

	₦		₦
(12a) Bank	4,000		
(12b) Bank	2,000	Balance c/d	6,000
	<hr/>		<hr/>
	6,000		6,000
Balance b/d	<hr/>		<hr/>
	6,000		6,000

3.2 Trial balance

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

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

A trial balance is a list of all the debit balances and all the credit balances on the accounts in the main ledger. A trial balance is 'extracted' from the main ledger simply by listing the balances on every account.

The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.

- Debit balances are assets, expenses or drawings.
- Credit balances are liabilities, income or equity (capital including share capital and reserve accounts in the case of a company).



Example: Adeyemi –Trial balance as at (it would be usual to give a date)

	Dr	Cr
Bank	15,000	
Capital		30,000
Loan		30,000
Van	40,000	
Stall	5,000	
Purchases	18,500	
Trade payables		4,500
Trade receivables	1,000	
Sales		21,000
Drawings	6,000	
	<hr/> 85,500	<hr/> 85,500

The purpose of a trial balance

A trial balance has two main purposes.

- It is a starting point for producing a statement of profit or loss and a statement of financial position at the end of an accounting period.
- It is a useful means of checking for errors in the accounting system. Errors must have occurred if the total of debit balances and total of credit balances on the main ledger accounts are not equal.



There is a practice question on page 109 of this chapter. If you have already attempted part a then do part b now. Otherwise do the whole exercise after completing all of section 3 of this chapter.

3.3 Preparing accounts from a trial balance

Year-end adjustments

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

- A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts.
- These adjustments (covered later in chapters 6 to 9) include adjustments for:
 - Depreciation expense (to reflect the use of non-current assets);
 - Accruals and prepayments;
 - Bad and doubtful debts; and
 - Inventory.
- Further adjustments are made as necessary to deal with items missed or incorrectly dealt with during a period.

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

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

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



Example: Adeyemi – Trial balance as at December 31, 2019

	Dr	Cr	Which element?
Bank	15,000		Asset
Capital		30,000	Equity
Loan		30,000	Liability
Van	40,000		Asset
Stall	5,000		Asset
Purchases	18,500		Expense
Trade payables		4,500	Liability
Trade receivables	1,000		Asset
Sales		21,000	Income
Drawings	6,000		Equity
	<hr/> 85,500	<hr/> 85,500	

Extra information:

The closing inventory of Adeyemi is ₦4,500

The only closing adjustment in the case of Adeyemi is in respect of the closing inventory.

Opening and closing inventory and the cost of sales

This appeared in the previous chapter. It is repeated here for your convenience.

The cost of sales in the statement of profit or loss is not the cost of goods purchased or the cost of goods produced. It must be the cost of the goods sold. The accruals or matching concept must be applied.

When there are differences between the quantity of materials purchased or made, and the quantity of materials used or sold, there is an increase or decrease in inventory during the period.

To calculate the cost of sales for a statement of profit or loss, it is necessary to make an adjustment for changes in the amount of inventory.



Illustration: Cost of sales

	₦
Opening inventory	X
Purchases	X
	<hr/>
Less: Closing inventory	(X)
Cost of sales	<hr/>

This is the total amount of goods X
 that were available to be sold.
 This is the total amount of goods
 still held at the end of the period.
 Therefore, this is the total amount of X
 goods that were sold.

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

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


Example: Adeyemi – Statement of profit or loss for the period ending December 31, 2019

	₦	₦
Sales		21,000
Opening inventory (none as it lists the first period of trading)	0	
Purchases	18,500	
	<hr/>	
Inventory at 31 December Year 5	18,500	
	<hr/>	
Cost of sales	(4,500)	
	<hr/>	
Gross profit	14,000	
	<hr/>	
Less: Expenses (none in this case)	7,000	
	<hr/>	
Net profit	0	
	<hr/>	
	7,000	

Adeyemi: Statement of financial position as at December 31, 2019.

	₦	₦
Non-current assets:		
Van	40,000	
Stall	5,000	
	<hr/>	
Current assets:		
Inventory	4,500	
Trade receivables	1,000	
Bank	15,000	
	<hr/>	
Total assets	20,500	
	<hr/>	
Capital introduced at start of business	65,500	
Net profit for the year		
	<hr/>	
Less: Drawings	30,000	
Capital at period end	7,000	
	<hr/>	
Non-current liabilities		
Loan	37,000	
	<hr/>	
Current liabilities:		
Trade payables	(6,000)	
Total capital and liabilities	31,000	
	<hr/>	
	30,000	
	<hr/>	
	4,500	
	<hr/>	
	65,500	



Complete the practice question at the end of Section 5.

4 THE GENERAL JOURNAL

Section overview

- Journal entries to record transactions
- Illustration using Adeyemi

4.1 Journal entries to record transactions

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

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

- postings from books of prime entry (explained in chapter 5);
- year-end adjustments (chapters 6 to 9);
- correction of errors (chapter 11) or
- any other adjustment.

The format of a journal entry is as follows:



Illustration:

Name of the account with the debit entry
Name of the account with the credit entry

Debit	Credit
X	X

Narrative explaining or describing the transaction

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

4.2 Illustration using Adeyemi



Example: Adeyemi revisited

- 1** Adeyemi introduces ₦30,000 cash as capital.
- 2** Adeyemi borrows ₦40,000 to purchase a van.
- 3** Adeyemi buys a market stall for ₦5,000 cash.
- 4** Adeyemi buys inventory for ₦18,000 on credit.
- 5** Adeyemi pays his supplier ₦10,000.
- 6** Adeyemi sells inventory for ₦12,000 cash.
- 7** Adeyemi sells inventory for ₦9,000 on credit.
- 8** Adeyemi repays ₦10,000 of the loan.
- 9** Adeyemi pays his trade suppliers ₦6,000.
- 10** Adeyemi receives ₦8,000 of the money owed to him by the customer (trade receivable).

Prepare journals for each of the above transactions.



Example: Adeyemi – Journal is in (g)

Transaction 1	Debit	Credit
	₦	₦
Cash	30,000	
Capital		30,000

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

Transaction 2

Cash	40,000
Loan payable	40,000
Asset – Van	40,000
Cash	40,000

Being: The borrowing of cash and the purchase of a van.

Transaction 3

Asset – Market stall	5,000
Cash	5,000

Being: The purchase of a market stall

Transaction 4

Purchases	Debit	Credit
	₦	₦
Payables	18,000	18,000

Being: The purchase of inventory on credit


Example: Adeyemi – Journal is in g transactions (continued)
Transaction 5

	Debit ₦	Credit ₦
Payables	10,000	
Cash		10,000

Being: A payment to a supplier.

Transaction 6

Cash	12,000	
Sales		12,000

Being: The cash sale of inventory.

Transaction 7

Receivables	9,000	
Sales		9,000

Being: The sale of inventory on credit.

Transaction 8

Loan payable	10,000	
Cash		10,000

Being: A part repayment on the loan.

Transaction 9

Payables	6,000	
Cash		6,000

Being: Payment to suppliers.

Transaction 10

Cash	8,000	
Receivables		8,000

Being: Cash received from credit

5 GENERAL LEDGER

Section overview

- Introduction
- Chart of accounts
- Year-end exercise

5.1 Introduction

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

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

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

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

5.2 Chart of accounts

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

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

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

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

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



Illustration: Chart of accounts

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

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

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

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

5.3 Year-end exercise

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

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

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

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

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

Process:

Step 1: Perform double entry as necessary to capture the year-end adjustments in the general ledger accounts.

Step 2: Perform double entry to transfer all incomes statements amounts to a profit or loss general ledger account.

Step 3: Close off this account

Step 4: Transfer the balance on this account to capital.

Step 5: Transfer the balance on the drawings account to capital and close off the capital account.

This session will now use the information about Adeyemi to illustrate this exercise.



Example: Adeyemi—Trial balance (reordered for this section) before the inventory adjustment was as follows:

	Dr	Cr
Bank	15,000	
Loan		30,000
Van	40,000	
Stall	5,000	
Trade payables		4,500
Trade receivables	1,000	
Capital		30,000
Drawings	6,000	
Sales		21,000
Purchases	18,500	
	<hr/> 85,500	<hr/> 85,500

Reminder: The closing inventory of Adeyemi is ₦4,500


Step1: Perform double entry in the general ledger for the year end adjustments

	Bank	
Balance b/d	15,000	
	Loan	
	Balance b/d	30,000
	Van	
Balance b/d	40,000	
	Stall	
Balance b/d	5,000	
	Trade payables	
	Balance b/d	4,500
	Trade receivables 1,000	
Balance b/d		
	Capital	
	Balance b/d	30,000
	Drawings	
Balance b/d	6,000	
	Sales	
	Balance b/d	21,000
	Purchases	
Balance b/d	18,500	
	Inventory (statement of profit or loss)	
	Balance b/d	4,500
	Inventory (asset)	
Balance b/d	4,500	



Example: Step 2: Perform double entry to transfer all incomes statements amounts to a profit or loss general ledger account.

Bank			
Balance b/d	15,000		
Loan			
	Balance b/d	30,000	
Van			
Balance b/d	40,000		
Stall			
Balance b/d	5,000		
Trade payables			
	Balance b/d	4,500	
Trade receivables			
Balance b/d	1,000		
Capital			
	Balance b/d	30,000	
Drawings			
Balance b/d	6,000		
Profit or loss (new account)			
Purchases	18,500	Sales	21,000
		Inventory	4,500
Sales			
Profit or loss	21,000	Balance	21,000
Purchases			
Balance b/d	18,500	Profit or loss	18,500
Inventory (statement of profit or loss)			
Profit or	4,500	Balance b/d	4,500
Inventory (asset)			
Balance b/d	4,500		


3: Close off the profit or loss account. (Only those accounts affected are shown).

	Capital		
	Balance b/d	30,000	
	Drawings		
Balance b/d	6,000		
Profit or loss (New Account)			
Purchases	18,500	Sales	21,000
		Inventory	4,500
Balance c/d	7,000		
	25,500		25,500
		Balance	7,000


Step 4: Transfer the balance on this account to capital.

	Capital		
	Balance b/d	30,000	
	Profit for the period	7,000	
Drawings			
Balance b/d	6,000		
Profit or loss (New Account)			
Purchases	18,500	Sales	21,000
		Inventory	4,500
Balance c/d	7,000		
	25,500		25,500
Capital	7,000	Balance b/d	7,000



Step 5: Transfer the balance on the drawings account to capital and close off the capital account.

Capital			
Drawings	6,000	Balance b/d	30,000
		Profit for the period	7,000
Balance c/d	31,000		
	37,000		37,000
		Balance c/d	31,000
Drawings			
Balance b/d	6,000	Capital	6,000



Final balances in the general ledger

Bank		
Balance b/d	15,000	
Loan		
		Balance b/d 30,000
Van		
Balance b/d	40,000	
Stall 5,000		
Balance b/d		
Trade payables		
		Balance b/d 4,500
Trade receivables 1,000		
Balance b/d		
Capital		
		Balance b/d 31,000
Inventory (asset)		
Balance b/d	4,500	

5.4 Year-end exercise in journals

Section 4 of this chapter explained the role of the journal.

The Adeyemi year-end exercise would require the following journals:



Example: Adeyemi—end of year general ledger exercise

Step 1	Debit	Credit
Inventory asset	4,500	
Inventory (statement of profit or loss)		4,500
Being: The recognition of closing inventory		

Step 2

Sales	21,000	
Profit or loss		21,000
Profit or loss	18,500	
Purchases		18,500
Inventory (statement of profit or loss)	4,500	

Being: Transfer of income and expense amounts to profit or loss

Step4 (there was no double entry in step 3)

Profit or loss	7,000	
Capital		7,000

Being: Transfer of profit for the period into capital

Step 5

Capital	6,000	
Drawings		6,000

Being: Transfer of drawings for the period into capital

**Practice question****1**

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

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

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

6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Apply the concept of double entry accounting to business transactions
- Explain the purpose of establishing a chart of accounts
- Close off and strike a balance from T accounts
- Extract a trial balance from T accounts
- Prepare journals for business transactions
- Describe the main features of the general ledger
- Post entries in the general ledger
- Explain the interaction between the general ledger balances and the trial balance

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SOLUTIONS TO PRACTICE QUESTIONS

Solution

1a

Bank	
₦	₦
(1) Capital	500,000
(4) Sales	50,000
(8) Trade receivables	40,000
(12) Bank loan	100,000
	<hr/>
	690,000
Balance b/d	543,000
	<hr/>
	543,000
Capital	
	₦
Balance c/d	500,000
	<hr/>
	500,000
	<hr/>
	500,000
	<hr/>
	500,000
Motor van	
	₦
(2) Bank	60,000
	<hr/>
	60,000
Balance b/d	60,000
	<hr/>
	60,000
Purchases	
	₦
(3) Bank	30,000
(5) Trade payables	100,000
	<hr/>
	130,000
Balance b/d	130,000
	<hr/>
	130,000

1a**Solution(continued)**

Sales		
	₦	₦
(4) Bank		50,000
(6) Trade receivables		80,000
Balance c/d	130,000	
	<u>130,000</u>	
		130,000
		Balance b/d
		<u>130,000</u>

Trade payables		
	₦	₦
(7) Bank	30,000	(5) Purchases
Balance c/d	70,000	100,000
	<u>100,000</u>	
		100,000
		Balance b/d
		<u>70,000</u>

Trade receivables		
	₦	₦
(6) Sales	80,000	(8) Bank
	<u>80,000</u>	<u>40,000</u>
Balance b/d	<u>40,000</u>	<u>40,000</u>
		<u>80,000</u>

Drawings		
	₦	₦
(9) Bank	10,000	Balance c/d
	<u>10,000</u>	<u>10,000</u>
Balance b/d	<u>10,000</u>	

Motor expenses		
	₦	₦
(10) Bank	2,000	Balance c/d
	<u>2,000</u>	<u>2,000</u>
Balance b/d	<u>2,000</u>	

1a**Solution(continued)****Insurance**

	₦		₦
(10) Bank	15,000	Balance c/d	15,000
	<hr/>		<hr/>
	15,000		15,000

Balance b/d 15,000

Bank loan

	₦		₦
Balance c/d	100,000	(12) Bank	100,000
	<hr/>		<hr/>
	100,000		100,000

Balance b/d 100,000

Solution**1b**

Emmanuel: Trial balance as at July 31, 2019

	Dr	Cr
Bank	543,000	
Capital		500,000
Van	60,000	
Purchases	130,000	
Trade payables		70,000
Trade receivables	40,000	
Sales		130,000
Drawings	10,000	
Motor expenses	2,000	
Insurance	15,000	
Bank loan		100,000
	<hr/>	<hr/>
	800,000	800,000

1c**Solution**

Emmanuel: Statement of profit or loss for the month ending 31 July 2019

	₦	₦
Sales		130,000
Opening inventory	0	
Purchases	130,000	
	<hr/>	
Closing inventory	130,000	
	<hr/>	
Cost of sales	(50,000)	
	<hr/>	
Gross profit	80,000	
	<hr/>	
Motor expenses	50,000	
	<hr/>	
Insurance	2,000	
	<hr/>	
Net profit	15,000	
	<hr/>	
	(17,000)	
	<hr/>	
	33,000	

Emmanuel: Statement of financial position as at 31 July 2019

	₦	₦
Non-current assets:		
Van	60,000	
Current assets:		
Inventory	50,000	
Trade receivables	40,000	
Bank	543,000	
	<hr/>	
Total assets	633,000	
	<hr/>	
Capital at 1 st January 2019	693,000	
Net profit for the year	500,000	
	<hr/>	
Less: Drawings	33,000	
Capital at 30 th June 2019	533,000	
	<hr/>	
Non-current liabilities		
bank loan	(10,000)	
	<hr/>	
Current liabilities:		
Trade payables	523,000	
	<hr/>	
Total capital and liabilities	100,000	
	<hr/>	
	70,000	
	<hr/>	
	693,000	

Sales and purchases

Contents

- 1 Introduction to books of prime entry
- 2 Accounting for sales
- 3 Accounting for purchases
- 4 Accounting for cash
- 5 Petty cash
- 6 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

B	Recording financial transactions
1	Identify source documents of accounting data and information such as invoices, receipts, credit notes, debit notes, purchase orders, goods received notes, cheque counterfoils, deposit slips, bank statements and payment vouchers.
2	Record and account for transactions and events relating to revenue/incomes, expenses, assets, liabilities and equity in accordance with Generally Accepted Accounting Principles (GAAP) using:
	a Books of prime entry; and
	b Cash books including internal control over cash.

Exam context

This chapter explains how sales and purchases are recorded in the accounting system.

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

- Explain the role of books of prime entry
- Describe the basic contents of the sales day book and the customer/debtors ledger
- Record entries in the sales day book and the customer/debtors ledger
- Account for discounts allowed
- Describe the basic contents of the purchase journal and purchase ledger/creditors ledger
- Record entries in the purchase journal and purchase ledger/creditors ledger
- Account for discounts received

1 INTRODUCTION TO BOOKS OF PRIME ENTRY

Section overview

- The role of books of prime entry
- Posting transactions

1.1 The role of books of prime entry

Book-keeping is the process of recording financial transactions in the accounting records (the ‘books’) of an entity. Transactions are recorded in accounts, and there is a separate account for each different type of transaction.

It is often the case that individual transactions are not recorded in the ledger accounts as they occur. Instead, they are recorded initially in records called books of prime entry (also known as books of original entry). Each of these ‘books’ or ‘journals’ is used to record different types of transaction. Periodically the totals of each type of transaction are double entered into the appropriate ledger accounts in the general ledger.

Books of prime entry include the following:

Book of prime entry	Function
Sales day book,	Records sales on credit (receivables) from sales invoices.
Sales returns day book	Records items returned by credit customers (credit notes issued to customers).
Purchases daybook	Records purchases on credit from suppliers (trade payables) from purchase invoices.
Purchases returns day book	Records returns of purchases on credit.
Cashbook	Records cash received into the bank account and cash paid out of the bank account. Cash receipts and payments are very much a part of the sales and purchases cycles.
Journal	Records transactions that are not recorded in any of the other books of original entry.

Books of prime entry are useful means of summarising large numbers of similar transactions like credit sales, credit purchases and cash and bank payments and receipts.

1.2 Posting transactions

You may find it useful to refer back to the diagram at paragraph 1.2 of chapter 4 before reading this section.

Books of prime entry are used to reduce the number of transactions that have to be recorded in the general ledger. For example, instead of recording 1,000 separate sales, a business could add them up and perform a single double entry on the totals. This means that the general ledger will contain one account for receivables in total rather than an account for each individual customer. This account is called the receivables control account. (Note, that in practice it might have another name but that does not affect its function).



Definition: Control account

An account which summarises a large number of transactions.

(Examples include receivables control account, payables control account and payroll control account).

However, this does create another problem. A business must have information about the individual customers to whom sales have been made and who owe them money. In order to provide this information a second record is kept of the individual balances of individual customers. This record is called the receivables ledger (or the sales ledger).

The receivables control account and the receivables ledger are updated at the same time. The process of transferring the details of transactions from the books of prime entry to the accounts in the ledgers is called '**posting**' the transactions.

The balance on the receivables control account should always equal the total of the list of balances in the receivables ledger. If this is not the case an error has been made and must be investigated. This is covered in chapter 10.

The receivables control account is part of the double entry system. Any entry into the receivables control account must be accompanied by an equal and opposite entry elsewhere in the general ledger.

The receivables ledger is not part of the double entry system. Any entry in it simply reflects entries that have been made in the receivables control account in the general ledger and not the other side of those entries.). It is sometimes described as a memorandum account.

Note that all the comments above could equally have been made in respect of purchases. Purchases are recorded in a purchases day book and posted to a payables control account in the general ledger. This is supported by a payables ledger which is a list of amounts owed by the business to individual suppliers.

This is a little complicated at first sight but this chapter continues to explain the above in some detail.

2 ACCOUNTING FOR SALES

Section overview

- Documents in the sales cycle
- Recording sales
- Recording sales returns
- Discounts allowed
- Receivables control account
- Terminology

2.1 Documents in the sales cycle

A business tries to make a profit by selling goods or services to customers. This creates revenue or income for the business.

Sales might be for cash (coin, by debit card, credit card, cheque or by some less common method such as banker's draft) or on credit.

The following documents might be used in a system designed to account for sales.

Document	Purpose	Impacts double entry?
Sales order	From the customer placing an order.	No
Goods despatched note	A notice to the customer to inform them that the goods have been despatched and are on their way.	No
Delivery note	A note that accompanies the goods.(A customer will check this to make sure that it agrees with his order and that it is consistent with what has actually been delivered.	No
Sales invoice	A request for payment from the customer for goods delivered. Invoices normally show a date, details of transaction and payment terms.	Yes
Statement	A document to show the customer the amount still owed at a point in time. It will be the net amount of all invoices issued less cash received by the business up to a point in time.	No
Credit note	Issued when a customer returns goods and the business agrees to this. The business issues a credit note to acknowledge that the amount specified is no longer owed to them by the customer.	Yes



Illustration: Credit note

A issues an invoice to a customer for ₦20,000.

A later agrees to reduce the amount payable by ₦1,000 because some of the goods were of poor quality.

A issues a credit note to the customer for ₦1,000.

The customer is now required to pay ₦19,000 which is the invoice for ₦20,000 less the credit note for ₦1,000.

2.2 Recording sales

Sales day book

The sales day book is one of the books of prime entry. It is used to make an initial record of sales on credit. Credit sales transactions are entered in the sales day book as a list.

Double entry and updating the receivables ledger

Periodically (daily, weekly, monthly) a total for all transactions is posted to sales and the receivables control account in the general ledger, and the individual amounts used to update the customers' individual balances in the receivables ledger.

- The total value of the transactions (since the previous time that entries were posted to the ledger) is transferred as a double entry to the general ledger:
- Each individual transaction is transferred to the receivables ledger and recorded in the account of the individual customer which is debited with the value of the transaction.



Illustration:

Sales on credit	Debit	Credit
General ledger:		
Receivables control account	X	
Sales		X
Receivables ledger:		
Individual customer accounts	X	

There is a diagram showing an overview of this system together with the purchases and cash system at the end of this chapter.

Responsibilities

The duty of the main accountant is to maintain the general ledger and extract financial information from it. The main accountant will also oversee accounting assistants (accounts clerks) whose duties are to maintain the day books, subsidiary ledger and thus the list of balances.



Example: Recording sales

A company made the following sales which are to be posted to the general ledger and the receivables ledger.

Sales day book:

Customer:	Sale
Danish	25,000
Fahad	10,000
Hasan	40,000
	<hr/> 75,000

General ledger

Receivables control account

Sales	₦ 75,000		
		Sales	₦

		₦ 75,000	
		Receivables	₦

Receivables ledger

Danish

Sales	₦ 25,000	
-------	----------	--

Fahad

Sales	₦ 10,000	
-------	----------	--

Hasan

Sales	₦ 40,000	
-------	----------	--

The postings to the general ledger might be recorded as a journal entry:

Debit	Credit
	₦
Receivables control account	75,000
Sales	75,000

Being: Posting of sales from the sales day book.

2.3 Recording sales returns

Sales returns day book

The sales returns day book is a book of prime entry that records goods returned by customers (perhaps because they are damaged or of unacceptable quality).

When goods are returned, a credit note is issued to the customer.

Double entry and updating the receivables ledger

Periodically (daily, weekly, monthly) a total for all returns is posted to the general ledger and the individual amounts used to update the customers' individual balances in the receivables ledger.



Illustration:

Sales on credit	Debit	Credit
General ledger:		
Sales returns	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X



Example

A company made the following sales which are to be posted to the general ledger and the receivables ledger.

Sales day book

	₦
Customer: A	40,000
Customer: B	50,000
Customer: C	30,000
Customer: D	20,000
	<hr/>
	140,000 (1)

Sales returns day book

	₦
Customer: A	5,000 (2)

Cash received

	₦
Customer: B	40,000
Customer: C	20,000
	<hr/>
	60,000 (3)

**Example: General ledger****Receivables control account**

₦	₦
Sales (1)	140,000
	<u>140,000</u>
Balance c/d	75,000
	<u>75,000</u>

Sales

₦	₦
	Receivables (1) 140,000

Sales returns

₦	₦
Receivables (2)	5,000

Bank

₦	₦
Receivables (3)	60,000

The postings to the general ledger might be recorded as journal entries

Debit	Credit
₦	₦
Receivables control account	140,000
Sales	140,000
Being: Posting of sales from the sales day book.	
Sales returns	5,000
Receivables control account	5,000
Being: Posting of sales returns from the sales returns day book.	
Bank	60,000
Receivables control account	60,000
Being: Cash received from customers	



Example: Receivables ledger

Customer A

	₦		₦
(1a) Sales	40,000	(2a) Sales returns	5,000
		Balance c/d	35,000
	<u>50,000</u>		<u>50,000</u>
Balance c/d	35,000		

Customer B

	₦		₦
(1b) Sales	50,000	(3a) Bank	40,000
		Balance c/d	10,000
	<u>50,000</u>		<u>50,000</u>
Balance c/d	10,000		

Customer C

	₦		₦
(1c) Sales	30,000	(3b) Bank	20,000
		Balance c/d	10,000
	<u>30,000</u>		<u>30,000</u>
Balance c/d	10,000		

Customer D

	₦	₦
(1d) Sales	20,000	

The balances on the accounts in the receivables ledger in total are

	₦
Customer: A	35,000
Customer: B	10,000
Customer: C	10,000
Customer: D	20,000
	<u>75,000</u>

The **receivables ledger** contains the accounts for each customer who is sold items on credit. Each receivables account shows how much the individual customer has purchased on credit, a detail of sales returns (i.e. any credit notes), how much he/she has paid and what he/she currently owes.

2.4 Discounts allowed

Introduction

Businesses sometimes give discounts to customers.

There are two main types of discount:

- trade discount; and
- settlement discount (or cash discount).

Trade discount

This is price reduction given to a customer. The invoice is issued at the reduced amount so there are no double entry problems caused by this type of discount. There is simply a sale at a lower price.



Example: Trade discounts

A building merchant offers bags of cement for sale at ₦500 per bag.

The price is reduced to ₦450 for any customer who buys 10 or more bags. The reduction of ₦50 per bag is a trade discount.

Arif buys 20 bags off the building merchant.

If there were no discount Arif would have to pay ₦10,000. However, because of the discount Arif has to pay only ₦9,000.

Note that from the builder's point of view this is a sale for ₦9,000. There is no special accounting needed for trade discounts.

Settlement discounts

A settlement discount might be offered in order to persuade credit customers to pay earlier.



Example: Settlement discounts

A building merchant offers credit terms to large customers.

It offers a 3% discount to any credit customer who settles an invoice within 30 days. (This means that the customer would only pay 97% of the invoice amount).

The reduction of 3% is a settlement discount.

Benjamin Builders buys goods worth ₦80,000.

If Benjamin Builders pays within 30 days it need only pay ₦77,600.

If Benjamin Builders does not pay within 30 days it must pay ₦80,000..

Discounts allowed

Discounts allowed are settlement discounts that a business offers to its credit customers. It is up to the customer to decide whether to pay the full amount or to pay the smaller amount earlier.

Accounting for discounts allowed

IFRS 15: Revenue from contracts with customers requires that revenue is recognised at the amount that the business making the sale expects to receive.

- Revenue is recognised as the net amount (discount deducted) when a customer is expected to take advantage of a settlement discount.
- Revenue is recognised as the gross amount (no deduction of the discount) when a customer is not expected to take advantage of a settlement discount.

Customer expected to take a discount

If a customer does not take a discount when expected to do so revenue is adjusted accordingly.



Example: Customer expected to take a discount (but does not qualify)

Facts as above but Benjamin pays in full as he was too late to qualify for the discount.

At date of sale:

Trade receivables Sales
(97% of 80,000)

Debit	Credit
77,600	77,600

On day 30

Trade receivables
Sales (3% of 80,000)

2,400	2,400
-------	-------

At date that payment is received

Bank
Trade receivables

80,000	80,000
--------	--------

Example: Customer expected to take a discount (and settles on time) Adeola has sold goods to Benjamin for ₦80,000.

Adeola offers a 3% settlement discount if payment is made within 20 days.

At date of sale:

Trade receivables Sales (97%
of 80,000)

77,600	77,600
--------	--------

At date that payment is received

Bank
Trade receivables

77,600	77,600
--------	--------

Customer not expected to take a discount



Example: Customer not expected to take a discount

Adeola has sold goods to Benjamin for ₦80,000.

Adeola offers a 3% settlement discount if payment is made within 20 days.

Based on previous experience, Adeola does not expect Benjamin to take advantage of the settlement discount and indeed, Benjamin pays after 20 days.

Adeola would record the transaction as follows:

	Debit ₦	Credit ₦
At date of sale:		
Trade receivables	80,000	
Sales		80,000
At date that payment is received (day 25)		
Bank	80,000	
Trade receivables		80,000

If a customer takes a discount when not expected to do so revenue is adjusted accordingly.



Example: Customer not expected to take a discount (but qualifies by settling on time)

Facts as above but Benjamin pays early to qualify for the discount.

	Debit ₦	Credit ₦
At date of sale:		
Trade receivables	80,000	
Sales		80,000
At date that payment is received (within 20 days)		
Sales	2,400	
Trade receivables		2,400
Bank (cash received = 97% of 80,000)	77,600	
Trade receivables		77,600

Revenue adjustments and the receivables ledgers

Adjustments to revenue must also be recorded in the individual customer accounts in the receivables ledger.

2.5 Receivables control account

A receivables ledger control account is the name given to the account in the general ledger for total receivables. A control account is an account that records total amounts – in this case, total amounts for receivables.

The receivables ledger control account records all transactions involving credit customers.

- Debit entries in the receivables control account are transactions that add to the total amount of receivables.
 - Credit entries in the receivables ledger control account are transactions that reduce the total amount of receivables.

Illustration: Double entries into receivables control account

Receivables control account		
Debit side (Dr)		Credit side (Cr)
Balance b/d	X	
Credit sales	X	Payments received from credit customers X
Dishonoured cheques (see below)	X	Sales returns X
Revenue adjustment (Customer fails to take a discount when expected to do so)	X	Revenue adjustment (Customer takes a discount when not expected to do so) X
		Bad debts written off (explained later in chapter 7). X
		Contra entries (explained later in this chapter) X
		Balance c/d X
Balance b/d	X	X

Dishonoured cheques

These are cheques received from customers where subsequently the bank refuses to make payment.

When a business receives a cheque from a customer it recognises that as an amount paid. If the business presents the cheque to the bank for payment and the bank refuse to accept it (perhaps because of insufficient funds in the customer's account) the business is still owed the money and must reverse the original entry (Dr Receivables, Cr Bank).

Entries not recorded in the receivables control account

Only transactions that relate to credit sales are recorded in the receivables ledger control account.

The following transactions are **not** recorded in the receivables ledger control account:

- Cash sales (for which the entry is Dr Bank, Cr Sales);
- Changes in the allowance for irrecoverable debts account (covered later in chapter 7).

The balance on the receivables control account might be described as trade receivables on the face of the statement of financial position.

2.6 Terminology

This chapter uses certain terminology to explain how sales might be accounted for. This is an area where you may see different terms used to describe what has been described above.

Used in this chapter	Common alternative
Sales day book	Sales journal
Receivables ledger	Debtors ledger, Sales ledger
Receivables control account	Receivables ledger control account Sales ledger control account Total sales control account Debtor control account Account receivable control account

3 ACCOUNTING FOR PURCHASES

Section overview

- Documents in the purchases cycle
- Recording purchases
- Recording purchase returns
- Discounts received
- Payables control account
- Contra entries
- Terminology

3.1 Documents in the purchases cycle

Businesses make purchases from suppliers. Purchases are similar in many respects to sales, except that the business is buying from a supplier rather than selling to a customer.

The following documents might be used in a system designed to account for purchases.

Document	Purpose	Impacts double entry?
Purchase order	A document sent by the business to place an order.	No
Goods received note	A document produced when goods are received. It is produced after the goods have been checked against the delivery note and what has actually been received.	No
	The GRN is sent to accounts staff who will check that what has been received is what was ordered and that the invoice agrees with what was received.	
Purchase invoice	A request for payment from the supplier for goods delivered.	Yes
Statement	A document from the supplier to show the amount still owed at a point in time.	No

3.2 Recording purchases

Purchases day book

The purchases day book is one of the books of prime entry. It is used to make an initial record of purchases on credit. Purchase transactions on credit are entered in the purchases day book as a list.

There may be several categories of item or service purchased each of which must be posted to an appropriate account.

Double entry and updating the payables ledger

Periodically (daily, weekly, monthly) a total for all transactions is posted to purchases and other expense accounts with the other side of the entry posted to the payables control account in the general ledger.

In addition the individual amounts are used to update the suppliers' individual balances in the payables ledger.

The payables (purchase) ledger is also used to record purchase invoices from suppliers of other items, as well as purchases of goods. (For example the payables ledger is used to record details of invoices for rental costs, telephone expenses, and electricity and gas supplies and so on).

Details of these expenses must be posted from the purchases ledger to the relevant accounts in the general ledger.

To facilitate this, a day book might have analysis columns which show the different types of expense.

Details of each individual invoice are also posted to the account of the individual supplier in the payables ledger.



Illustration:

Purchases on credit	Debit	Credit
General ledger:		
Purchases	X	
Expense 1	X	
Expense 2 (etc.)		
Payables control account		X
Payables ledger:		
Individual customer accounts		X

There is a diagram showing an overview of this system together with the sales and cash system at the end of this chapter.

**Illustration: Recording purchase**

Purchase day book		Total ₦(000)	Purchases ₦(000)	Energy ₦(000)	Sundry ₦(000)
3 May	BV Supplies	500	500		
3 May	South Electric	1,200			1,200
3 May	CD Power	3,000		3,000	
3 May	Sad Stationery	650			650
3 May	Woods Widgets	4,800	4,800		
3 May	Small Plastic	3,200	3,200		
3 May	Southern Gas	750			750
3 May	IT Solutions	500			500
		14,600	8,500	3,000	3,100

A journal can easily be constructed to effect the double entry

	Debit	Credit
	₦	₦
Purchases	8,500	
Payables control account		8,500
Energy expenses	3,000	
Payables control account		3,000
Sundry expenses	3,100	
Payables control account		3,100

3.3 Recording purchase returns

Purchases returns day book

The purchases returns day book is similar to the purchases day book, except that it records goods returned to suppliers.

When goods are returned to a supplier, a credit note is received. The purchases returns day book records the credit note details.

The total purchases returns are posted to the general ledger, by:

- debiting the total trade payables account
- crediting the purchases returns account, or possibly the purchases account.

Returns to individual suppliers are also debited in the supplier's individual account in the payables ledger.



Illustration:

Purchase returns	Debit	Credit
------------------	-------	--------

General ledger:

Payables	X
Purchase returns	X

Payables ledger:

Individual customer accounts	X
------------------------------	---



Example

A company made the following sales which are to be posted to the general ledger and the receivables ledger.

Purchases day book		₦
Supplier: A	30,000	
Supplier: B	60,000	
Supplier: C	20,000	
Supplier: D	70,000	
	<hr/>	
	180,000	(1)

Purchase returns day book ₦

Supplier: B	20,000	(2)
-------------	--------	-----

Cash paid to: ₦

Supplier: A	29,000	
Supplier: D	25,000	
	<hr/>	
	54,000	(3)

Discount received ₦

Supplier: A	1,000	(4)
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**Example: General ledger**

Payables control account			
	₦	₦	
Purchase returns (2)	20,000	Purchases (1)	180,000
Bank (3)	54,000		
Discount received (4)	1,000		
Balance c/d	105,000		
	<hr/> 180,000		
	Balance c/d	<hr/> 180,000	
	105,000		
Purchases			
	₦	₦	
Payables (1)	180,000		
Purchase returns			
	₦	₦	
	Payables (2)	20,000	
Bank			
	₦	₦	
	Payables (3)	54,000	
Discount received			
	₦	₦	
	Payables (4)	1,000	



Example: General ledger

The postings to the general ledger might be recorded as journal entries

	Debit	Credit
	₦	₦
Purchases	180,000	
Payables control account		180,000
Being: Posting of purchases from the purchases day book.		
Payables control account	20,000	
Purchase returns		20,000
Being: Posting of purchase returns from the purchase returns day book.		
Payables control account	54,000	
Bank		54,000
Being: Cash paid to suppliers		
Payables control account	1,000	
Bank		1,000
Being: Discounts received		

**Example: Payables ledger****Supplier A**

	₦		₦
(3a) Bank	29,000	(1a) Purchases	30,000
(4) Discount received	1,000		
	<u>30,000</u>		<u>30,000</u>

Supplier B

	₦		₦
(2) Purchase returns	20,000	(1b) Purchases	60,000
Balance c/d	40,000		
	<u>60,000</u>		<u>60,000</u>
		Balance c/d	40,000

Supplier C

	₦		₦
		(1c) Purchases	20,000

Supplier D

	₦		₦
(3b) Bank	25,000	(1d) Purchases	70,000
Balance c/d	45,000		
	<u>70,000</u>		<u>70,000</u>
		Balance c/d	45,000

The balances on the accounts in the payables ledger in total are

	₦
Supplier: A	—
Supplier: B	40,000
Supplier: C	20,000
Supplier: D	45,000
	<u>105,000</u>

The **payables ledger** contains the accounts for each supplier of goods or services on credit. Each trade payables account shows how much the entity has bought on credit from a particular supplier, details of purchase returns, how much it has paid and what it currently owes to the supplier.

3.4 Discounts received

Discounts received are settlement discounts that a business has been offered by its suppliers and which it takes up. The business pays earlier but pays less.

Accounting for discounts received

The invoice is recorded in payables at the full amount when it is received. Discount received can only be recognised when payment is made within a given time frame so that a business becomes entitled to a discount.

Discounts received from suppliers are recorded in a discounts received account. If a business decides to take up the offer of a settlement discount by paying the smaller amount sooner, the double entry for the payment is:



Illustration: Discount received double entry

	Debit	Credit
Trade payables	X	
Bank (cash paid to supplier)		X
Discount received (discount taken by us)		X

The entry in the discount received account is a credit entry because it is effectively a reduction in an expense. In the statement of profit or loss, it will be shown either as 'other income' or as a negative expense.

Discounts received do not affect the total figure for purchases in the period, or the total cost of sales. In this respect they differ from purchase returns, which do reduce total purchase costs.

- Discounts received are accounted for as an addition to profit in the period.
- They are not accounted for as a deduction from purchase costs.



Example: Discount received

Adeola has sold goods to Benjamin for ₦80,000.

Adeola offers a 3% settlement discount if payment is made within 20 days. Benjamin pays in 19 days.

Benjamin would record the transaction as follows:

	Debit	Credit
At date of purchase:		
Purchase	80,000	
Trade payables		80,000
At date of payment		
Trade payables	80,000	
Bank (cash paid = 97% of 80,000)		77,600
Discount received (discount taken by us = 3% of 80,000)		2,400

Discounts received and the payables ledgers

Discounts received are recorded in the individual supplier accounts in the payables ledger.

3.5 Payables control account

The payables ledger control account is the name given to the account in the general ledger for total trade payables.

Opening payables balance

The opening balance in the payables ledger control account is a credit balance, because amounts payable are liabilities.

The payables ledger control account records all transactions involving credit purchases. Since business entities make most of their purchases on credit, the control account records virtually all purchases.

- Credit entries in the payables control account are transactions that add to the total amount of payables.
- Debit entries in the payables ledger control account are transactions that reduce the total amount of payables.



Illustration: Double entries into payables control account

Debit side(Dr)	Credit side(Cr)
	Balance b/d X
Purchase returns X	
Payments to suppliers X	
Discounts received for early payment X	
Contra entries (explained later in this chapter)	
Balance c/d X	
	X _____
X	X _____
	Balance b/d X

The balance on the payables control account might be described as trade payables on the face of the statement of financial position.

3.6 Contra entries

A business might sell goods or services to another business, and also buy goods or services from that same business.

The other business is both a customer and a supplier, and might therefore be a receivable and a trade payable at the same time. When this happens, the two businesses might agree to offset the amounts that they owe each other, leaving a net amount payable by the business with the higher debt.

A contra entry is a double entry that offsets one amount against another.

Contra entries must be made in the general ledger and also the receivables and payables ledgers.



Illustration: Contra entry

Sales on credit	Debit	Credit
General ledger:		
Payables control account	X	
Receivables control account		X
Receivables ledger:		
Individual customer account		X
Payables ledger:		
Individual customer account	X	



Example: Contra entry

A buys goods from Z, and also sells services to Z.

A currently owes ₦120,000 to Z and is owed ₦50,000 by Z.

A and Z might agree to offset these two debts, leaving A owing the net amount of ₦70,000 to Z.

A contra entry is used to record this agreement in the accounting system.

Books of A:

	Debit	Credit
General ledger	₦	₦
Payables control account	50,000	
Receivables control account		50,000

(This reduces the balance on both accounts)

Receivables ledger:

Z's account (owed by Z)	50,000
-------------------------	--------

Payables ledger:

Z's account (owed to Z)	50,000
-------------------------	--------

3.7 Terminology

This chapter uses certain terminology to explain how purchases might be accounted for. This is an area where you may see different terms used to describe what has been described above.

Used in this chapter	Common alternative
Purchases day book	Purchases journal
Payables ledger	Creditors ledger, Purchases ledger
Payables control account	Payables ledger control account Purchases ledger control account Total purchases control account Creditor control account Account payable control account Bought ledger adjustment account

4 ACCOUNTING FOR CASH

Section overview

- The cashbook
- Cash receipts
- Cash payments

4.1 The cashbook

The cash book is often a book of prime entry. It is used to record receipts and payments of cash into the business bank account.

The cash book has two sides, a side for receipts of money and a side for payments. Both sides have a number of columns so that cash receipts and payments can be analysed to make it easier to construct journals for double entry.

A business can analyse the amounts received and paid in any way it chooses.

4.2 Cash receipts

Cash from cash sales is banked on a regular basis. It is entered as a cash receipt in the cash book when it has been banked.

Cash might be received from a credit customer in a number of ways. Usually payment is made by cheque or by bank transfer. Payments by cheques must be banked on a regular basis. When a cheque is received it is entered into the cash book as a cash receipt.

On a periodic basis the receipts side of the cash book is summed and totals posted to the general ledger. Amounts received from credit customers are also recognised in the customer's personal account in the receivables ledger must also be adjusted.

Some businesses might choose to use a column in the cash receipts side of the cash book to record revenue adjustments for settlement discount taken when the original receivable did not anticipate that it would be. This is nothing to do with cash as such but the discounts might be recorded here so that the business is able to keep track of it. Such a record is described as being a memorandum (reminder).

A simplified example of the **cash receipts side** of the cash book is shown below.



Illustration: Cash receipts

	Total	Receivables	Other receipts	Revenue adjustment (memoonly)
	₦	₦	₦	₦
Smith Company	28,500	28,500		1,500
K Brown	5,000	5,000		
Banking from Cash sale	1,000		1,000	
Dividend	5,000		5,000	
C Cropper	57,000	57,000		3,000
VB Industries	87,000	87,000	-	
	183,500	177,500	6,000	4,500

A journal can easily be constructed to affect the double entry

	Debit	Credit
	₦	₦
Bank	183,500	
Receivables control account		177,500
Sale		1,000
Dividend income		5,000
And		
Discounts allowed		4,500
Receivables control account		4,500

The cash received from individual customers and the discounts allowed to individual customers must be credited to their individual accounts in the receivables ledger.

4.3 Cash payments

Cash payments are recorded in a similar way to cash receipts. Payments are recorded in both the general ledger and (if the payment is to a supplier) in the account of the supplier in the payables ledger.

A business might choose to record discounts received in a memorandum column in the cash book.

A simplified example of the cash payments side of the cash book is shown below.

Illustration: Cash payments		Total	Payables	Expenses	Discount received
		₦	₦	₦	₦
KPT Supplies		59,000	59,000		
Duck Company		86,000	86,000		
Rent		74,500		74,500	
Fast Supplies		2,200	2,200	-	
		221,700	147,200	74,500	1,000

A journal can easily be constructed to affect the double entry

Debit	Credit
₦	₦
Payables control account	147,200
Expenses	74,500
Bank	221,700

And

Payables control account	1,000
Discounts received	1,000

The cash paid to individual suppliers and the discounts received from individual suppliers will be debited to their individual accounts in the payables ledger.

There is a diagram showing an overview of this system together at the end of this chapter.

5 PETTY CASH

Section overview

- Definition of petty cash
- Recording petty cash transactions

5.1 Definition of petty cash

Petty cash is cash (notes and coins) held by a business to pay for small items of expense, in situations where it is more convenient to pay in notes and coin than to pay through the bank account. Petty cash might be used, for example, to pay for bus fares, taxi fares, tea and coffee for the office, and so on.

5.2 Recording petty cash transactions

When petty cash transactions take place, the entity needs to record both an expense, and a reduction in the asset "petty cash".

These entries are made in the main ledger accounts as follows:



Illustration: x

Office expenses

Debit

Petty cash

Credit

X

Although the amounts involved in petty cash are, for most businesses, very small, it is one of the easiest assets to be stolen or "lost".

Usually the responsibility for looking after the petty cash is assigned to an accounts clerk. The accounts clerk will maintain a balance of petty cash in a lockable petty cash tin and will pay out cash to a person as long as that person is able to present an invoice for an amount spent or signs a note (petty cash voucher) to say that they have received cash. The accounts clerk will also maintain a petty cash book. This is a book of prime entry and is summarised and posted to the general ledger on a periodic basis,

Imprest system

X

A very common petty cash system is called the imprest system. Under this system a set amount is established (say ₦10,000). This set amount is called the imprest.

At any moment in time, the petty cash balance plus the amounts on invoices and notes (petty cash vouchers) should sum to the imprest. Periodically the invoices are removed and replaced by cash to re-establish the imprest in cash.



Example: Imprest system

A business uses an imprest system to control its petty cash. The imprest is set at ₦10,000.

At the start of the month there is ₦10,000 cash in the petty cash tin.

An amount of ₦600 is paid to Lydia to compensate her for a payment she made out of her own pocket on behalf of the business.

After this transaction the petty cash tin will contain ₦9,400 cash and an invoice from Lydia for ₦600. These two amounts add back to the imprest.

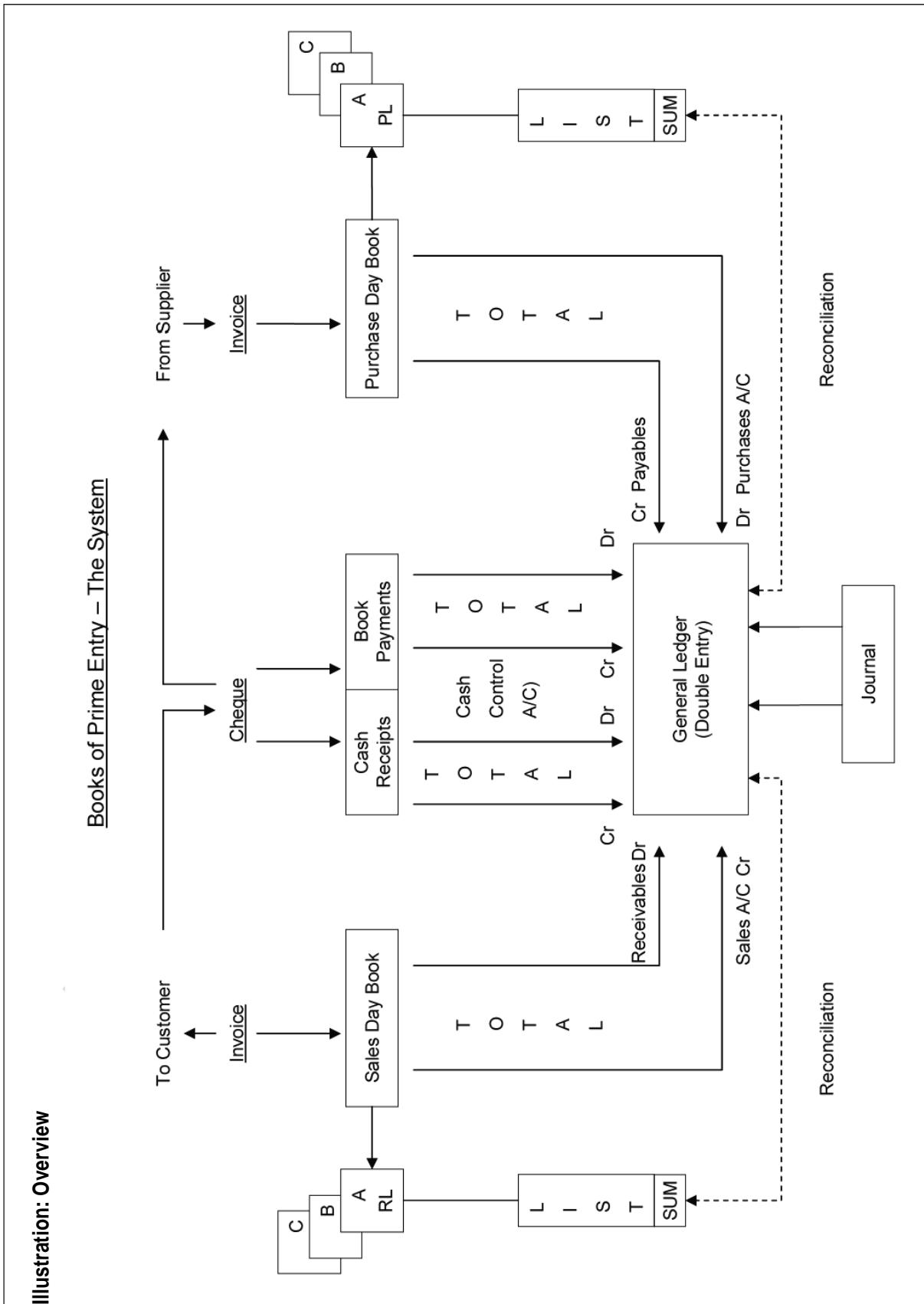
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6 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the role of books of prime entry
- Describe the basic contents of the sales day book and the customer/debtors ledger
- Record entries in the sales day book and the customer/debtors ledger
- Account for discounts allowed
- Describe the basic contents of the purchase journal and purchase ledger/creditors ledger
- Record entries in the purchase journal and purchase ledger/creditors ledger
- Account for discounts received



Non-current assets and depreciation

Contents

- 1 End of year adjustments
- 2 Non-current assets
- 3 Depreciation and carrying amount
- 4 Methods of charging depreciation
- 5 Derecognition of property, plant and equipment
- 6 Disclosure requirements of IAS 16
- 7 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

D	Accounting for transactions in financial statements	
1	Accounting for Property, Plant and Equipment (PPE) in accordance with IAS 16	
	a	Identify the elements of PPE cost.
	b	State how the PPE cost is initially recorded and measured.
	c	Compute, explain and record depreciation using the straight line and reducing balance methods.
	d	Account for depreciation in the statement of profit or loss and other comprehensive income.
	e	Account for disposal of PPE.
	f	Prepare simple notes to account for movements in PPE.

IAS 16: *Property, plant and equipment* is an examinable document.

Exam context

This chapter explains the accounting rules for property, plant and equipment. This could form the basis of a question on its own or be part of a question.

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

- Identify the cost of an item of property, plant and equipment
- Calculate depreciation expense using straight line and reducing balance methods
- Account for depreciation expense
- Post journal entry to record depreciation expense
- Calculate profit (loss) on disposal of an item of property, plant and equipment
- Account for profit (loss) on disposal of an item of property, plant and equipment
- Construct a simple property, plant and equipment note to the financial statements

1 END OF YEAR ADJUSTMENTS

Section overview

- The need for end-of-year adjustments
- Check list of end-of-year adjustments

1.1 The need for end-of-year adjustments

Start of a financial year

At the start of a financial year the asset, liability and capital accounts in the general ledger contain the balances brought forward at the end of the last year as set out in last year's statement of financial position.

The income and expense accounts in the general ledger are empty as they will have been transferred to the income and expense account for the calculation of profit.

During the financial year

During the year the business records transactions to appropriate accounts in the general ledger.

The balances on the asset and liability accounts at any one time reflect the position at the start of the year and the effect of transactions relevant to those accounts that have occurred during the period.

The balances on the income and expense accounts reflect the activity during the period.

End of a financial year

Balances on the accounts in the general ledger are extracted to produce a trial balance. The trial balance is the net effect of all of the transactions in the year and forms the basis for the preparation of the financial statements.

However, certain adjustments must be made to income, expenses, assets and liabilities before the financial statements can be finalised to take account of items not captured as regular accounting transactions.

Adjustments are needed for:

- opening and closing inventory
- accrued expenses and prepaid expenses
- bad and doubtful debts
- non-current assets and depreciation.

Having made the adjustments, a business can then prepare its financial statements, calculating the profit or loss it has made for the year and adding the resultant figure to capital.

A general ledger exercise is then carried out:

- Balances on income and expense accounts are transferred to a profit or loss account. The balance on this account is the profit or loss for the year and should agree with the profit or loss shown in the statement of profit or loss.

- The profit for the year is added to capital, or the loss is subtracted from capital.

1.2 Checklist of end-of-year adjustments

A check list showing the end-of-year adjustments required to prepare financial statements is shown below.

The first of these is explained in detail in this chapter and explanations of the rest follow in subsequent chapters.

Accounting area	Nature of the end of year adjustment	Chapter
Non-current assets and depreciation	<p>A depreciation charge for non-current assets is calculated, and included in the statement of profit or loss.</p> <p>The carrying amount of non-current assets in the statement of financial position is reduced by accumulated depreciation on those assets.</p>	6
Bad debts and doubtful debts	<p>Establish the amount of bad debts to be written off and the change in an allowance for doubtful debts. These items are included in the statement of profit or loss.</p> <p>In the statement of financial position, total receivables are reduced by bad debts written off. In addition, the allowance for doubtful debts is set off against the figure for total receivables.</p>	7
Accruals and prepayments	<p>Establish the amount of accrued expenses or prepaid expenses at the end of the financial year.</p> <p>Opening and closing accrued expenses or prepaid expenses are needed to calculate the amount to include in the statement of profit or loss for certain expense items.</p> <p>Accruals and prepayments also appear in the statement of financial position.</p>	8
Opening and closing inventory	<p>Establish the value of closing inventory.</p> <p>Use the values for opening and closing inventory to calculate the cost of sales and gross profit for the statement of profit or loss.</p>	9

2 NON-CURRENT ASSETS

Section overview

- Introduction
- IAS 16: Property, plant and equipment
- Capital and revenue items: capital and revenue expenditure
- Depreciation and non-current assets

2.1 Introduction

The assets of a business are classified as current assets or non-current assets.

IAS 1 (***Presentation of financial statements***) defines current assets and then states that all other assets should be classified as non-current assets.

Current assets include, cash, receivables, prepayments (see chapter 7) and inventory. They are all items that will be used or recovered in the short term.

A ***non-current asset*** is an asset which is used by the business over a number of years.

Non-current assets may be:

- Tangible non-current assets***. These are physical assets, such as property (land and buildings), plant and equipment (including motor vehicles); or
- Intangible non-current assets***. These are assets that do not have a physical existence such as patent rights.

2.2 IAS16: Property, plant and equipment

Rules on accounting for property, plant and equipment are contained in ***IAS 16 Property, plant and equipment***.



Definitions

Property, plant and equipment are tangible items that:

- Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- Are expected to be used during more than one period.

Initial measurement

Property, plant and equipment are initially recorded in the accounts of a business at their cost.



Definition

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition or construction.

The cost of an item of property, plant and machinery consists of:

- its purchase price after any trade discount has been deducted, plus any import taxes or *non-refundable* sales tax; plus
- the directly attributable costs of 'bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management' (**IAS 16 Property, plant and machinery**). These directly attributable costs may include:
 - employee costs arising directly from the installation or construction of the asset;
 - the cost of site preparation;
 - delivery costs ('carriage inwards');
 - installation and assembly costs;
 - testing costs; and
 - professional fees directly attributable to the purchase.

A question might provide information about the installation cost of an asset. This is capitalised as part of the cost of the asset.



Example: Cost

A company has purchased large item of plant.

The following costs were incurred.

	₦
List price of the machine	1,000,000
Trade discount given to company	50,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
Administration expense	150,000
Purchase price of the machine (1,000,000 – 50,000)	950,000
Delivery cost	100,000
Installation cost	125,000
Cost of site preparation	200,000
Architect's fees	15,000
	<hr/> 1,390,000

2.3 Capital and revenue items: capital and revenue expenditure

The difference between capital and revenue items, and between capital and revenue expenditure was explained in an earlier chapter.

Improvements are capitalised

Expenditure on a non-current asset after acquisition is treated as capital expenditure when it represents an improvement. This is added to the cost of the original asset.

Repairs

- Ongoing day-to-day repairs and maintenance: Expenditure on a non-current asset after acquisition is treated as revenue expenditure when it is incurred to make minor repairs that restore the asset to its original functionality.
- Major repairs and overhauls: Some assets, by their nature, might require major periodic repairs or overhaul. These costs are capital in nature and are capitalised. For example, an aircraft might need a major periodic engine service/overhaul. The cost of such an overhaul would be capitalised.

Advance payments

A business might make an advance payment towards a non-current asset.

This is recognised as a receivable known as an advance. It represents the right that the business has to receive an asset (or part of one) at some time in the future.

Illustration: Advance payments

	Debit	Credit
Receivable – Advance	X	
Cash (bank)		X

Advances are not depreciated. An advance will become part of the cost of an asset when it is purchased.

Illustration: Treatment of advance when asset is purchased

	Debit	Credit
Cost of the asset	X	
Receivable – Advance		X

The definition of 'cost' for property, plant and equipment has close similarities with the cost of inventories, although property, plant and equipment will often include more items of 'other expense' within cost.

For example when a business entity acquires a new building the cost of the building might include professional fees such as the fees for an architect and surveyor.

Costs are no longer recognised when the item is ready for use. This is when it is in the location and condition necessary for it to be capable of operating in the manner intended by management.

2.4 Depreciation and non-current assets

A business invests in assets in order to generate profit.

The accruals concept results in the recognition of revenue and the cost of earning that revenue in the statement of profit or loss in the same accounting period.

This is relatively straight forward for costs. For example, rent for a period enables a business to use premises that are used to make profit. The rent is charged to statement of profit or loss.



Examples: Recognition of costs in the statement of profit or loss

- Rental expense** Rental payments due in a period enable a business to use premises that are used to make profit.
The rent is charged to the statement of profit or loss.
- Energy expense** Energy used in a period enables a business to make profit. Energy is charged to the statement of profit or loss.
- Inventory** Items sold in the period are recognized in the statement of profit or loss at the same time as there venue from selling those items.

Expenditure on non-current assets is also incurred to enable a business to generate a profit. A non-current asset will help a business generate profit over several accounting periods. The cost of the benefit received from the use of such an asset must be recognised in the statement of profit or loss in the same period that the benefit is recognised.

Depreciation

Depreciation is an expense that matches the cost of a non-current asset to the benefit earned from its ownership. It is calculated so that a business recognises the full cost associated with a non-current asset over the entire period that the asset is used. In effect, the cost of the asset is transferred to the statement of profit or loss over the life of the asset. This may be several years.

This section explains depreciation as an expense calculated at the end of the accounting period as an end-of-year adjustment. This might be the case for small businesses but larger businesses will often use software that is able to recognise depreciation on a monthly basis.

3 DEPRECIATION AND CARRYING AMOUNT

Section overview

- Definition of depreciation
- Accounting for depreciation
- The purpose of depreciation

3.1 Definition of depreciation

Depreciation is a method of spreading the depreciable amount of a non-current asset over its expected useful life (economic life), so that an appropriate portion of the cost is charged in each accounting period.



Definitions (from IAS 16)

Depreciation: The systematic allocation of the depreciable amount of an asset over its useful life.

Depreciable amount: The cost of an asset (or its revalued amount, in cases where a non-current asset is revalued during its life) less its residual value.

Residual value: The expected disposal value of the asset (after deducting disposal costs) at the end of its expected useful life.

Useful life: The period over which the asset is expected to be available for use by the business entity.

Note that the revaluation of non-current assets is in this syllabus. It is mentioned above for completeness. You will learn about this in later syllabuses.



Example: Depreciation

An item of equipment cost ₦300,000 and has a residual value of ₦50,000 at the end of its expected useful life of four years.

Depreciation is a way of allocating the depreciable amount of ₦250,000 (= ₦300,000 - ₦50,000) over the four years of the asset's expected life.

Depreciation should be charged as an expense in the statement of profit or loss, each year, over the life of the asset.

Depreciation of a new asset commences from the date that an asset is available for use.

Most non-current assets must be depreciated, although there are some exceptions to this rule. For example, land is not depreciated because it has an indefinite useful life.

3.2 Accounting for depreciation

The double entry for depreciation is carried out using two accounts (for each category of non-current asset).



Illustration: Depreciation double entry

	Debit	Credit
Depreciation expense	X	
Accumulated depreciation		X

The balance on the depreciation expense account is taken to the statement of profit or loss as an expense for the period.

The accumulated depreciation account contains all of the depreciation recognised to date. When the final statement of financial position is prepared it is deducted from the cost of the assets. The non-current asset figure in the statement of financial position is made up of two figures, the cost less accumulated depreciation.

The balance on the accumulated depreciation account is carried forward as a (credit) balance at the end of the period and appears in the statement of financial position as a deduction from the cost of the non-current assets. The figure that appears in the statement of financial position is known as the **carrying amount** (or **net book value**).



Illustration: Carrying amount of a non-current asset

	#
Non-current asset at cost	X
Less accumulated depreciation	(X)
Carrying amount (net book value)	X

This figure appears on the face of the statement of financial position

Accounts in the ledger for non-current assets and accumulated depreciation

There are separate accounts in the general ledger for each category of non-current assets (for example, an account for land and buildings, an account for plant and machinery, an account for office equipment, an account for motor vehicles, and so on) and the accumulated depreciation for each of these categories of non-current assets.

This means that each category of non-current assets can be shown separately in the financial statements.



Example: Accounting for depreciation

A company purchases a non-current asset in Year 1 for ₦90,000. In Year 1, the depreciation charge is ₦15,000.

These transactions should be recorded as follows:

Asset account

	₦		₦
Year 1			
Cash/creditors	90,000	Balance c/f	90,000
	<u>90,000</u>		<u>90,000</u>
Year 2			
Balance b/f	90,000		

Accumulated depreciation account

	₦		₦
Year 1			
Balance c/f	15,000	Depreciation account	15,000
	<u>15,000</u>		<u>15,000</u>
Year 2			
		Balance b/f	15,000

Depreciation account

	₦		₦
Year 1			
Accumulated depreciation	15,000	Statement of profit or Loss	15,000
	<u>15,000</u>		<u>15,000</u>

At the end of Year 1, the carrying amount of the asset in the statement of financial position is:

	₦
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	(15,000)
Carrying amount	<u>75,000</u>

**Example continued:**

The depreciation charge in Year 2 is also ₦15,000. The ledger accounts in Year 2 will be as follows:

Asset account			
<i>Year 2</i>	₦		
Balance b/f	90,000	Balance c/f	90,000
	90,000		90,000
<i>Year 3</i>			
Balance b/f	90,000		

Accumulated depreciation account			
<i>Year 2</i>	₦		
		Balance b/f	15,000
Balance c/f	30,000	Depreciation account	15,000
	30,000		30,000
<i>Year 3</i>		Balance b/f	30,000

Depreciation account			
<i>Year 2</i>	₦		
Accumulated depreciation	15,000	Statement of profit or Loss	15,000

At the end of Year 2, the carrying amount of the asset in the statement of financial position is:

	₦
Non-current asset at cost (or valuation)	90,000
Less: Accumulated depreciation	(30,000)
Carrying amount	60,000

**Practice question****1**

An item of equipment cost ₦40,000 at the beginning of Year 1. It has an expected life of 5 years.

The annual depreciation charge is ₦8,000.

Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.

a Equipment account

b Accumulated depreciation of equipment account **c** depreciation of equipment account

3.3 The purpose of depreciation

It is important to understand the purpose of depreciation. Depreciation is an application of the accruals concept or matching concept.

When a non-current asset is purchased the cost is:

- taken to the non-current asset account at cost and
- shown in the statement of financial position.

The cost is capitalised. However this asset is used within the business in order to earn profits. Therefore some element of its original cost must be charged to the statement of profit or loss ('charged to profit and loss') each period in order to match the 'consumption' of the cost or value of the assets with the income that the asset is generating.

Depreciation is the element of the cost of the non-current asset that is charged to the statement of profit or loss each period.

There are several ways of calculating the depreciation charge for the year.

4 METHODS OF CALCULATING DEPRECIATION

Section overview

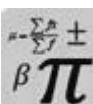
- Straight-line method
- Reducing balance method

4.1 Straight-line method



Definition: Straight line depreciation

Where the depreciable amount is charged in equal amounts to each reporting period over the expected useful life of the asset.



Formula: Straight-line depreciation

$$\text{Depreciation charge} = \frac{\text{Cost of asset less expected residual value}}{\text{Expected useful life (years)}}$$

For the year

With the straight-line method, the annual depreciation charge is the same for each full financial year over the life of the asset (unless the asset is subsequently re-valued during its life).

This is the most common method in practice, and the easiest to calculate.



Example: Straight line depreciation

A machine cost ₦250,000. It has an expected economic life of five years and an expected residual value of ₦50,000 at the end of that time.

Annual depreciation is:

$$\text{Depreciation charge} = \frac{250,000 - 50,000}{5 \text{ years}} = \text{₦40,000 per annum}$$

An exam question might state that a full year's depreciation is charged in the year of acquisition. This would mean that a full annual charge would be recognised even if the asset was only owned for the last few months of the year.



Example: Straight line depreciation – mid-year acquisition

A machine cost ₦250,000. It has an expected economic life of five years.

It is expected that the machine will have a zero scrap value at the end of its useful life.

The machine was bought on the 1st September and the company has a 31st December year end.

The depreciation charge in the first year of ownership is:

$$\text{Depreciation charge} = \frac{250,000}{5 \text{ years}} \times \frac{4}{12} = \text{₦16,667}$$

Depreciation as a percentage of cost

Another way of stating straight-line depreciation is to express the annual depreciation charge as a percentage of the cost of the asset. For example, suppose that an asset has an expected life of 10 years and zero residual value. If straight-line depreciation is used, the annual depreciation charge will be 10% of the cost of the asset.

Similarly, if a non-current asset has an expected life of six years and a residual value equal to 10% of its cost, straight-line depreciation would be 15% of cost each year ($= (100\% - 10\%)/6$ years).

4.2 Reducing balance method



Definition: Reducing balance method

Where the annual depreciation charge is a fixed percentage of the carrying amount of the asset at the start of the period.



Formula: Reducing balance depreciation

$$\text{Depreciation charge} = \frac{\text{Carrying amount at the start of the year}}{\text{For the year}} \times \text{Fixed\%}$$

The annual depreciation charge is highest in Year 1 and lowest in the final year of the asset's economic life.



Example: Reducing balance method

A machine cost ₦100,000. It has an expected life of five years, and it is to be depreciated by the reducing balance method at the rate of 30% each year.

Annual depreciation and carrying amount over the life of the asset will be as follows.

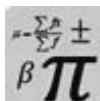
Annual depreciation

Year	Carrying amount at start of year ₦	charge (at 30% of the reducing balance) ₦	Carrying amount at end of year ₦
1	100,000	30,000	70,000
2	70,000	21,000	49,000
3	49,000	14,700	34,300
4	34,300	10,290	24,010

Calculating the reducing balance

The reducing balance reduces the cost of an asset down to its expected residual value over its expected useful life.

The reducing balance percentage can be calculated using the following formula.



Formula: Calculation of reducing balance percentage

$$x = 1 - J \frac{\text{Residual value}}{\text{Cost}}$$

Where:

x=The reducing balance percentage

n = Expected useful life.



Example: Reducing balance

An asset cost ₦10,000 and has an expected residual value of ₦2,000 at the end of its expected useful life which is 5years.

The reducing balance percentage is calculated as follows.

$$x = 1 - J \frac{\text{Residual value}}{\text{Cost}} = 1 - J \frac{2,000}{10,000} = 0.275 \text{ or } 27.5\%$$

This percentage reduces ₦10,000 to ₦2,000 over 5 years.

Year	Carrying amount at start of year ₦	Annual depreciation charge (at 27.5% reducing balance) ₦	Carrying amount at end of year ₦
1	10,000	2,750	7,250
2	7,250	1,994	5,256
3	5,256	1,445	3,811
4	3,811	1,048	2,763
5	2,763	763	2,000

Note that the depreciation charge in year 5 contains a rounding difference of 3.



Practice questions

2

- 1 An item of equipment cost ₦1,260,000. It has an expected useful life of six years and an expected residual value of ₦240,000. Using the straight-line method of depreciation:
What is the annual depreciation charge?
What will be the carrying amount of the asset after four years?

- 2 The financial year of a company is 1st January to 31st December. A non-current asset was purchased on May 1, for ₦60,000. Its expected useful life is five years and its expected residual value is zero. It is depreciated by the straight-line method.
Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.
a Equipment account
b Accumulated depreciation of equipment account **c** depreciation of equipment account

- 3 A non-current asset cost ₦64,000. It is depreciated by the reducing balance method, at the rate of 25% each year.
Complete the following ledger accounts for Years 1, 2 and 3 and calculate the carrying amount of the asset at the end of each period.
a Equipment account
b Accumulated depreciation of equipment account **c** depreciation of equipment account

- 4 An office property cost ₦5million, of which the land value is ₦2million and the cost of the building is ₦3 million. The building has an estimated life of 50years.
Complete the following ledger accounts for Years 1 and 2 and calculate the carrying amount of the asset at the end of each period.
a Equipment account
b Accumulated depreciation of equipment account **c** depreciation of equipment account

5 DERECOGNITION OF PROPERTY, PLANT AND EQUIPMENT

Section overview

- Gain or loss on disposal of a non-current asset
- Accounting for the disposal of property, plant and equipment
- Disposal of property, plant and equipment: part-exchange of an old asset

5.1 Gain or loss on disposal of a non-current asset

Property, plant and equipment are eventually disposed of:

- by sale, or
- if they have no sale value, through disposal as scrap.

Disposal can occur at any time, and need not be at the end of the asset's expected useful life.

The effect of a disposal on the statement of financial position (or accounting equation) is that:

- the asset (at cost or valuation) is no longer in the statement of financial position, and
- the accumulated depreciation on the asset is also no longer in the statement of financial position.

The carrying amount of the asset is therefore removed from the accounting equation.

There is a gain or loss on disposal of the asset, as follows:



Illustration: Gain or loss on disposal

	₦
Sale proceeds on disposal	X
Less Disposal costs	(X)
Net disposal value	<u>X</u>
Asset at cost	X
Less: Accumulated depreciation	<u>(X)</u>
Carrying amount at date of disposal	<u>(X)</u>
Gain /loss on disposal	X

**Example:**

A non-current asset originally cost ₦75,000. Accumulated depreciation is ₦51,000.

The asset is now sold for ₦18,000. Disposal costs are ₦500. What is the gain or loss on disposal?

**Answer****Gain or loss on disposal**

	₦	₦
Sale proceeds on disposal	18,000	
Less Disposal costs	(500)	
Net disposal value	<u>17,500</u>	
Asset at cost	75,000	
Less: Accumulated depreciation	(51,000)	
Carrying amount at date of disposal	<u>(24,000)</u>	
Loss on disposal	<u>(6,500)</u>	

**Practice question****3**

A non-current asset cost ₦96,000 and was purchased on June 1, Year 1. Its expected useful life was five years and its expected residual value was ₦16,000. The asset is depreciated by the straight-line method.

The asset was sold on September 1, Year 3 for ₦68,000. There were no disposal costs.

It is the company policy to charge depreciation on a monthly basis. The financial year runs from January 1 to December 31.

What was the gain or loss on disposal?

**Practice question****4**

A non-current asset was purchased on 1 June Year 1 for ₦216,000. Its expected life was 8 years and its expected residual value was ₦24,000. The asset is depreciated by the straight-line method. The financial year is from January 1, to December 31.

The asset was sold on September 1, Year 4 for ₦163,000. Disposal costs were ₦1,000.

It is the company policy to charge a proportionate amount of depreciation in the year of acquisition and in the year of disposal, in accordance with the number of months for which the asset was held.

What was the gain or loss on disposal?

5.2 Accounting for the disposal of property, plant and equipment

In the general ledger the gain or loss on disposal of a non-current asset is recorded in a **disposal of asset account**. The double entry transactions required are as follows – for an asset recorded at cost rather than at a re-valued amount.

Step 1: Transfer the cost of the non-current asset from the asset account to the disposal account:

Step 2: Transfer the accumulated depreciation on the asset from the accumulated depreciation account to the disposal account:



Illustration:

	Debit	Credit
Disposal account	X	
Non-current asset account (cost of the asset)		X
Accumulated depreciation account (or Allowance for depreciation account)	X	
Disposal account		X

The carrying amount of the asset is now in the disposal account.

Step 3: Record the disposal costs in the disposal account.



Illustration:

	Debit	Credit
Disposal account (disposal expenses)		X
Bank or Payables account		X

Step 4: Record the sale proceeds in the disposal account:



Illustration:

	Debit	Credit
Bank or Receivables account	X	
Disposal account (sale proceeds)		X

Step 5: The balance on the disposal account is the gain or loss on disposal. This is transferred to the statement of profit or loss.

**Example:**

A non-current asset cost ₦82,000 when purchased. It was sold for ₦53,000 when the accumulated depreciation was ₦42,000. Disposal costs were ₦2,000.

Required

Show the book-keeping entries to record the disposal.

**Answer**

Disposal of asset account		
Non-current asset account	₦ 82,000	₦ Accumulated depreciation account
Disposal expenses (Bank)	2,000	Sales value (Receivables) 53,000
Gain on disposal (statement of profit or loss)	11,000	
	95,000	95,000
Non-current asset account		
Opening balance	₦ 82,000	₦ Disposal account 82,000
Accumulated depreciation account		
Disposal account	₦ 42,000	₦ Opening balance 42,000
Receivables account		
Disposal account (sale value of disposal)	₦ 53,000	₦
Bank account		
	₦	₦ Disposal account (disposal expenses) 2,000
Statement of profit or loss		
	₦	₦ Disposal account (gain on disposal) 11,000

Non-current asset accounts in the general ledger are usually maintained for a category of assets rather than for individual assets. This means that when a non-current asset is disposed of, there will be a closing balance to carry forward on the asset account and the accumulated depreciation account.


Example:

In the previous example, suppose that the balance on the non-current asset account before the disposal was ₦500,000 and the balance of the accumulated depreciation account was ₦180,000.

The accounting entries would be as follows:

Property, plant and equipment account

	₦		₦
Opening balance b/f	500,000	Disposal account	82,000
	<hr/> 500,000	Closing balance c/f	<hr/> 418,000
Opening balance b/f	418,000		<hr/> 500,000

Accumulated depreciation account

	₦		₦
Disposal account	42,000	Opening balance b/f	180,000
Closing balance c/f	<hr/> 138,000		<hr/> 180,000
	<hr/> 180,000	Opening balance b/f	<hr/> 138,000

Practice question
5

A motor vehicle cost ₦80,000 two years ago. It has been depreciated by the reducing balance method at 25% each year. It has now been disposed of for ₦41,000. Disposal costs were ₦200.

The balance on the motor vehicles account before the disposal was ₦720,000 and the balance on the accumulated depreciation of motor vehicles account was ₦250,000.

Show the book-keeping entries to record the disposal.



5.3 Disposal of property, plant and equipment: part-exchange of an old asset

Sometimes, a supplier will agree to take an old asset in part-exchange for the sale of a new asset. This practice is quite common, for example, with motor vehicles. A business entity may buy a new motor vehicle from a car dealer, and the car dealer will take an old motor vehicle in part-exchange for the new one. This arrangement is known as a “trade-in”. (The business entity is said to be “trading-in” the old vehicle and the car dealer is said to be granting a “trade in allowance”).

Disposals of assets in part-exchange for a new asset are accounted for in much the same way as disposals of property, plant and equipment for cash. The only difference is that:

- The disposal value of the old asset is the amount that the seller of the new asset allows in part-exchange for the new asset.
- The cost of the new asset is the full purchase price, but the double entry is partly to bank/payables (for the cash payment) and partly to the disposal account for the old asset (for the part-exchange value).

Example:



Entity X has several motor cars that are accounted for as property, plant and equipment.

As at 1 January Year 5, the cost of the entity's cars was ₦200,000 and the accumulated depreciation was ₦80,000.

On 2 January Year 5, Entity X bought a new car costing ₦50,000.

The car dealer accepted a car owned by Entity X in part-exchange, and the part-exchange value of this old car was ₦4,000.

This car originally cost ₦30,000 and its accumulated depreciation is ₦25,000.

Required

- (a) Calculate the gain or loss on disposal of the old car
- (b) Show how the purchase of the new car and the disposal of the old car will be recorded in the ledger accounts of Entity X.

Answer

(a)

	₦	₦
Sale proceeds on disposal (part-exchange value)	4,000	
Less Disposal costs	0	
Net disposal value	<u>4,000</u>	
Asset at cost	30,000	
Less: Accumulated depreciation	<u>(25,000)</u>	
Carrying amount at date of disposal	(5,000)	
Loss on disposal	<u>(1,000)</u>	



Answer (b)

Disposal of asset account

	₦		₦
Motor vehicles account	30,000	Accumulated depreciation account	25,000
		Motor vehicles account	
		(Trade-in value)	4,000
		Loss on disposal (statement of profit or loss)	1,000
	<u>30,000</u>		<u>30,000</u>

Motor vehicles account

1 January	₦		₦
Opening balance	200,000	Disposal account	30,000
Bank (50,000 – 4,000)	46,000		
Disposal of asset account	4,000	Closing balance	220,000
	<u>250,000</u>		<u>250,000</u>
2 January			
Opening balance	220,000		

Accumulated depreciation account

1 January	₦		₦
Disposal account	25,000	Opening balance	80,000
Closing balance	55,000		
	<u>80,000</u>		<u>80,000</u>
2 January			
		Opening balance	55,000

Bank account

	₦		₦
	46,000	Motor vehicles account	46,000
		(Cash paid for new car)	

Statement of profit or loss

	₦		₦
Disposal account (Loss on disposal)	1,000		

**Practice question****6**

A company has several motor cars that are accounted for as non-current assets. As at January 1, Year 2, the cost of the cars was ₦120,000 and the accumulated depreciation was ₦64,000.

During January the company bought a new car costing ₦31,000 and was given a part-exchange allowance against an old car of ₦8,000. The car being part exchanged originally cost ₦28,000 and its accumulated depreciation is ₦18,000.

Required

- (a) Calculate the gain or loss on disposal of the old car
- (b) Show how the purchase of the new car and the disposal of the old car will be recorded in the ledger accounts.

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6 DISCLOSURE REQUIREMENTS OF IAS 16

Section overview

- Disclosure requirements of IAS16

6.1 Disclosure requirements of IAS 16

IAS 16 - **Property, Plant and Equipment** requires the following disclosures in the notes to the financial statements, for each major class of property, plant and equipment.

- ❑ The measurement bases used (cost or revaluation model (not in syllabus))
- ❑ The depreciation methods used
- ❑ The useful lives or depreciation rates used
- ❑ Gross carrying amounts and the accumulated depreciation at the beginning and at the end of the period
- ❑ A reconciliation between the opening and closing values for gross carrying amounts and accumulated depreciation, showing:
 - Additions during the year
 - Disposals during the year
 - Depreciation charge for the year
 - Assets classified as held for sale in accordance with IFRS 5
 - Acquisitions of assets through business combinations
 - Impairment losses (beyond the scope of this syllabus)

The following is an example of how a simple table for tangible non-current assets may be presented in a note to the financial statements.

**Illustration: Property, plant and equipment note to the accounts**

	Property ₦m	Plant and equipment ₦m	Total ₦m
Cost			
At the start of the year	7,200	2,100	9,300
Additions	920	340	1,260
Disposals	(260)	(170)	(430)
At the end of the year	7,860	2,270	10,130
Accumulated depreciation			
At the start of the year	800	1,100	1,900
Depreciation expense	120	250	370
Accumulated depreciation on disposals	(55)	(130)	(185)
At the end of the year	865	1,220	2,085
Carrying amount			
At the start of the year	6,400	1,000	7,400
At the end of the year	6,995	1,050	8,045

7 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Identify the cost of an item of property, plant and equipment
- Calculate depreciation expense using straight line and reducing balance methods
- Account for depreciation expense
- Post journal entry to record depreciation expense
- Calculate profit (loss) on disposal of an item of property, plant and equipment
- Account for profit (loss) on disposal of an item of property, plant and equipment
- Construct a simple property, plant and equipment note to the financial statements

SOLUTIONS TO PRACTICE QUESTIONS

Solution

1

a

Equipment account

YEAR 1	₦	₦
Cash	40,000	Balance c/d
	40,000	40,000
		40,000
YEAR 2		
Balance b/d	40,000	Balance c/d
	40,000	40,000
		40,000
Balance b/d	40,000	

b

Equipment – accumulated depreciation

YEAR 1	₦	₦
		Depreciation
Balance c/d	8,000	8,000
	8,000	
		8,000
YEAR 2		
Balance b/d	16,000	Balance b/d
	16,000	8,000
		8,000
Depreciation		16,000
		16,000
		16,000
Balance b/d		16,000

c

Depreciation expense

YEAR 1	₦	₦
Acc. depreciation	8,000	Statement of profit or loss
	8,000	8,000
		8,000
YEAR 2		
Acc. depreciation	8,000	Statement of profit or loss
	8,000	8,000
		8,000

Carrying amounts at end of:

	Year 1 (₦)	Year 2 (₦)
Cost	40,000	40,000
Accumulated depreciation	(8,000)	(16,000)
Carrying amount	32,000	24,000

Solutions

1 Annual depreciation = $\frac{N(1,260,000 - 240,000)}{6 \text{ years}} = N170,000.$

After 4 years:

Asset at cost	N 1,260,000
Less accumulated depreciation: N170,000 x 4)	680,000
Carrying amount	<u>580,000</u>

2 Annual depreciation = $\frac{N(60,000 - 0)}{5 \text{ years}} = N12,000.$ Charge in

the year of acquisition = $N12,000 \times 8 \text{ months} / 12 \text{ months}$

= N8,000

a Equipment account

YEAR 1	N		N
Cash	60,000	Balance c/d	60,000
	<u>60,000</u>		<u>60,000</u>
YEAR 2			
Balance b/d	60,000	Balance c/d	60,000
	<u>60,000</u>		<u>60,000</u>
Balance b/d	60,000		

b Equipment – accumulated depreciation

YEAR 1	N		N
Balance c/d	8,000	Depreciation	8,000
	<u>8,000</u>		<u>8,000</u>
YEAR 2			
Balance b/d	20,000	Balance b/d	8,000
	<u>20,000</u>	Depreciation	12,000
			<u>20,000</u>
Balance b/d	20,000	Balance b/d	20,000

c Depreciation expense

YEAR 1	N		N
Acc. depreciation	8,000	Statement of profit or loss	8,000
	<u>8,000</u>		<u>8,000</u>
YEAR 2			
Acc. depreciation	12,000	Statement of profit or loss	12,000
	<u>12,000</u>		<u>12,000</u>

Carrying amounts at end of: Year1(N) Year2(N)

Cost	60,000	60,000
Accumulated depreciation	(8,000)	(16,000)
Carrying amount	<u>52,000</u>	<u>44,000</u>

Solutions (continued)**2****3 Working:**

	₦
Cost of the asset	64,000
Year 1 depreciation (25%)	(16,000)
Carrying amount at the end of year 1	<u>48,000</u>
Year 2 depreciation (25%)	(12,000)
Carrying amount at the end of year 2	<u>36,000</u>
Year 3 depreciation (25%)	(9,000)
Carrying amount at the end of year 3	<u>27,000</u>

a Equipment account

YEAR 1	₦	₦
Cash	64,000	Balance c/d
	<u>64,000</u>	64,000
		<u>64,000</u>
YEAR 2		
Balance b/d	64,000	Balance c/d
	<u>64,000</u>	64,000
		<u>64,000</u>
YEAR 3		
Balance b/d	64,000	Balance c/d
	<u>64,000</u>	64,000
		<u>64,000</u>
Balance b/d	64,000	

b Equipment – accumulated depreciation

YEAR1	₦	₦
Balance c/d	16,000	Depreciation
	<u>16,000</u>	16,000
		<u>16,000</u>
YEAR 2		
Balance b/d	28,000	Balance b/d
	<u>28,000</u>	16,000
		<u>16,000</u>
YEAR 3		
Balance b/d	37,000	Depreciation
	<u>37,000</u>	12,000
		<u>12,000</u>
		28,000
Balance b/d	37,000	Balance b/d
	<u>37,000</u>	28,000
		<u>28,000</u>
		9,000
		<u>9,000</u>
		37,000
Balance b/d	37,000	Balance b/d
	<u>37,000</u>	37,000
		<u>37,000</u>

Solutions(continued)**2****3 continued... c**

Depreciation expense		
YEAR 1	₦	₦
Acc. depreciation	16,000	Statement of profit or loss 8,000
	<u>16,000</u>	<u>16,000</u>
YEAR 2		
Acc. depreciation	12,000	Statement of profit or loss 12,000
	<u>12,000</u>	<u>12,000</u>
YEAR 3		
Acc. depreciation	9,000	Statement of profit or loss 9,000
	<u>9,000</u>	<u>9,000</u>

Carrying amounts at end of:	Year 1 (₦)	Year 2 (₦)	Year 2 (₦)
Cost	64,000	64,000	64,000
Accumulated depreciation	(16,000)	(28,000)	(37,000)
Carrying amount	<u>48,000</u>	<u>36,000</u>	<u>27,000</u>

4 Annual depreciation = $\frac{\text{₦}(3,000,000)}{50 \text{ years}} = \text{₦}60,000$.

(Land is not depreciated (except in certain circumstances)).

a Land and buildings account

YEAR 1	₦	₦
Cash	5,000,000	Balance c/d
	<u>5,000,000</u>	<u>5,000,000</u>
YEAR 2		
Balance b/d	5,000,000	Balance c/d
	<u>5,000,000</u>	<u>5,000,000</u>

b Land and buildings – accumulated depreciation

YEAR 1	₦	₦
Balance c/d	60,000	Depreciation
	<u>60,000</u>	<u>60,000</u>
YEAR 2		
Balance b/d	120,000	Balance b/d
	<u>120,000</u>	<u>60,000</u>
		Depreciation
		120,000
		<u>120,000</u>
		Balance b/d
		<u>120,000</u>

Solutions(continued)**2**

c		Depreciation expense	
YEAR1	₦		₦
Acc. depreciation	60,000	Statement of profit or loss	60,000
	60,000		60,000
YEAR 2		Statement of profit or loss	
Acc. depreciation	60,000		60,000
	60,000		60,000
Carrying amounts at end of:		Year 1 (₦)	Year 2 (₦)
Cost		5,000,000	5,000,000
Accumulated depreciation		(60,000)	(120,000)
Carrying amount		<u>4,940,000</u>	<u>4,880,000</u>

Solution**3**

Annual depreciation = ₦(96,000 – 16,000)/5 years = ₦16,000.

Monthly depreciation = ₦16,000/12 = ₦1,333.33.

Disposal value less disposal costs	₦	₦
		68,000
Cost of the asset		96,000
Accumulated depreciation at the time of disposal (= 27 months × ₦1,333.33)		(36,000)
Carrying amount at the date of disposal		<u>60,000</u>
Gain on disposal		<u>8,000</u>

Solutions

Annual depreciation = ₦(216,000 – 24,000)/8 years = ₦24,000.

	₦	₦
Disposal value	163,000	
Less disposal costs	(1,000)	
	<hr/>	<hr/>
	162,000	
Accumulated depreciation at the time of disposal		
Year to 31 December Year 1: (₦24,000 × 7/12)	14,000	
Years 2 and 3: (₦24,000 × 2 years)	48,000	
Year to 31 December Year 4: (₦24,000 × 8/12)	16,000	
	<hr/>	<hr/>
	78,000	
Cost of the asset	216,000	
Carrying amount at the date of disposal	<hr/>	138,000
Gain on disposal	<hr/>	24,000

Solution**5**

	₦	₦
Cost of the asset	80,000	
Year 1 depreciation ($\times 25\%$)	(20,000)	20,000
Carrying amount at end of Year 1	<u>60,000</u>	
Year 2 depreciation ($\times 25\%$)	(15,000)	15,000
Accumulated depreciation at date of disposal		<u>35,000</u>

Disposal account

	₦	₦
Motor vehicles account	80,000	Accumulated depreciation 35,000
Bank (disposal costs)	200	Receivables 41,000
	<u>80,200</u>	Statement of profit or loss (loss on disposal) 4,200
		<u>80,200</u>

b

Motor vehicles

	₦	₦
Opening balance b/d	720,000	Disposal of asset account 80,000
	<u>720,000</u>	Closing balance c/d 640,000
Opening balance b/d	640,000	<u>720,000</u>

c

Accumulated depreciation on motor vehicles

	₦	₦
Disposal of asset account	35,000	Opening balance b/f 250,000
Closing balance c/d	<u>215,000</u>	
	250,000	250,000
		Opening balance b/d 215,000

Solution**6**

	₦
Sale proceeds on disposal (part-exchange value)	8,000

Asset at cost	28,000
Less: Accumulated depreciation	<u>(18,000)</u>
Carrying amount at date of disposal	<u>(10,000)</u>
Loss on disposal	<u>(2,000)</u>

Disposal account

₦		₦	
Motor vehicles account	28,000	Accumulated depreciation account	18,000
		Motor vehicles account (Trade-in value)	8,000
		Loss on disposal	2,000
	28,000		28,000

b

Motor vehicles			
₦			
Opening balance	120,000	Disposal account	28,000
Bank (31,000 – 8,000)	23,000		
Disposal of asset account	8,000	Closing balance	123,000
	151,000		151,000
Opening balance	151,000		

c

Accumulated depreciation on motor vehicles			
₦			
Disposal account	18,000	Opening balance	64,000
Closing balance	46,000		
	64,000		64,000
		Opening balance	46,000

Bad and doubtful debts

Contents

- 1 Bad debts and doubtful debts
- 2 Doubtful debts
- 3 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

C	Reconciliation in financial accounting	
	4	Accounting treatment for bad and doubtful debts
	a	Account for the write off of bad debts.
	b	Account for the recovery of bad debts.
	c	Determine the balance on the allowance for doubtful debts accounts.
	d	Account for the movement on the allowance for doubtful debts accounts.
	e	Account for movements in receivables.

Exam context

This chapter explains the accounting treatment for bad and doubtful debts.

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

- Account for the write off of bad debts
- Account for the recovery of bad debts
- Measure the balance on the allowance account for doubtful debts
- Account for the movement on the allowance account for doubtful debts
- Understand the write off and recovery of debts against which an allowance has been made

1 BAD DEBTS AND DOUBTFUL DEBTS

Section overview

- Introduction
- Accounting for bad debts
- Bad debts recovered

1.1 Introduction

A business might make all its sales for cash but many businesses make some or even all their sales on credit. There is often no alternative to offering credit to customers. If competitors offer credit, then a business will have little alternative but to offer credit as well so as not to lose customers. A major benefit of offering credit is that it usually increases revenue, compared to what revenue would be if all sales were for cash.

If sales are made on credit, there is always a chance that some customers will fall into financial difficulty and be unable to pay what they owe.

It would be misleading to the users of the financial statements if a business continued to show receivables where there is no chance, or only a slight chance of collecting them.

The application of the concept of prudence would require that there should be an adjustment to reflect the fact that there are some receivables which the business thinks that it will not recover.

There are two categories of problem receivables for which adjustment might be required.

Bad debts (also known as irrecoverable debts or receivables)

A bad debt is an amount owed by a customer that the business believes it will never be able to collect.

Examples of circumstances that might lead to the conclusion that a receivable is irrecoverable include:

- The bankruptcy or insolvency of a customer.
- The death of a customer who has left insufficient assets to pay off his debts.
- A dispute with a customer over whether a contract has been fulfilled or not.
- The dishonesty of a customer (where a person has obtained goods on credit with no intention to pay).

Doubtful debts

A doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so. For example, the business might know that the customer is in difficulty but that he might be able to work his way out of it. This casts doubt on the collectability of the receivable but it still might be possible if the customer is able to recover from his difficulties.

Examples of circumstances that might lead to the conclusion that a receivable is doubtful include:

- A customer experiencing cash flow problems.
- A customer taking an unusually long time to settle a debt.
- A customer experiencing operational difficulties which might lead to financial problems (for example, strikes, natural disasters disrupting production, etc.).

Bad debts and doubtful debts are accounted for differently, although there is often just a single **bad and doubtful debts expense account** in the general ledger.

Prudence

A business should not show an asset in its financial statements at an amount greater than the cash it will generate. When such a circumstance arises the asset is reduced in value down to the cash expected to result from the ownership of the asset.

1.2 Accounting for bad debts

Bad debts are receivables that an entity is owed, but that it now does not expect to collect.

When a specific debt (receivable) is considered bad or irrecoverable, it is written off. This means that it is removed from the accounting system and supporting records.



Illustration: Write off of bad debt – double entry

Write off of bad debt	Debit	Credit
General ledger:		
Bad and doubtful debts expense	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

When a bad debt is written off, it is reduced to zero in the receivables ledger (and total receivables account):

- The total value of receivables is reduced (reducing assets).
- The bad debt is recorded as an expense (reducing profit and hence capital).

**Example: Write off of bad debt**

A business has trade receivables of ₦750,000 but decides to write off a bad debt of ₦15,000.

Receivables control account

	₦		₦
Balance b/f	750,000	Bad and doubtful debts	15,000
	<hr/> 750,000	Closing balance c/f	<hr/> 735,000
Opening balance b/f	735,000		<hr/> 750,000

Bad and doubtful debts account (expense)

₦	₦
Receivables	15,000

At the end of the financial period, the bad debt expense is transferred to the statement of profit or loss as an expense for the period.

General ledger

₦	₦
Statement of profit or loss	Bad and doubtful debts
doubtful debts	15,000
(This reduces the balance on both accounts)	
15,000	
15,000	

The balance on the customer's account in the receivables ledger is reduced by ₦15,000 (in all probability, from ₦15,000 to ₦0.)

1.3 Bad debts recovered

On rare occasions cash in respect of a debt that had been written off as bad in a previous year is subsequently received in a later period. The double entry for recording the recovery of a bad debt is:

Illustration: Subsequent recovery of bad debt – double entry

Write off of bad debt	Debit	Credit
General ledger:		
Cash	X	
Bad debt recovered		X

The credit will be recognised as a reduction of the bad debt expense in the statement of profit and loss. This recognises that the business had previously recognised an expense when it first wrote off the debt where, in hindsight, it need not have done so.



2 DOUBTFUL DEBTS

Section overview

- Basic double entry for doubtful debts
- Accounting for changes in the allowance account
- Bad and doubtful debts together
- Doubtful debts recovered
- Aged receivables analysis
- Summary of the rules on bad and doubtful debts

2.1 Basic double entry for doubtful debts

As stated above, a doubtful debt is an amount owed by a customer that the business believes might prove difficult to collect but they still hope to do so.

The accounting treatment has to serve two objectives.

- The exercise of prudence requires that the value of the receivable should be adjusted downwards (perhaps to zero) and an expense recognised for the loss in value; but
- The receivable must stay in the accounting records so that the business continues to chase payment.

This is achieved in the following way. Instead of writing off the debt (which would remove it from the records) a business sets up an allowance account.



Illustration: Accounting for doubtful debts—basic double entry

Debit Credit

General ledger:

Bad and doubtful debts expense	X
Allowance for doubtful debts	X

Receivables ledger:

No entry	X
----------	---

Note that the **allowance account** might also be called the **provision for doubtful debts account**.

The allowance is a credit balance which is then set against the carrying amount of the receivables in the statement of financial position.



Illustration: Presentation of receivables in statement of financial position

In the statement of financial position:	₦
Trade receivables (net of bad debts written off)	X
Allowance for doubtful debts	(X)
Figure shown for trade receivables on the face of the statement of financial position	<u> </u> X <u> </u>

Measurement of the allowance

An allowance is only recognised for a debtor (receivable) if the business knows that the debtor might not pay. Therefore, when a business has information about the financial difficulties of specific debtors it would set up an allowance account for these.

In addition, a business with many debtors would know from experience that at each year end some of the debtors are in difficulty but it does not know who these are yet. In such cases a business might recognise a further general amount in the allowance. Note that the business would have to justify this amount; it cannot recognise a general allowance as it pleases. This must be based on verifiable experience.



Example: Measuring allowance for doubtful debts

The Acure Cocoa Company has receivables at the year-end of ₦1,500,000.

It has carried out a year-end review of its receivables and discovered that a customer owing ₦75,000 has suffered a fire at their factory which will stop production for 3 months. The chief accountant believes that this casts doubt on their ability to pay their debt.

In addition, it is practice of the Acure Cocoa Company to recognise an allowance for 5% of its receivables. This is based on experience and the treatment has been approved by the company's auditor.

The Acure Cocoa Company would recognise the following allowance:

Allowance for specific receivable	₦
	75,000
General allowance:	
Total receivables	1,500,000
Less amount for which there is a specific allowance	(75,000)
	1,425,000
General allowance @ 5%	71,250
Total allowance required	<u>146,250</u>

In the statement of financial position:

Trade receivables	₦
Allowance for doubtful debts	(146,250)
Figure shown for trade receivables on the face of the statement of financial position	<u>1,353,750</u>

In summary, when a bad debt is written off, receivables are reduced. An allowance for irrecoverable debts is different from bad debts. When an allowance for irrecoverable debts is created, total receivables are not reduced. Instead, the allowance for irrecoverable debts is recorded in a separate account in the general ledger – an allowance for irrecoverable debts account. This always has a credit balance.

2.2 Accounting for changes in the allowance account

The double entry shown above is a little simplistic. In practice a business will recognise an allowance balance at each year end. When this is the case it is the movement on the allowance that is recognised as an expense.



Example: Accounting for change in the allowance

A business started on 1st January Year 1.

The balance on receivables and the required allowance for doubtful debts at the end of each of the first three years were as follows:

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	20,000	24,000	18,000

The example continues on the next page.


Example: Accounting for change in the allowance

Bad and doubtful debts expense account

YEAR 1	₦		₦
Allowance account (1)	20,000		Statement of profit or loss
	<u>20,000</u>		20,000
	20,000		<u>20,000</u>
YEAR 2			
Allowance account (2)	4,000		Statement of profit or loss
	<u>4,000</u>		4,000
	4,000		<u>4,000</u>
YEAR 3			
Statement of profit or Loss	6,000		Allowance account (3)
	<u>6,000</u>		6,000
	6,000		<u>6,000</u>

Allowance for doubtful debts

YEAR 1	₦		₦
Balance b/d	0		Expense account (1)
Balance c/d	20,000		20,000
	<u>20,000</u>		<u>20,000</u>
	8,000		8,000
YEAR 2			
Balance c/d	24,000		Balance b/d
	<u>24,000</u>		20,000
	24,000		Expense account (2)
	<u>24,000</u>		4,000
	24,000		<u>24,000</u>
YEAR 3			
Expense account (3)	6,000		Balance b/d
Balance c/d	18,000		24,000
	<u>18,000</u>		<u>24,000</u>
	24,000		24,000
	<u>24,000</u>		Balance b/d
	24,000		18,000

Note that in year 3 there is a credit to the bad debt expense. This would reduce the expense recognised in the year (or may even be an item of income).

	Year 1	Year 2	Year 3
Receivables	1,000,000	1,200,000	900,000
Allowance required	(20,000)	(24,000)	(18,000)
	<u>980,000</u>	1,176,000	882,000

It is not obvious in the above example but the way to calculate the expense in respect of the allowance account is to identify the movement on the allowance.

Remember that any balance on the allowance account is a credit balance.



Illustration: Change in the allowance

	Debit	Credit
Increase in allowance		
Bad and doubtful debts expense		X
Allowance for doubtful debts		X
Decrease in allowance		
Allowance for doubtful debts	X	



Example: Accounting for change in the allowance—Continued

Year 2

	Year 2
Allowance required at the start of the year	20,000 Cr
Allowance required at the end of the year	24,000 Cr
	<hr/> 4,000 Cr

In order to change a credit balance of 20,000 to a credit balance of 24,000 we must:

	Dr	Cr
Bad and doubtful debts expense	4,000	
Allowance for doubtful debts		4,000

Year 3

	Dr	Cr
Allowance required at the start of the year	24,000 Cr	
Allowance required at the end of the year	18,000 Cr	
	<hr/> 6,000 Dr	

In order to change a credit balance of 24,000 to a credit balance of 18,000 we must:

	Dr	Cr
Allowance for doubtful debts	6,000	
Bad and doubtful debts expense		6,000

2.3 Bad and doubtful debts together

Any question on this area will involve both bad debts and doubtful debts.

This is best seen with an example.



Example:

A business has trade receivables of ₦75,000.

It identifies that ₦5,000 of these debts are irrecoverable and should be written off.

An allowance for irrecoverable debts of ₦2,000 should be created. It is the first time that the business has opened such an account.

These transactions will be accounted for as follows:

Receivables account		
Opening balance b/f	₦ 75,000	Bad debt expense (1) ₦ 5,000
		Closing balance c/f ₦ 70,000
	75,000	75,000
Opening balance b/f	70,000	

Note: The balance on the trade receivables account is reduced by the bad debts written off, but not by the allowance for doubtful debts.

Bad and doubtful debts(expense)		
Receivables (1)	₦ 5,000	Statement of profit or loss ₦ 7,000
Allowance (2)	2,000	
	7,000	7,000

Allowance for doubtful debts		
	₦	₦
		Band DD expense(2) 2,000

(Where "Band DD" is "Bad and doubtful debts").

In the statement of financial position, trade receivables will be reported as:

Trade receivables	₦ 70,000
Less: Allowance for irrecoverable debts	2,000
	68,000


Example (continued into year 2)

In year 2, credit sales were ₦200,000, receipts from customers were ₦185,000 and bad debts written off were ₦8,000.

The allowance for irrecoverable debts is to be reduced from ₦2,000 to ₦1,500. These transactions can be summarised as follows:

Receivables account			
	₦	₦	
Opening balance b/f	70,000	Bank	185,000
Sales	200,000	Bad debt expense (1)	8,000
	<u>270,000</u>	Closing balance c/f	<u>77,000</u>
Opening balance b/f	<u>77,000</u>		<u>270,000</u>

Bad and doubtful debts(expense)			
	₦	₦	
Receivables (1)	8,000	Allowance (2)	500
	<u>8,000</u>	Statement of profit or loss	<u>7,500</u>
			<u>8,000</u>

Note: The amount charged in this account as an expense for the period is the bad debt written off minus the reduction in the allowance for irrecoverable debts.

Allowance for doubtful debts			
	₦	₦	
Bank DD expense(2) (2,000 – 1,500)	500	Opening balance b/f	2,000
Closing balance c/f	<u>1,500</u>		<u>2,000</u>
	<u>2,000</u>	Opening balance b/f	<u>1,500</u>

In the statement of financial position, trade receivables will be:

	₦
Trade receivables	77,000
Less: Allowance for irrecoverable debts	<u>1,500</u>
	<u>75,500</u>

1

**Practice question**

Continuing the same example above, the following year (Year3) sales (all on credit) were ₦250,000, receipts from customers were ₦252,000 and bad debts written off were ₦7,000.

It is decided to reduce the allowance for doubtful debts from ₦1,500 to ₦900. Record these transactions in the following ledger accounts:

- Receivables control account
- Bad and doubtful debts
- Allowance for doubtful debts

2.4 Doubtful debts recovered

The accounting treatment to record a receipt of cash in respect of a doubtful debt is the same as for any other debt.

**Illustration: Subsequent recovery of doubtful debt – double entry**

	Debit	Credit
General ledger:		
Cash	X	
Receivables		X
Receivables ledger:		
Individual customer accounts		X

There is no special accounting treatment to reflect the fact that the business has received cash for a debt against which it has already recognised an expense.

Common sense suggests that the business should now recognise a credit to the statement of profit or loss but this happens automatically through the use of basic allowance accounting.

This is because the recovered amount will no longer be included as an allowance when this is re-estimated at the year-end. If all other things are equal this will cause the allowance account to fall. This fall results in a credit to the bad and doubtful debt expense account thus reducing the expense recognised in the statement of profit or loss.



Example: Doubtful debts recovered

At the start of a period a business has an allowance for doubtful debts made up as follows:

	Allowance
Allowance required for customer A receivable	6,000 Cr
Allowance required for customer B receivable	2,000 Cr
	8,000 Cr

Customer B pays in full during the period. The only necessary double entry is:

Dr	Cr
Cash	2,000
Receivables control account	2,000

At the period end the allowance for customer B's receivable is no longer required.

	Allowance
Allowance required at the start of the year	8,000 Cr
Allowance required at the end of the year	6,000 Cr
	2,000 Dr

In order to change a credit balance of 8,000 to a credit balance of 6,000 we must:

Dr	Cr
Allowance for doubtful debts	2,000
Bad and doubtful debts expense	2,000

Therefore, the credit to the statement of profit or loss to reflect the fact that an expense was previously recognized when, with hind sight, there was no need to do so, happens automatically when the year end allowance is remeasured.

2.5 Aged receivables analysis

Preparing an aged receivables analysis is a method of attempting to assess the likelihood of bad debts or to make an assessment of doubtful receivables. This is an analysis for each individual credit customer of their total debtor balance, showing how long each invoice has been outstanding. A typical format for an aged receivables analysis is given below:



Illustration: Aged debtors (receivables) analysis

Customer	Credit limit	Total owed	< 30 days	30 – 60 days	60 – 90 days	Over 90 days
	₦	₦	₦	₦	₦	₦
X	20,000	5,500	3,000	–	2,500	–
Y	15,000	2,700	–	1,000	1,000	700

If a customer has old amounts outstanding, these should be investigated and an attempt should be made to collect payment. However the investigation may indicate that the amount should either be written off as a bad debt, or that an allowance should be made for an irrecoverable debt. (In other words, the debt is not written off yet, but the chances of it being paid look doubtful.)

2.6 Summary of the rules on bad and doubtful debts

The rules for dealing with bad debts and doubtful debts at the end of the financial year can be summarised as follows:



Illustration:

Annual charge in the statement of profit or loss:	₦
Bad debts written off	X
Plus: increase in allowance for doubtful debts; or	X
Less: decrease in allowance for doubtful debts	(X)

	X

In the statement of financial position	₦
Trade receivables (net of bad debts written off)	X
Allowance for doubtful debts	X
Figure shown for trade receivables on the face of the statement of financial position	_____
	X

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Account for the write off of bad debts
- Account for the recovery of bad debts
- Measure the balance on the allowance account for doubtful debts
- Account for the movement on the allowance account for doubtful debts
- Understand the write off and recovery of debts against which an allowance has been made

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions	1
Receivables control account	
Opening balance b/f	₦ 77,000
Sales	250,000
	<hr/>
	327,000
Opening balance b/f	68,000
	Bad and doubtful debts (bad debts written off)
	7,000
	Bank
	252,000
	Closing balance c/f (= balancing figure)
	68,000
	<hr/>
	327,000
Bad and doubtful debts expense	
Trade receivables (= bad Debts written off)	₦ 7,000
	<hr/>
	Allowance for doubtful debts
	(= reduction in allowance)
	600
	Statement of profit or loss (= balancing figure)
	6,400
	<hr/>
	7,000
Allowance for doubtful debts	
Bad and doubtful debts (= reduction in allowance)	₦ 600
Closing balance c/f	900
	<hr/>
	Opening balance b/f
	1,500
	<hr/>
	Opening balance b/f
	900

Accruals and prepayments

Contents

- 1 Accruals and prepayments introduced
- 2 Accruals
- 3 Prepayments
- 4 Unearned and accrued income
- 5 Chapter reviews

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

C Reconciliation in financial accounting	
5 Accounting treatment for accruals and prepayments	
a	Explain the meaning of an accrual.
b	Account for accruals.
c	Explain the meaning of a prepayment.
d	Account for prepayments.
e	Explain the meaning of accrued and unearned incomes.
f	Account for accrued and unearned incomes.

Exam context

This chapter explains the accounting treatment for accruals and prepayments.

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

- Explain the meaning of an accrual
- Account for accruals using both methods
- Explain the meaning of a prepayment
- Account for prepayments using both methods
- Explain the meaning of accrued and unearned income
- Account for accrued and unearned income

1 ACCRUALS AND PREPAYMENTS INTRODUCED

Section overview

- The accruals concept (matching concept)
- Accruals and prepayments

1.1 The accruals concept (matching concept)

Financial statements are prepared using the accruals basis of accounting rather than on a cash basis. This means that:

- sales are recognised in the same period as the related cost of making the sale;
- income is recognised in the statement of profit or loss in the same period as the transaction that gave rise to it (not necessarily when cash is paid); and
- expenses are recognised in the statement of profit or loss as they arise (not as they are paid).

For example, the cost of rental charges on office accommodation should be spread over the period of time to which the rental payments relate, regardless of when the actual payment of rent occurs.



Illustration: Accruals basis

A business pays annual rental in advance on June 1, each year. Rent paid on June 1, 2018 = ₦240,000

Rent paid on June 1, 2019 = ₦300,000

The financial year ends on September 30.

The rental expense for the year ended September 30, 2019 is:

Period:	₦
October 1, 2018 to May 31, 2019	
8/12 of 240,000 (the last 8 months of the rental year)	160000
June 1, 2019 to September 30, 2019	
4/12 of 300,000 (the first 4 months of the rental year)	100,000
	<hr/>
	260,000

1.2 Accruals and prepayments

Accruals

A business might incur an expense before the year end but not receive an invoice until after the year-end. If this is the case the business must estimate the amount of the expense and recognise it as an expense and a liability.

The liability is known as an accrual. The business is said to be making an accrual for the expense or accruing for the expense.

Prepayments

A business might pay or at least be invoiced for some expenses in advance.

When the invoice is received the business will recognise the full liability as a debit in an expense account. It would be wrong to then clear all of this to the statement of profit or loss in the current period. Some of it relates to the next period. This part must be recognised as an asset (it represents a right to receive some kind of service in the next period) called a prepayment.

There are two approaches to accounting for both accruals and prepayments:

- Method 1 – using two accounts; and
- Method 2 – using one account.

Each of these will be explained in turn.

2 ACCRUALS

Section overview

- Accrued expenses (accruals)
- Method 1: the 'two account' approach for accrued expenses (accruals)
- Method 2: the 'one account' approach for accrued expenses (accruals)

2.1 Accruals (accrued expenses)

A business might incur expenses during a period but may not have been sent the invoice by the period end.

Since there has been no payment and no invoice, a financial transaction has not yet occurred and there is not yet anything to record as a book-keeping entry in the ledgers. However, to apply the accruals basis of accounting, the expense must be charged in the statement of profit or loss for the accounting period to which the expense relates. This is done by creating an accrued expense at the end of the accounting period.

An accrued expense (accrual) is an estimate of the cost that has been incurred in the financial period, and it is included in expenses in the statement of profit or loss for the period and recognised as a liability (called an accrual) in the statement of financial position.

Accruals are often necessary when expenses are paid in arrears (i.e. at the end of a period of expense).

**Example:**

Uche sets up in business on January 1, Year1. The business has at December 31, year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 three months in arrears and telephone invoices received in Year 1 are as follows:

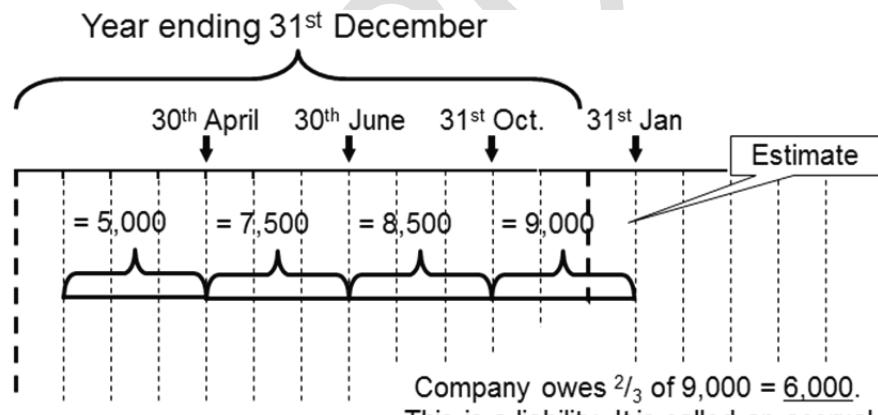
	₦
30 April	5,000
31 July	7,500
31 October	8,500

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be ₦9,000.

The accrual for November and December Year 1 should be ₦6,000 ($\frac{2}{3} \times 9,000$).

This can be represented as follows:



\therefore Expense for the year = 5,000 + 7,500 + 8,500 + 6,000 accrued = 27,000

There are two ways of accounting for accruals at the end of an accounting period. These will be explained in turn.

2.2 Method1: the ‘two account’ approach for accrued expenses (accruals)

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The accrued expense is recorded in an accrued expenses account. The double entry for this adjustment is as follows



Illustration: Accruals using two accounts.

	Debit	Credit
Expense account	X	
Accruals account		X

This adds the accrued expense to the expenses recognised as the result of having received invoices earlier in the current accounting period.

The credit balance on the accruals account is a liability, and is included in the statement of financial position as a current liability.



Example(continued):Year1

Payments in the year were:

	₦
30 April	5,000
31 July	7,500
31 October	8,500

The accrual for November and December Year 1 is ₦6,000 ($\frac{₦9,000 \times 2}{3}$)

Method 1: two account approach

Telephone expenses account		
Year 1	₦	
Bank	5,000	Statement of profit or loss
Bank	7,500	27,000
Bank	8,500	
Accrued expense (accruals account)	6,000	
	27,000	27,000

Accruals account		
Year 1	₦	₦
Closing balance c/d	6,000	Telephone expenses
	6,000	6,000
Year 2		
		Opening balance b/d
		6,000

The expense in the statement of profit or loss for Year 1 is ₦27,000 and the accrued expense of ₦6,000 is included in the statement of financial position as a current liability at the end of Year 1.

Reversal of the accrual

There is a complication. At the year end the expense account is cleared to the statement of profit or loss and there is a credit balance carried down on the accruals account.

Assume that the invoice that arrives in January is ₦9,500. The accounting system will record the following double entry:



Example: January invoice received

	Debit	Credit
Expense account	9,500	
Liability		9,500

However, an expense of ₦6,000 and a liability of ₦6,000 has already been recognised in respect of this invoice. If no further adjustment is made the 6,000 is being included twice.

There is a simple way to prevent this. The double entry that set up the accrual at the end of the last period is reversed:



Example: Reversal of the accrual (start of year 2)

The following double entry is processed at the start of year 2:

	Debit	Credit
Accruals account	6,000	
Expense account		6,000

This removes the accrual so that it is not counted twice as a liability and the balance on the expense account is adjusted down to the amount that has not yet been expensed for this invoiced.

Telephone expense account			
Year2			
Payables	9,500	Accruals(reversal)	6,000
Accruals			
Year2 (at start of the year)			
Telephone expense	6,000	Balance b/d	6,000

**Example: Year 2**

In Year 2, the telephone invoices are as follows:

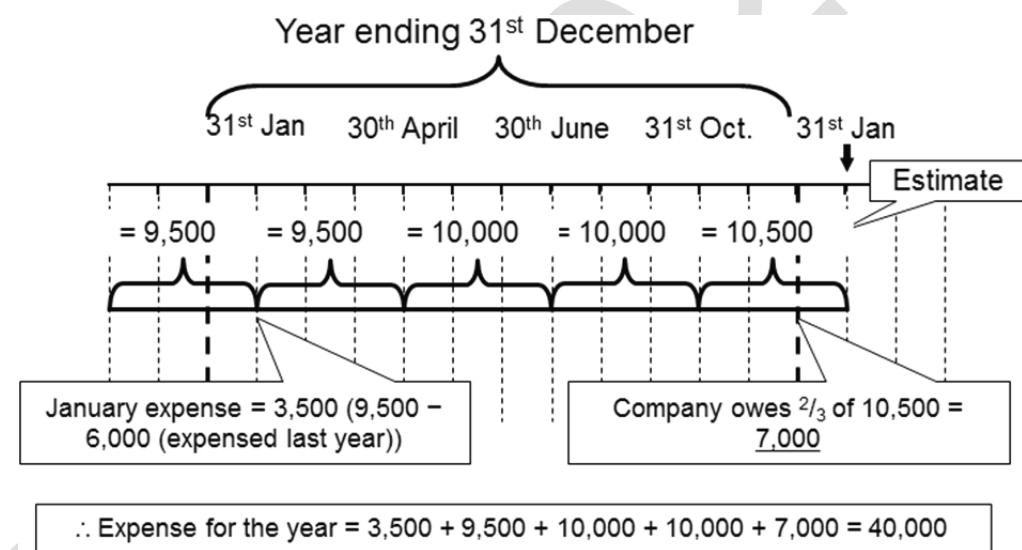
₦	
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be ₦10,500.

The accrual for November and December Year 1 should be ₦7,000 ($\text{₦}10,500 \times \frac{2}{3}$).

This can be represented as follows:





Example: Year 2

In Year2, the telephone invoices areas follows:

	₦
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be ₦10,500.

The accrual for November and December Year 1 should be ₦7,000 ($\frac{\text{₦10,500}}{3} \times 2/3$).

Method 1: two account approach

Telephone expenses account		
Year 2	₦	₦
Bank	9,500	Accruals account (reversal of year 1 accrual)
Bank	9,500	6,000
Bank	10,000	Statement of profit or loss
Bank	10,000	(balancing figure)
Accrued expense (accruals account)	7,000	40,000
	<u>46,000</u>	<u>46,000</u>

Accruals account		
Year 2	₦	₦
Telephone expense account(reversal of Year 1 accrual)	6,000	Opening balance b/d
Closing balance c/d	7,000	7,000
	<u>13,000</u>	<u>13,000</u>
		Opening balance b/d
		7,000

The expense in the statement of profit or loss for Year 2 is ₦40,000 and the accrued expense of ₦7,000 is included in the statement of financial position as a current liability at the end of Year2.

2.3 Method2: the ‘one account’ approach for accrued expenses (accruals)

This approach is trickier to understand. The accrual is recognised in the expense account.

There are two ways of achieving this.

- The total expense can be calculated and transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) leaving a balancing figure on the expense account as an accrual; or
- The accrual can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) as a balancing figure



Example: Year 1

Uche sets up in business on 1 January Year 1. The business has a 31 December year end.

The business acquired a telephone system on 1 February.

Telephone charges are paid every 3 months in arrears and telephone invoices received in Year 1 are as follows:

	₦
30 April	5,000
31 July	7,500
31 October	8,500

To calculate the telephone expenses for Year 1, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 2) is expected to be ₦9,000.

The accrual for November and December Year 1 should be ₦6,000 ($\frac{₦9,000 \times 2}{3}$).

Method 2: one account approach

Telephone expenses account

Year 1	₦	₦
Bank	5,000	Statement of profit or loss 27,000
Bank	7,500	
Bank	8,500	
Closing balance (accrued expense) c/d	6,000	
	<u>27,000</u>	<u>27,000</u>
		Opening balance b/d 6,000

In order to make the above work either:

- 1) Calculate the expense transferred to the statement of profit or loss (27,000) and calculate the accrual taken as a balancing figure; or
- 2) Calculate the accrual needed (6,000) and then calculate the expense transferred to the statement of profit or loss (27,000) as a balancing figure (6,000). This is usually the easiest way.

There is no need to reverse the accrual using the one account method as it is already in the expense account at the start of the next year.



Example (continued): Year 2

In Year 2, the telephone invoices are as follows:

	₦
31 January	9,500
30 April	9,500
31 July	10,000
31 October	10,000

To calculate the telephone expenses for Year 2, it is necessary to estimate the expense for November and December, and to make an accrual.

The next invoice (at the end of January Year 3) is expected to be ₦10,500.

The accrual for November and December Year 1 should be ₦7,000 ($\text{₦}10,500 \times \frac{2}{3}$).

Method 2: one account approach

Telephone expenses account

Year 2	₦		₦
Bank	9,500	Opening balance b/d	6,000
Bank	9,500	Statement of profit or loss	40,000
Bank	10,000		
Bank	10,000		
Closing balance (accrued expense) c/d	7,000		
	<hr/> 46,000		<hr/> 46,000
		Opening balance b/d	7,000

In order to make the above work either:

- 1) Calculate the expense transferred to the statement of profit or loss (40,000) and calculate the accrual taken as a balancing figure(7,000);or
- 2) Calculate the accrual needed (7,000) and then calculate the expense transferred to the statement of profit or loss (40,000) as a balancing figure. This is usually the easiest way.

Calculating the expense for the statement of profit or loss

Method 2 requires the calculation of either the closing accrual or the charge to the statement of profit or loss, the other number being taken as a balancing figure. **It is almost always easier to calculate the accrual.**

The amount charged to the statement of profit or loss can be calculated as follows. It is worth spending a little time trying to understand this.



Example: Charge to the statement of profit or loss

From first principles

	Year 1
January	0
February to April	5,000
May to July	7,500
August to October	8,500
November and December (accrual)	<u>6,000</u>
	<u>27,000</u>

	Year 2
November to January	9,500
Less amount already expensed last year for November and January	(6,000)
Therefore: January	3,500
February to April	9,500
May to July	10,000
August to October	10,000
November and December (accrual)	<u>7,000</u>
	<u>40,000</u>

In fact, what is going on above can be represented by the following:



Illustration:

	₦
Invoices/payments for the year	X
+ Closing accrued expense	<u>X</u>
	X
- Opening accrued expense	<u>(X)</u>
= Expense for the year	<u>X</u>

**Example:****Invoices/payments for the year:**

	Year 1	Year 2
January	0	9,500
February to April	5,000	9,500
May to July	7,500	10,000
August to October	8,500	10,000
+ Closing accrued expense	<u>6,000</u>	<u>7,000</u>
	27,000	46,000
- Opening accrued expense	<u>0</u>	<u>(6,000)</u>
= Expense for the year	<u>27,000</u>	<u>40,000</u>

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3 PREPAYMENTS

Section overview

- Prepayments (prepaid expenses)
- Method 1: the 'two accounts' method
- Method 2: the 'one account' method
- Prepaid expenses: calculating the expense for the statement of profit or loss

3.1 Prepayments (prepaid expenses)

Prepaid expenses are expenses that are recorded in the accounts in the current period, because a purchase invoice has been received or a payment has been made, but all or part of the expense relates to a future accounting period.

Prepaid expenses occur whenever payments are made in advance for an expense item.

To apply the accruals basis of accounting, the expenses that have been recorded in the accounts but that relate to a future accounting period should be:

- excluded from the expenses in the statement of profit or loss for the current year and recognised as an asset (a prepayment) at the year-end; and then
- included in the expenses for the next financial period (which is the period to which they relate).

Example: Year 1



Moses setup in business on January 1, Year 1 preparing financial statements to December 31, each year.

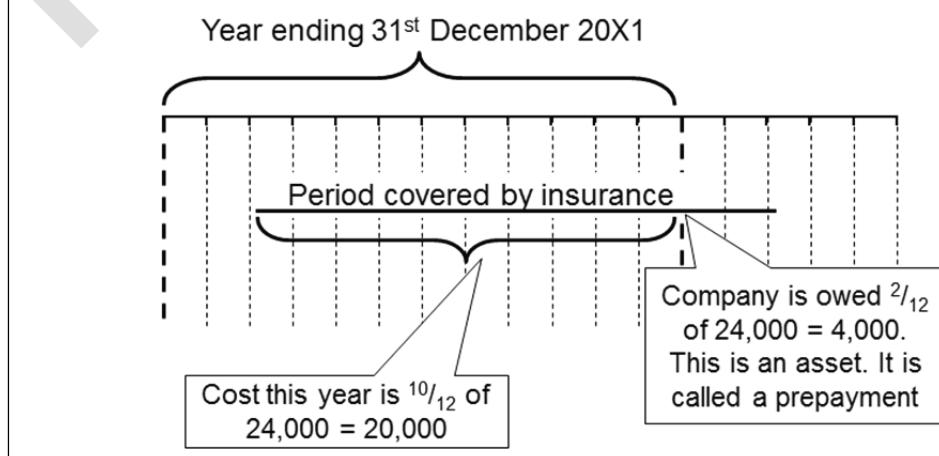
On March 1, he obtains annual insurance on his office building, starting from March 1, at cost of ₦24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of profit or loss for insurance in Year 1 should therefore be ₦20,000 ($\text{₦}24,000 \times \frac{10}{12}$).

The prepaid expense for Year 2 is ₦4,000 ($\text{₦}24,000 \times \frac{2}{12}$).

This can be represented as follows:



There are two ways of accounting for prepayments at the end of an accounting period. These will be explained in turn.

3.2 Method 1: the ‘two accounts’ method

This is the easier approach. Also note that it is the method used in computerised accounting systems.

The prepayment is estimated and then transferred from the expense account to a prepayment account:



Illustration: Prepayment using two accounts.

	Debit	Credit
Prepayment account (an asset)	X	
Expense account		X

The prepayment is a credit entry in the expense account therefore reducing the expense recognised in the current period.

The debit balance on the prepayments account is included in the statement of financial position as a current asset.

**Example: Year 1**

Moses sets up in business on January 1, Year 1 preparing financial statements to December 31, each year.

On March 1, he obtains annual insurance on his office building, starting from March 1, at cost of ₦24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of profit or loss for insurance in Year 1 should therefore be ₦20,000 ($\text{₦}24,000 \times 10/12$).

The prepaid expense for Year 2 is ₦4,000 ($\text{₦}24,000 \times 2/12$).

Method 1: two accounts approach

Insurance expense			
Year 1	₦		₦
Bank	24,000	Prepayments	4,000
	<hr/>	Statement of profit or loss	20,000
	<hr/>		<hr/>
	24,000		24,000

Prepayments account			
Year 1	₦		₦
Insurance expense	4,000	Closing balance c/d	4,000
	<hr/>		<hr/>
	4,000		4,000
Opening balance b/d	<hr/>		<hr/>
	4,000		4,000

Reversal of the prepayment

At the beginning of the next accounting period, the balance in the prepayments account is transferred back to the expense account so that it will be recognised as an expense in the next accounting period.



Example (continued): Reversal of the prepayment (at the start of year 2)

The following double entry is processed at the start of year 2:

Debit	Credit
Insurance expense	4,000
Prepayments	4,000

This reinstates the prepayment as an expense that relates to the second year.

Insurance expense	
Year 2	
Prepayments (reversal)	4,000
Prepayments	
Year 2 (at start of the year)	
Balance b/d	4,000
	Insurance expense
	4,000

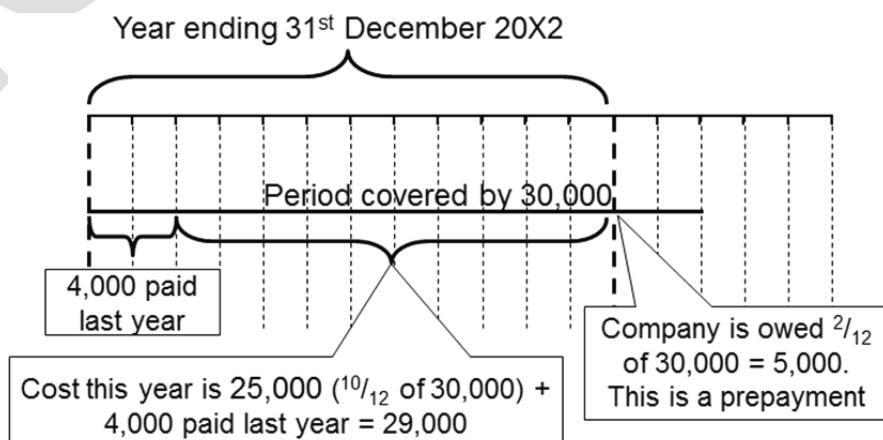


Example (continued): Year 2

In Year 2, the annual insurance premium payable on March 1, is ₦30,000 for the year to February 28, Year 3.

The prepaid expense at the end of Year 2 is therefore ₦5,000 ($\frac{2}{12}$ of ₦30,000) and the insurance expense in Year 2 is accounted for as follows:

This can be represented as follows:



**Example (continued): Year 2**

In Year 2, the annual insurance premium payable on March 1, is ₦30,000 for the year to February 28, Year 3.

The prepaid expense at the end of Year 2 is therefore ₦5,000 ($\text{₦}30,000 \times 2/12$) and the insurance expense in Year 2 is accounted for as follows:

Method 1: 'two accounts' approach

Insurance expense		
Year 2	₦	
Prepayments	4,000	Prepayments
Bank	30,000	Statement of profit or loss (balancing figure)
	<u>34,000</u>	<u>29,000</u>
		<u>34,000</u>
Year 3		
Prepayments (reversal)	5,000	

Prepayments		
Year 2	₦	
Opening balance b/d	4,000	Insurance expenses
Insurance expenses account	5,000	4,000
	<u>9,000</u>	<u>5,000</u>
		<u>9,000</u>
Year 3		
Opening balance b/d	5,000	Insurance expenses (reversal)
		5,000

The expense in the statement of profit or loss is ₦29,000.

This consists of the prepayment at the beginning of the year (₦4,000 for January and February) plus the expense for the 10 months from March to December ($(\text{₦}30,000 \times 10/12) = \text{₦}25,000$).

The prepaid expense of ₦5,000 at the end of Year 2 is included in the statement of financial position as a current asset.

3.3 Method2: the ‘one account’ method

This approach is trickier to understand. The prepayment is recognised in the expense account.

There are two ways of achieving this.

- The total expense can be calculated and transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) leaving a balancing figure on the expense account as a prepayment; or
- The prepayment can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Statement of profit or loss; Cr Expense account) as a balancing figure.



Example: Year 1

Moses sets up in business on January 1, Year 1 preparing financial statements to December 31, each year..

On March 1, he obtains annual insurance on his office building, starting from March 1, at cost of ₦24,000, payable annually in advance.

10 months of the insurance cost relates to the current financial period (Year 1) and 2 months of it relates to insurance in the next financial year (January and February Year 2).

The charge to the statement of profit or loss for insurance in Year 1 should therefore be ₦20,000 ($\text{₦}24,000 \times \frac{10}{12}$).

The prepaid expense for Year 2 is ₦4,000 ($\text{₦}24,000 \times \frac{2}{12}$).

Method 2: one account approach

Insurance expenses		
Year1		
Bank	₦ 24,000	Statement of profit or loss 20,000
	<hr/>	<hr/>
	24,000	4,000
Year 2		<hr/>
Opening balance b/d	4,000	24,000

The expense in the statement of profit or loss is ₦20,000 and the prepaid expense is included in the statement of financial position as a current asset at the end of Year 1.

There is no need to reverse the prepayment using the one account method as it is already in the expense account at the start of the next year.



Example (continued): Year 2

In Year 2, the annual insurance premium payable on March 1, is ₦30,000 for the year to February 28, Year 3.

The prepaid expense at the end of Year 2 is therefore ₦5,000 ($\text{₦}30,000 \times \frac{2}{12}$) and the insurance expense in Year 2 is accounted for as follows:

Method 2: 'one account' approach

Insurance expenses		
	₦	₦
Year 2		
Opening balance b/d	4,000	Statement of profit or loss
Bank	30,000	(balancing figure)
	<hr/> 34,000	29,000
Year 3		Closing balance c/d
Opening balance b/d	5,000	5,000
	<hr/>	<hr/> 34,000

3.4 Prepaid expenses: calculating the expense for the statement of profit or loss

Method 2 requires the calculation of either the closing prepayment or the charge to the statement of profit or loss, the other number being taken as a balancing figure. **It is almost always easier to calculate the prepayment.**

The amount charged to the statement of profit or loss can be calculated as follows. It is worth spending a little time trying to understand this.



Example: Charge to the statement of profit or loss

		Year 1
January, February		0
March to December:		
$\frac{10}{12}$ of 24,000		<u>20,000</u>
		<u>20,000</u>
		Year 2
January, February:		
$\frac{2}{12}$ of 24,000		4,000
March to December:		
$\frac{10}{12}$ of 30,000		<u>25,000</u>
		<u>29,000</u>

The expense may also be calculated as follows:



Illustration:

	₦
Invoices/payments for the year	X
+ Opening prepaid expense	<u>X</u>
	X
- Closing prepaid expense	<u>(X)</u>
= Expense for the year	<u>X</u>



Example:

	₦	₦
Invoices/payments for the year	24,000	30,000
+ Opening prepaid expense	<u>0</u>	<u>4,000</u>
	24,000	34,000
- Closing prepaid expense	<u>(4,000)</u>	<u>(5,000)</u>
= Expense for the year	<u>20,000</u>	<u>29,000</u>

4 UNEARNED AND ACCRUED INCOME

Section overview

- Introduction
- Unearned income
- Accrued income

4.1 Introduction

A business may have miscellaneous forms of income, for example, from renting out property.

When a business entity has income from sources where payments are made in advance or in arrears. The accruals basis of accounting applies, and the amount of income to include in the statement of profit or loss for a period is the amount of income that relates to that period. It may therefore be necessary to apportion income on a time basis and there may be unearned income or accrued income to account for.

Unearned income or income received in advance

This is where a business has received income in advance. For example, a business might rent out a property for which the tenant must pay in advance.

Only the income that relates to the period is recognised in the statement of profit or loss and the balance is recognised as a liability of the business. (Note that it is an asset of the tenant).

Accrued income

This is where a business receives income in arrears.

For example, a business might rent out a property for which the tenant must pay in arrears. The tenant might owe the business money at the business's year-end.

All of the income that relates to the period must be recognised in the statement of profit or loss. It is necessary to recognise the amount owed to the business as an asset at the year-end.

4.2 Unearned income or income received in advance

The method of calculating income for the year when there is unearned income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.



Example: Unearned income or income received in advance

A business rents out a part of its premises.

The rent is payable every six months, on May 1, and November 1, in advance. The company has a year end of December 31.

The annual rental for the year to April 30, 2019 was ₦48,000 (received in two amounts of ₦24,000 on May 1, 2018 and ₦24,000 on November 1, 2018).

The annual rental for the year to April 30, 2020 was ₦60,000 (received in two amounts of ₦30,000 on May 1, 2019 and ₦30,000 on November 1, 2019).

Income for the year ending December 31, 2019 is:

For the 4 months January 1, – April 30, 2019:	₦
$\frac{4}{12} \times ₦48,000$	16,000
For the 8 months May 1, – December 31, 2019:	
$\frac{8}{12} \times ₦60,000$	40,000
Rental income for the year to December 31, 2019	<u>56,000</u>

At December 31, 2018 there was unearned rental income for the period January 1, – April 30, 2019.

The amount of unearned income is $\frac{4}{12}$ of the ₦24,000 received on November 1, 2018 which came to ₦16,000. (This represents 4 months at ₦4,000 per month)

This was included as a current liability in the statement of financial position as at the end of the last financial year.

At December 31, 2019 there is unearned rental income for the period January 1, – April 30, 2020.

The amount of unearned income is $\frac{4}{12}$ of the ₦30,000 received on November 1, 2019 which comes to ₦20,000. (This represents 4 months at ₦5,000 per month)

This is recognised as a current liability as at the end of the financial year.

Unearned income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used the closing unearned income liability must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: 'Two accounts' method

Income has been paid to the business but some of it relates to the next period. This amount must be transferred from the income account to a liability account

**Example: Unearned income**

	Debit	Credit
Income	X	
Unearned income (liability)		X

**Example (continued): Unearned income**

The double entry is as follows:

Rental income		
	Unearned income (reversal of 2018 unearned income)	16,000
	Cash (May 1, 2019)	30,000
Unearned income (to be recognised in 2020)	20,000	
Statement of profit or loss	56,000	
	76,000	76,000

Unearned income		
	Balance b/d (at January 1, 2019)	16,000
Rental income (reversal of 2018 unearned income)	16,000	
Balance c/d	20,000	Rental income
	36,000	20,000
		36,000
		Balance b/d
		20,000

Method 2: 'One account' method

The unearned income is brought down as a liability on the income account.

There are two ways of achieving this.

- The total income for the period can be calculated and transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) leaving a balancing figure on the expense account as the unearned income liability; or
- The unearned income liability can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) as a balancing figure



Example (continued): Unearned income (One account approach)

The double entry is as follows:

Rental income		
	Balance b/d	16,000
	Cash (May 1, 2019)	30,000
Statement of profit or loss		
	56,000	Cash (November 1, 2019) 30,000
Balance c/d	20,000	
	76,000	76,000
		Balance b/d
		20,000

4.3 Accrued income

The method of calculating income for the year when there is accrued income is the same in principle as the method of calculating an expense for the year when there is an accrued charge or a prepaid expense.



Example: Accrued income

A business rents out a part of its premises.

Rentals are payable each quarter in arrears on January 31, April 30, July 31 and October 31.

The company has a year end of December 31.

The annual rental was ₦30,000 per year until October 31, 2019 (or ₦2,500 per month received in 4 amounts of ₦7,500 on January 31, April 30, July 31 and October 31).

The annual rental was increased to ₦36,000 per year from November 1, 2019 (or ₦3,000 per month received in 4 amounts of ₦9,000 on January 31, April 30, July 31 and October 31).

Income for the year ending December 31, 2019 is:

For the 10 months January 1, – October 31, 2019:	₦
$\frac{10}{12} \times ₦30,000$	25,000
For the 2 months November 1, – December 31, 2019:	<hr/>
$\frac{2}{12} \times ₦36,000$	6,000
Rental income for the year to December 31	<hr/> 31,000

At December 31, 2018 there was rental earned but not yet received.

This is the rental income for November and December 2018, which will not be received until January 31, 2019.

The amount of the accrued income is ₦5,000 ($\frac{2}{3}$ of 7,500 or 2 months at ₦2,500 per month) and was included in last year's income and recognised as a current asset at the end of last year financial year.

At December 31, 2019 there is rental earned but not yet received.

This is the rental income for November and December 2019, which will not be received until January 31, 2020.

The amount of the accrued income is ₦6,000 ($\frac{2}{3}$ of ₦9,000 or 2 months at ₦3,000 per month) and is included in income and recognised as a current asset at the end of the financial year.

Accrued income (just as for prepayments and accruals) can be accounted for using either one or two accounts to record the transactions. If two accounts are used, the closing accrued income asset must be reversed to the income account at the start of the next period (just as is the case for prepayments and accruals).

Method 1: 'Two accounts' method

Income has been earned in the current period. This amount must be recognised.

**Example: Accrued income**

	Debit	Credit
Accrued income (asset)	X	
Income		X

**Example (continued): Accrued income**

The double entry is as follows:

Rental income		
Accrued income (reversal of 2018 accrued income)	₦ 5,000	₦
		Cash (31 January 2019) 7,500
		Cash (30 April 2019) 7,500
		Cash (31 July 2019) 7,500
		Cash (31 October 2019) 7,500
		Accrued income (for November and December 2019) 6,000
Statement of profit or loss	31,000	36,000
	<u>36,000</u>	<u>36,000</u>
Accrued income		
Balance b/d (at January 1, 2019)	5,000	
Rental income	6,000	Rental income (reversal of 2018 accrued income) 5,000
	<u>11,000</u>	Balance c/d 6,000
Balance b/d	6,000	<u>11,000</u>

Method 2: 'One account' method

The accrued income is brought down as an asset on the income account.

There are two ways of achieving this.

- The total income for the period can be calculated and transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) leaving a balancing figure on the expense account as the accrued income asset; or
- The accrued income asset can be calculated and recognised in the expense account leaving the amount transferred to the statement of profit or loss (Dr Income account; Cr Statement of profit or loss) as a balancing figure



Example (continued): Accrued income (One account approach)

The double entry is as follows:

Rental income			
	₦		₦
Balance b/d	5000	Cash (31 January 2019)	7,500
		Cash (30 April 2019)	7,500
		Cash (31 July 2019)	7,500
Statement of profit or loss	31,000	Cash (31 October 2019)	7,500
		Balance c/d	6,000
	36,000		36,000
Balance b/d	6,000		

5 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain the meaning of an accrual
- Account for accruals using both methods
- Explain the meaning of a prepayment
- Account for prepayments using both methods
- Explain the meaning accrued and unearned income
- Account for accrued and unearned income

ICAN 2021

Inventory

Contents

- 1 End-of-year adjustments for inventory
- 2 Measurement of inventory
- 3 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

F	Financial statements (continued)	
	3	Accounting for inventories (IAS 2)
	a	Explain the nature of inventories.
	b	Explain IAS 2 requirements for valuation of inventories.
	c	Explain the elements of cost of inventories.
	d	Explain the valuation and recognition of inventories on the basis of lower of cost and net realisable value.
	e	Explain and measure the value of inventory using first-in-first-out (FIFO) and weighted average cost (WAC).
	f	Explain the impact of various valuation methods on the profit or loss for a period.
	g	Explain the adjustment of opening and closing values of inventory in the financial statements.
	h	Explain the use of periodic and perpetual inventory methods.

IAS 2: Inventories is an examinable document.

Exam context

This chapter explains how inventory is accounted for. It covers both double entry and measurement.

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

- Explain periodic and perpetual inventory systems
- Post inventory entries at the end of the period in case of periodic inventory system.
- Measure inventory at the lower of cost and net realisable value
- Measure cost of inventory using cost formulas

1 END-OF-YEAR ADJUSTMENTS FOR INVENTORY

Section overview

- Recording inventory
- Periodic inventory method (period-end method): accounting procedures
- Perpetual inventory method: accounting procedures
- Summary of journal entries under each system

1.1 Recording inventory

In order to prepare a statement of profit or loss it is necessary to be able to calculate gross profit. This is done by comparing the sale proceeds from the sale of items of inventory to the cost of those items. This is an application of the accruals concept (matching principle).

In order to calculate gross profit it is necessary to record opening inventory, purchases and closing inventory.

There are two main methods of recording inventory.

- Periodic inventory method (period end system)
- Perpetual inventory system

Each method uses a ledger account for inventory but these have different roles.

A question on year-end adjustments for inventories will normally require you to use the periodic inventory method but the perpetual inventory system is examinable in its own right.

1.2 Periodic inventory method (period – end method): accounting procedures

This system is based on the use of two ledger accounts:

- Purchases account which is used to record all purchases during the year; and
- Inventory account which is used to record the value of inventory at the beginning/end of the financial year.

It operates as follows:

Year 1

A business starts on 1 January Year 1. This business has no opening inventory. All inventory purchased in the year to 31 December Year 1 is recorded in the purchases account.



Illustration: Purchases through the year

	Debit	Credit
Purchases	X	
Cash or liabilities		X

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year.

This is transferred to cost of sales clearing the purchases account to zero.



Illustration: Year end transfer to cost of sales

	Debit	Credit
Cost of sales		X
Purchases		X

At the end of the year cost of sales must be calculated. Purchases are not the same as cost of sales because the company still holds some of the items that it purchased.

The number of items of inventory still held is established through an inventory count. This involves the staff of the business counting every item of inventory and making a record of this. The inventory is then valued (usually at cost). This figure is the closing inventory.

It is recognised as an asset on the statement of financial position and as a credit entry on the statement of profit or loss (where it reduces the cost of sales expense).



Illustration: Closing inventory double entry

	Debit	Credit
Inventory (statement of financial position)		X
Cost of sales (Statement of profit or loss)		X

The exact location of the credit entry might be to one of several accounts but ultimately it always achieves the same purpose, that is, to reduce cost of sales. Thus it might be a credit to a statement of profit or loss inventory account (which is later transferred to a cost of sales account) or it might be a credit to the cost of sales account.

At the end of year 1 the purchases and the credit entry for closing inventory form part of the profit for the period. The debit entry for closing inventory is carried down into year 2 as an asset.

Year 2

The closing inventory in year 1 becomes the opening inventory in year 2

All inventory purchased in the year to 31 December Year 2 is recorded in the purchases account.

At the end of the year a trial balance is extracted. One of the balances in the trial balance is the purchases figure for the year. Another of the balances is the opening inventory which has been there since the start of the year.

The purchases together with the opening inventory are what the business could have sold in the period. These are both transferred to the cost of sales.

**Illustration: Year end transfer to cost of sales**

	Debit	Credit
Cost of sales	X	
Purchases		X
Cost of sales		X
Inventory(statement of financial position)		X

Note: that this is the transfer of the opening inventory to cost of sales)

At the end of the financial year, the closing inventory is physically counted and valued. The closing inventory double entry is then processed.

**Illustration: Closing inventory double entry**

	Debit	Credit
Inventory (statement of financial position)	X	
Cost of sales (Statement of profit or loss)		X

In summary

Opening inventory in the trial balance (a debit balance) and purchases (a debit balance) are both transferred to cost of sales.

Illustration: Carrying amount of a non-current asset

	₦
Non-current asset at cost	X
Less accumulated depreciation	(X)
Carrying amount (net book value)	X

This figure appears on the face of the statement of financial position

This clears both accounts.

Closing inventory is recognised in the inventory account as an asset (a debit balance) and the other side of the entry is a credit to cost of sales.

Cost of sales comprises purchase in the period adjusted for movements in inventory level from the start to the end of the period.

**Illustration: Cost of sales**

	Year 1	Year 2
	₦	₦
Opening inventory (a debit)	—	X
Purchases (a debit)	X	X
	<hr/>	<hr/>
Closing inventory (a credit)	X	X
	<hr/>	<hr/>
Cost of sales	(X)	(X)
	<hr/>	<hr/>
	X	X

**Example:**

Port Harcourt Trading had opening inventory of ₦10,000.

Purchases during the year were ₦30,000.

Closing inventory at the end of Year 2 was ₦12,000.

At the year end, the following entries are necessary

Purchases account

	₦		₦
Balance b/d	30,000	(1) Cost of sales	30,000

Inventory account

	₦		₦
Balance b/d	10,000	(2) Cost of sales	10,000
(3) Cost of sales	12,000	Removal of opening inventory	
Recognition of closing inventory	12,000		
	<u>22,000</u>		<u>12,000</u>
Opening balance b/d	12,000		<u>22,000</u>

Cost of sales

	₦		₦
(1) Purchases	30,000		
(2) Opening inventory	10,000		
	<u>40,000</u>		
Cost of sales b/f	28,000		

The cost of sales total is then transferred to the statement of profit or loss.

The cost of sales is part of the statement of profit or loss and can be presented as follows:

	₦	₦
Sales		X
Opening inventory	10,000	
Purchases	30,000	
	<u>40,000</u>	
Closing inventory	(12,000)	
Cost of sales		(28,000)
Gross profit		<u>X</u>

Remember the following:

- In a period-end system of accounting for inventory, the double entries are between the inventory account and the statement of profit or loss.
- The cost of opening inventory is included in the cost of sales. It is an expense, and expense is a debit entry. So debit the statement of profit or loss (and credit the inventory account) with the cost of the opening inventory.
- The cost of closing inventory is included in the statement of financial position as an asset, so there must be a debit balance for the closing inventory. So debit Inventory (and credit Statement of profit or loss) with the valuation of the closing inventory.



Practice questions

1

The following trial balance has been extracted from the ledger of Kaduna Market Traders at June 30, 2019.

	Debit	Credit
Salaries	₦000	₦000
Drawings	10,500	
Lighting and heating	3,000	
Sales		500
Trade receivables	30,000	
Rent	10,000	
Office expenses	2,000	
Capital at 1 July 2018		1,000
Purchases	27,500	
Inventory at 1 July 2018	14,000	
Trade payables		2,000
Property, plant and machinery	4,000	
Cash	17,500	
	1,000	
	<u>61,500</u>	<u>61,500</u>

Closing inventory at June 30, 2019 has been valued at ₦1,500,000.

Required

Prepare the statement of profit or loss for the year to June 30, Year 3 and the statement of financial position as at that date.

1.3 Perpetual inventory method: accounting procedures

A single account is used to record all inventory movements. The account is used to record purchases in the period and inventory is brought down on the account at each year-end. The account is also used to record all issues out of inventory. These issues constitute the cost of sales.

When the perpetual inventory method is used, a record is kept of all receipts of items into inventory (at cost) and all issues of inventory to cost of sales.

Each issue of inventory is given a cost, and the cost of the items issued is either the actual cost of the inventory (if it is practicable to establish the actual cost) or a cost obtained using a valuation method.

Each receipt and issue of inventory is recorded in the inventory account. This means that a purchases account becomes unnecessary, because all purchases are recorded in the inventory account.

All transactions involving the receipt or issue of inventory must be recorded, and at any time, the balance on the inventory account should be the value of inventory currently held.



balanceExample:

Port Harcourt Trading had opening inventory of ₦10,000.

Purchases during the year were ₦30,000.

Closing inventory at the end of Year 2 was ₦12,000.

The following entries are necessary during the period.

Inventory account		
	₦	₦
versa) Balance b/d	10,000	Cost of sales
Cash or creditors (purchases in the year)	30,000	28,000
	<hr/> 40,000	<hr/> 12,000
Opening balance b/d	12,000	<hr/> 40,000

Furthermore, all transactions involving any kind of adjustment to the cost of inventory must be recorded in the inventory account.



Example:

Ibadan Retail (IR) had opening inventory of ₦100,000.

Purchases during the year were ₦500,000. Inventory with a cost of ₦18,000 was returned to a supplier. One of the purchases in the above amount was subject to an express delivery fee which cost the company an extra ₦15,000 in addition to the above amount.

IR sold goods during the year which had cost ₦520,000. Goods which had cost ₦20,000 were returned to the company.

Just before the year end goods which had cost ₦5,000 were found to have been damaged whilst being handled by IR's staff.

The following entries are necessary during the period.

Inventory account			
	₦	₦	
Balance b/d	100,000		
Cash or creditors (purchases in the year)	500,000	Returns to supplier	18,000
Special freight charge	15,000		
Returns from customers	20,000	Cost of goods sold	500,000
	<hr/> 635,000	Normal loss	5,000
Opening balance b/d	112,000	Closing balance c/d	112,000
	<hr/> 635,000		<hr/> 635,000

1.4 Summary of journal entries under each system

Entry	Periodic inventory method	Perpetual inventory method
Opening inventory	Closing inventory as measured and recognised brought forward from last period.	Closing balance on the inventory account as at the end of the previous period
Purchase of inventory	Dr Purchases Cr Payables/cash	Dr Inventory Cr Payables/cash
Freight paid	Dr Carriage inwards Cr Payables/cash	Dr Inventory Cr Payables/cash
Return of inventory to supplier	Dr Payables Cr Purchase returns	Dr Payables Cr Inventory
Sale of inventory	Dr Receivables Cr Sales	Dr Receivables Cr Sales and Dr Cost of goods sold Cr Inventory
Return of goods by a supplier	Dr Sales returns Cr Receivables	Dr Sales returns Cr Receivables and Dr Inventory Cr Cost of goods sold
Normal loss	No double entry	Dr Cost of goods sold Cr Inventory
Abnormal loss	Dr Abnormal loss Cr Purchases	Dr Abnormal loss Cr Inventory
Closing inventory	Counted, valued and recognised by: Dr Inventory (statement of financial position) Cr Cost of sales (Cost of goods sold)	Balance on the inventory account

2 MEASUREMENT OF INVENTORY

Section overview

- Introduction
- Cost of inventory
- Net realisable value
- Cost formulas
- Inventory and drawings

2.1 Introduction

Rules on accounting for inventory are set out in **IAS 2: Inventories**.

Basic rule

The valuation of inventory can be extremely important for financial reporting, because the valuation affects cost of sales, profit and total asset values in the statement of financial position.

Inventory must be measured in the financial statements at the **lower** of:

- cost; and
- net realisable value(NRV).

2.2 Cost of inventory

IAS2 states that 'the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.

Purchase cost

The **purchase cost** of inventory will consist of the following:

- the purchase price
- plus import duties and other non-recoverable taxes (but excluding recoverable sales tax)
- plus transport, handling and other costs directly attributable to the purchase (carriage inwards), if these costs are additional to the purchase price.

The purchase price **excludes** any settlement discounts, and is the cost after deduction of trade discount.



Example: Purchase cost I

Kumo Consumer Electrics (KCE) buys goods from an overseas supplier.

It has recently taken delivery of 1,000 units of component X.

The quoted price of component X was ₦1,200 per unit but KCE has negotiated a trade discount of 5% due to the size of the order.

The supplier offers an early settlement discount of 2% for payment within 30 days and KCE intends to achieve this.

Import duties of ₦60 per unit must be paid before the goods are released through custom.

Once the goods are released through customs KCE must pay a delivery cost of ₦5,000 to have the components taken to its warehouse.

Purchase price (1,000 × ₦1,200 × 95%)	₦	1,140,000
Import duties (1,000 × ₦60)	₦	60,000
Delivery cost	₦	5,000
Cost of inventory	<hr/>	<hr/> 1,205,000

The intention to take settlement discount is irrelevant.

Conversion costs

When materials purchased from suppliers are converted into another product in a manufacturing or assembly operation, there are also conversion costs to add to the purchase costs of the materials. Conversion costs must be included in the cost of finished goods and unfinished work in progress.

Conversion costs consist of:

- costs directly related to units of production, such as costs of direct labour (i.e. the cost of the labour employed to perform the conversion work)
- fixed and variable **production overheads**, which must be allocated to costs of items produced and closing inventories. (Fixed production overheads must be allocated to costs of finished output and closing inventories on the basis of the **normal production capacity** in the period)
- other costs incurred in bringing the inventories to their present location and condition.

You may not have studied cost and management accounting yet but you need to be aware of some of the costs that are included in production overheads (also known as factory overheads). Production overheads include:

- costs of indirect labour, including the salaries of the factory manager and factory supervisors
- depreciation costs of non-current assets used in production
- costs of carriage inwards, if these are not included in the purchase costs of the materials

Only production overheads are included in costs of finished goods inventories and work-in-progress. Administrative costs and selling and distribution costs must not be included in the cost of inventory.

Note that the process of allocating costs to units of production is usually called absorption. This is usually done by linking the total production overhead to some production variable, for example, time, wages, materials or simply the number of units expected to be made.



Example: Conversion costs

Kumo Consumer Electrics (KCE) manufactures control units for air conditioning systems.

The following information is relevant:

Each control unit requires the following:

1 component X at a cost of ₦1,205 each

1 component Y at a cost of ₦800 each

Sundry raw materials at a cost of

The company faces the following monthly expenses:

Factory rent	₦ 16,500
Energy cost	7,500
Selling and administrative costs	10,000

Each unit takes two hours to assemble. Production workers are paid ₦300 per hour.

Production overheads are absorbed into units of production using an hourly rate. The normal level of production per month is 1,000 hours.

The cost of a single control unit is as follows:

Materials:	₦
Component X	1,205
Component Y	800
Sundry raw materials	150
	2,155
Labour (2 hours × ₦300)	600
Production overhead ($\frac{₦16,500 + 7,500}{1,000 \text{ hours}} \times 2 \text{ hours}$)	48
	2,803

The selling and administrative costs are not part of the cost of inventory

2.3 Net realisable value



Definition: Net realisable value

Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Net realisable value is the amount that can be obtained from selling the inventory in the normal course of business, less any further costs that will be incurred in getting it ready for sale or disposal.

- Net realisable value is usually higher than cost. Inventory is therefore usually valued at cost.
- However, when inventory loses value, perhaps because it has been damaged or is now obsolete, net realisable value will be lower than cost.

The cost and net realisable value should be compared for each separately-identifiable item of inventory, or group of similar inventories, rather than for inventory in total.



Example: Lower of cost and net realisable value

A business has four items of inventory. A count of the inventory has established that the amounts of inventory currently held, at cost, are as follows:

	₦	₦	₦
	Cost	Sales price	Selling costs
Inventory item A1	8,000	7,800	500
Inventory item A2	14,000	18,000	200
Inventory item B1	16,000	17,000	200
Inventory item C1	6,000	7,500	150

The value of closing inventory in the financial statements:

	Lower of:	₦
A1	8,000 or (7,800 – 500)	7,300
A2	14,000 or (18,000 – 200)	14,000
B1	16,000 or (17,800 – 500)	16,000
C1	6,000 or (7,000 – 200)	6,000
Inventory valuation		43,300

2.4 Cost formulae

With some inventory items, particularly large and expensive items, it might be possible to recognise the actual cost of each item.

In practice, however, this is unusual because the task of identifying the actual cost for all inventory items is impossible because of the large numbers of such items.

A system is therefore needed for measuring the cost of inventory.

The historical cost of inventory is usually measured by one of the following methods:

- First in, first out (FIFO)
- Weighted average cost (AVCO)



Example:

On January 1, a company had an opening inventory of 100 units which cost ₦50 each.

During the month it made the following purchases:

April 5: 300 units at ₦60 each

July 14: 500 units at ₦70 each

October 22: 200 units at ₦80 each.

During the period it sold 800 units as follows: 9

May: 200 units

July 25: 200 units

November 23: 200 units

December 12: 200 units

This means that it has 300 units left ($100 + 300 + 500 + 200 - (200 + 200 + 200 + 200)$) but what did they cost?

There are various techniques that have been developed to answer this question.

The easiest of these is called FIFO (first in first out). This approach assumes that the first inventory sold is always the inventory that was bought on the earliest date. This means closing inventory is always assumed to be the most recent purchased.

In the above example a FIFO valuation would assume that the 300 items left were made up of the 200 bought on 22 October and 100 of those bought on July 14, giving a cost of ₦23,000 $\{(200 @ 80) + (100 @ 70)\}$

Each of these can be shown on an inventory ledger card as follows.

**Example: Inventory ledger card (FIFO)**

Date	Receipts			Issues			Balance		
	Qty	@	₦	Qty	@	₦	Qty	@	₦
Jan 1 b/f	100	50	5,000				100	50	5,000
Apr 5	300	60	18,000				300	60	18,000
							400	50/60	23,000
May 9				100	50	5,000	100	50	5,000
				100	60	6,000	100	60	6,000
				200	50/60	11,000	(200)	50/60	(11,000)
							200	60	12,000
Jul 14	500	70	35,000				500	70	35,000
Jul 25				200	60	12,000	(200)	60	12,000
							500	70	35,000
Oct 22	200	80	16,000				200	80	16,000
Nov 23				200	70	14,000	(200)	70	(14,000)
							500	70/80	37,000
Dec 12				200	70	14,000	(200)	70	(14,000)
	1,100		74,000	800			51,000	300	70/80
									23,000
Note: 1,100 minus 800 equals 300									
74,000 minus 51,000 equals 23,000									

The weighted average method calculates a new average cost per unit after each purchase. This is then used to measure the cost of all issues up until the next purchase.


Example: Inventory ledger card (weighted average method)

Date	Receipts			Issues			Balance		
	Qty	@	₦	Qty	@	₦	Qty	@	₦
Jan 1 b/f	100	50	5,000				100	50	5,000
Apr 5	300	60	18,000				300	60	18,000
							400	57.5	23,000
May 9				200	57.5	11,500	(200)	57.5	(11,500)
							200	57.5	11,500
Jul 14	500	70	35,000				500	70	35,000
							700	66.43	46,500
Jul 25				200	66.43	13,286	(200)	66.43	(13,286)
							500	66.43	33,214
Oct 22	200	80	16,000				200	80	16,000
							700	70.31	49,214
Nov 23				200	70.31	14,062	(200)	70.31	(14,062)
							500	70.31	35,152
Dec 12				200	70.31	14,062	(200)	70.31	(14,062)
	1,100		74,000	800			52,910	300	70/80
									21,090
Note: 1,100 minus 800 equals 300									
74,000 minus 52,910 equals 21,090									

2.5 Inventory and drawings

The owner of a sole trader business might decide to take some inventory for his or her personal use. For example, the owner of a local shop might take some of the goods bought for the shop and use them for personal consumption.

When this happens, it is important that the financial statements of the sole trader should provide a faithful representation of the financial performance of the business. In order to achieve this objective:

- Drawings by the business owner in the form of inventory should be accounted for as drawings (withdrawals of capital).
- The cost of sales should exclude the items taken by the owner as drawings.

Drawings of inventory might be common in small sole trader businesses, but are less common in bigger business entities, where stricter controls over inventory might be considered necessary. Small businesses normally use the period-end inventory system, and when the owner takes some inventory for personal use, the appropriate accounting entry in the main ledger is:



Illustration: Purchases through the year

	Debit	Credit
Drawings	X	
Purchases		X

The inventory taken by the owner is valued at cost (not selling price).

This accounting adjustment therefore reduces the total cost of purchases, so that the cost of sales will exclude the cost of the inventory taken.

If a perpetual inventory system is used, the appropriate accounting entry would be:



Illustration: Purchases through the year

	Debit	Credit
Drawings	X	
Inventory		X

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain periodic and perpetual inventory systems
- Post inventory entries at the end of the period in case of periodic inventory system.
- Measure inventory at the lower of cost and net realisable value
- Measure cost of inventory using cost formulas

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SOLUTIONS TO PRACTICE QUESTIONS

Solution

1

Kaduna Market Traders: Income statement for the year to June 30, 2019

	₦000	₦000
Sales		30,000
Opening inventory	2,000	
Purchases	14,000	
	<u>16,000</u>	
Less: Closing inventory	(1,500)	
Cost of sales		(14,500)
Gross profit		15,500
Expenses:		
Salaries	10,500	
Lighting and heating	500	
Rent	2,000	
Office expenses	1,000	
	<u>(14,000)</u>	
Net profit		1,500

Kaduna Market Traders: Statement of financial position as at June 30, 2019

	₦000	₦000
Non-current assets		
Property, plant and machinery		17,500
Current assets		
Inventory	1,500	
Trade receivables	10,000	
Cash	1,000	
	<u>12,500</u>	
Total assets		30,000
Equity and liabilities		
Capital at July 1, 2018		27,500
Net profit for the year		1,500
	<u>29,000</u>	
Less: Drawings		(3,000)
Capital at June 30, 2019		26,000
Current liabilities		
Trade payables		4,000
Total equity and liabilities		30,000

Control accounts and control account reconciliations

Contents

- 1 Receivables control accounts and receivables control account reconciliations
- 2 Payables control accounts and payables control account reconciliations
- 3 Supplier statements: reconciliation with ledger account
- 4 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

C Reconciliation in financial accounting	
2 Control accounts and reconciliations	
a	Explain the use of receivables control account.
b	Explain the receivables control account reconciliation.
c	Explain the use of payables control account.
d	Explain the payables control account reconciliation.
e	Explain the purpose of suppliers' statements and their reconciliation with the ledgers.

Exam context

This chapter explains the use of reconciliations to identify processing errors in the sales and purchases systems.

It also explains how balances generated by the accounting system might be reconciled to external statements.

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

- Understand the relationship between control accounts and subsidiary ledger for accounts receivable and accounts payable.
- Prepare control accounts and corresponding subsidiary ledger from information provided.
- Perform control account reconciliation for accounts receivable and accounts payable.
- Identify errors and correct errors from control account reconciliations

1 RECEIVABLES CONTROL ACCOUNTS AND RECEIVABLES CONTROL ACCOUNT RECONCILIATIONS

Section overview

- Receivables control accounts
- Receivables control account reconciliations

1.1 Receivables control account

Chapter 5 explained that sales and purchases transactions are recorded in day books. The totals from the day books are posted to control accounts in the general ledger. These are supported by a separate record which is a list of individual balances that comprise the total in the general ledger.

A control account is an account which represents a total value of a number of separate balances.

The receivables control account

The receivables control account is an account for recording the value of transactions in total with credit customers. The balance on the receivables control account (debit balance) is the total amount currently owed by all customers.

The receivables control account will contain some or all of the totals to date for all of the following postings to the account.



Illustration: Receivables control account

Receivables control account		
Balance b/d	X	Cash X
Sales	X	Sales returns X
Dishonoured cheques	X	Bad debts X
Revenue adjustment (Customer fails to take a discount when expected to do so)	X	Revenue adjustment (Customer takes a discount when not expected to do so) X
		Contra X
		Credit notes X
		Balance c/d X
Balance b/d	X	X

There must also be individual accounts for each credit customer in a separate receivables ledger.

1.2 Receivables control account reconciliation

Reconciliation means making sure that two figures or totals are consistent with each other and agree with each other. The control accounts in an accounting system can be used for control purposes, to make sure that transactions have been recorded correctly in the accounts.

This is because if the transactions have been recorded correctly the balance on the receivables control account in the general ledger should equal the total of the balances on all the individual customer accounts in the receivables ledger.

A reconciliation check can be made to make sure that these totals are the same. If they are different, the cause of the error (or errors) should be found and corrected.

A receivables control account reconciliation involves a comparison between the totals, looking for the reasons for any differences between them, and correcting errors that are discovered in the checking process.

Why might there be differences?

The balance on the receivables ledger control account might differ from the total of all the balances on the accounts in the receivables ledger for the following reasons:



Illustration: Possible errors

	Error	Correction
1	The total of the credit sales in the sales day book is correctly debited to the receivables control account but one of the individual transactions is not posted from the sales day book to the individual accounts in the receivables ledger.	Adjust the individual customer's
2	The total of cash received from customers, recorded in the cash book, has been posted correctly to the receivables ledger control account, but a receipt from a customer is not posted from the cash book to the individual accounts in the receivables ledger.	Adjust the individual customer's balance
3	The sales day book may be added up incorrectly so that the wrong amount is posted to the receivables ledger control but the individual accounts in the receivables ledger are correctly updated.	Adjust the receivables ledger control account in the general ledger.
4	A contra entry might be recorded in the general ledger but not in the receivables ledger (or vice versa).	Adjust the appropriate record for the missing entry

The errors described above do not result in differences in the total of debit and credit entries in the general ledger. Consequently, the existence of an error will not be discovered by preparing a trial balance.

However, these errors should be discovered by a control account reconciliation.

Preparing a receivables control account reconciliation

To make a control account reconciliation, the starting point is to compare the control account balance with the total of all the balances on the individual customer (receivables ledger) or supplier (payables ledger) accounts.

If the totals differ, the reasons for the difference need to be discovered. When the reasons are discovered, the errors must be corrected. A correction might involve:

- changing the control account balance; or
- changing one or more balances on individual customer or supplier accounts.

The two totals should be equal after all corrections have been made. If a difference still remains between the totals, this means that at least one error remains undetected.



Example: Receivables control account reconciliation

The balance on the receivables ledger control account in the general ledger of Entity Z is ₦53,690.

The balances on the customer accounts in the receivables ledger are as follows:

	₦
Customer A	12,000
Customer B	8,000
Customer C	6,000
Customer D	11,000
Customer E	<u>15,000</u>
	<u>52,000</u>

An investigation is carried out into the difference between the total account balances in the receivables ledger and the balance on the receivables control account.

- (1) A sale on credit of ₦1,700 to Customer A has not been recorded in the customer's account in the receivables ledger, but is included in the control account balance.
- (2) Customer B has supplied goods to Entity Z to the value of ₦400, and these have not yet been paid for by Entity Z. It has been agreed that this amount should be offset against the money owed to Entity Z by Customer B. No entries have yet been made for this 'contra' adjustment in the general ledger or the receivables and payables ledgers.
- (3) Sales returns of ₦550 by Customer C have been recorded in C's individual account in the receivables ledger, but the transaction was not posted to the general ledger.
- (4) Customer D took advantage of a nearly settlement discounts having ₦240. Entity Z had not expected Customer D to take the discount. This has been recorded in D's individual account in the receivables ledger, but the transaction was not posted to the general ledger.
- (5) Sales returns of ₦800 by Customer E have not been recorded in the customer's account in the receivables ledger, but are included in the control account balance.


Example: Receivables control account reconciliation

Receivables control account			
	₦	₦	
Balance b/d	53,690	(2) Contra entry	400
		(3) Sales returns	550
		(4) Discounts allowed	240
		Balance c/d	52,500
	53,690		53,690
Balance b/d	52,500		

The balances on the accounts in the receivables ledger in total are

Total balances in receivables ledger	52,000
(1) Sale (Customer A)	1,700
(2) Contra entry (Customer B)	(400)
(5) Sales returns (Customer E)	(800)
	52,500

The balances on the accounts in the receivables ledger would all be corrected and become:

Customer A: 12,000 + 1,700	13,700
Customer B: 8,000 - 400	7,600
Customer C	6,000
Customer D	11,000
Customer E: (15,000 – 800)	14,200
	52,500

**Practice question****1**

The balance on Yusuf's receivables ledger control account on 31 December was ₦3,800,000 which did not agree with the net total of the list of receivables ledger balances at that date.

The following errors were found:

- a) Debit balances in the receivables ledger, amounting to ₦103,000, had been omitted from the list of balances.
- b) A bad debt amounting to ₦400,000 had been written off in the receivables ledger but had not been posted to the bad debts expense account or entered in the control account.
- c) An item of goods sold to Eric, ₦250,000, had been entered once in the sales day book but posted to his account twice.
- d) Yusuf had expected Godwin to take advantage of a settlement discount of ₦25,000. Godwin did not settle the account in time to qualify for the discount. This has been recorded correctly in Godwin's own account but not entered in the general ledger.
- e) No entry had been made in the control account in respect of the transfer of a debit of ₦70,000 from Monday's account in the receivables ledger to his account in the payables ledger.
- f) The discount allowed column in the cash account had been undercast by ₦140,000.

Required:

Make the necessary adjustments in the receivables control account and bring down the corrected balance.

Show the adjustments to the net total of the original list of balances to reconcile with this amended balance.

2 PAYABLES CONTROL ACCOUNTS AND PAYABLES CONTROL ACCOUNT RECONCILIATIONS

Section overview

- The payables control account
 - Payables control account reconciliations

2.1 The payables control account

The payables control account is an account for recording the value of credit purchase transactions in total. The balance on the payables control account (credit balance) is the total amount currently owed to all suppliers.

There must also be individual accounts for each credit suppliers in a separate payables ledger.

The payables control account will contain some or all of the totals to date for all of the following postings to the account.



Illustration: Payables control account

Payables control account			
		Balance b/d	X
Cash	X	Purchases	X
Discounts received	X		
Purchase returns	X		
Contra	X		
Balance c/d	X		
	X		X
	X	Balance b/d	X

There must be individual accounts for each supplier in a separate payables ledger.

2.2 Payables control account reconciliation

A payables control account reconciliation involves a comparison between the totals on the payables control account and the list of balances in the payables ledger.

Why might there be differences?

The balance on the payables ledger control account might differ from the total of all the balances on the accounts in the payables ledger for the following reasons:



Illustration: Possible errors

	Error	Correction
1	The total of the credit purchases in the purchases day book is correctly credited to the payables control account but one of the individual transactions is not posted from the purchases day book to the individual accounts in the payables ledger.	Adjust the individual customer's balance
2	The total of cash paid to suppliers, recorded in the cashbook, has been posted correctly to the payables ledger control account, but a payment to a supplier is not posted from the cash book to the individual accounts in the payables ledger.	Adjust the individual customer's balance
3	The purchases day book may be added up incorrectly so that the wrong amount is posted to the payables ledger control but the individual accounts in the payables ledger are correctly updated.	Adjust the payables ledger control account in the general ledger.
4	A contra entry might be recorded in the general ledger but not in the payables ledger (or vice versa).	Adjust the appropriate record for the missing entry


Example: Payables control account reconciliation

The balance on the payables control account was ₦971,860 as at December 31. Balances extracted from the payables ledger on this date totaled ₦962,380.

- 1 The purchases day book was undercast by ₦60,000.
- 2 A cash account total of ₦108,580 was posted to the control account as ₦90,580.
- 3 A credit balance of ₦13,860 on the suppliers' ledger had been set off against a customer's ledger debit balance but no entry had been made in the control accounts.
- 4 A credit balance of ₦37,620 had been omitted from the list of balances.

Payables control account		
	₦	₦
(2) Cash error	18,000	Balance b/d 971,860
(3) Contra	13,860	(1) Purchase day book undercast 60,000
Balance c/d	<u>1,000,000</u>	
	<u>1,031,860</u>	<u>1,031,860</u>
		Balance b/d 1,000,000

The balances on the accounts in the receivables ledger in total are

	₦
Total balances in receivables ledger	962,380
(4) Omission of balance	37,620
	<u>1,000,000</u>

3 SUPPLIER STATEMENTS: RECONCILIATION WITH LEDGER ACCOUNT

Section overview

- Supplier statements
- Reconciliation of a statement with the supplier's ledger account

3.1 Supplier statements

It is common business practice for suppliers to send monthly statements to their regular credit customers, listing the transactions that have occurred between the supplier and the customer during the month (such as sales, sales returns, payments and settlement discounts given). The statement ends with a balance showing the amount that, according to the supplier's accounting records, the customer currently owes.

3.2 Reconciliation of a statement with the supplier's ledger account

On receiving a statement from a supplier, a reconciliation check can be carried out. The purpose of this check is to compare the transactions and balance shown on the supplier's statement with the transactions and balance in the supplier's account in the payables ledger.

Any differences between the statement balance and the ledger account balance should be investigated and explained. Any problems, including errors, should be dealt with.

Reasons for differences

There are various reasons why the statement balance from a supplier might differ from the balance on the payables ledger account for the supplier.

- The supplier might have omitted a transaction from the statement, in which case the supplier's accounting records are incorrect.
- The customer might have omitted a transaction from its accounting records, in which case the customer's accounting records are incorrect.

Transactions that might have been omitted include sales/purchase transactions, payments, discounts, contra entries and returns/credit notes.

Carrying out a reconciliation

To carry out a reconciliation between the balance on a supplier's statement and the balance on the supplier's ledger account in the customer's payables ledger, the following steps should be taken.

- Compare the two totals. If they differ, the reasons for the difference should be discovered.
- The reasons for the difference can be identified fairly easily, by comparing the transactions listed in the supplier's statement with the transactions recorded in the ledger account for the supplier.
- If there is an omission or other error by the supplier, the supplier should be notified. For the purpose of making the reconciliation, the supplier's statement balance should be amended to allow for the error.

- If there has been an omission or error in the customer's accounting records, the error should be corrected and the balance on the supplier's account in the payables ledger will change.

If all the differences are identified, explained and where necessary corrected, the two balances should be equal – the amended balance on the supplier's statement and the amended balance on the supplier's account in the payables ledger.



Example: Reconciliation of statement to supplier's ledger account

Emmanuel received a statement of account from a supplier Akachi, showing a balance to be paid of ₦5,900. Emmanuel's payables ledger account for Akachi shows a balance due to Akachi of ₦3,360.

Investigation reveals the following:

- (1) Cash paid to Akachi ₦1,650 has not been allowed for by Akachi.
- (2) Sales returned to Akachi ₦780 have not been allowed for by Akachi.
- (3) Emmanuel's ledger account for Akachi has not been adjusted for ₦110 of cash discount disallowed by Akachi.

A reconciliation of the statement balance and the balance in the ledger account can be made, as follows.

Statement:		Ledger account:	
Balance	₦ 5,900	Balance	₦ 3,360
Adjust for:		Adjust for:	
Cash payment	(1,650)	Discount disallowed	110
Sales returns	(780)		
Adjusted balance	3,470	Corrected balance	3,470

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Understand the relationship between control accounts and subsidiary ledger for accounts receivable and accounts payable.
- Prepare control accounts and corresponding subsidiary ledger from information provided.
- Perform control account reconciliation for accounts receivable and accounts payable.
- Identify errors and correct errors from control account reconciliations

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

Receivables control account

	₦		₦
Balance b/d	3,800,000	(b) Bad debt	400,000
(d) Revenue adjustment due to failing to qualify for expected discount	25,000	(e) Contra entry	70,000
		(f) Discount allowed	140,000
		Balance c/d	3,215,000
	<u>3,825,000</u>		<u>3,825,000</u>
Balance b/d	3,215,000		

The balances on the accounts in the receivables ledger in total are

	₦
Total balances in receivables ledger (balancing figure)	3,362,000
(a) Omitted balances	103,000
(c) Correction of double posting	(250,000)
	<u>3,215,000</u>

Bank reconciliations

Contents

- 1 Bank reconciliations
- 2 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

C	Reconciliation in financial accounting	
3	Bank reconciliation	
	a	State the purpose of bank reconciliation statement.
	b	Identify the causes of difference between cash book and bank statement balances.
	c	Prepare bank reconciliation statement.
	d	Identify and correct cash book errors.
	e	Explain the use of adjusted cash book to determine the cash position in the financial statements.

Exam context

This chapter explains how to reconcile the balance in a cash account in the general ledger to the balance on the bank statement.

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

- Identify the main reasons for differences between the cash book and bank statements;
- Prepare a bank reconciliation from information provided; and
- Post journal entries to correct cash book errors identified by the bank reconciliation.

1 BANK RECONCILIATIONS

Section overview

- The cash book (bank account in the general ledger) and bank statements
- Differences and the need for a reconciliation
- Possible cause of confusion
- Format of a bank reconciliation statement
- Bank reconciliations and overdrawn balances

1.1 The cashbook (bank account in the general ledger) and bank statements

Chapter 4 explained that the cash book is a book of prime entry used to record all receipts and payments of cash.

There are many different methods by which a business might make payment to suppliers and receive payment from customers.

Methods include:

- Cash (this is quite rare in all but the smaller businesses);
- Cheques;
- Bank transfers – An amount transferred directly from a bank account holder's account to the bank account of another party on the instruction of the first person;
- Credit and debit cards – People often use these to pay for goods and services purchased from businesses. Once a sale is made the business asks the credit (debit) card company to make the payment on behalf of the card holder. The credit (debit) card company then recovers the cash from the cardholder;
- Many modern businesses now accept online payment for sales of goods and provision of services. Payment is often received through the use of credit cards and debit cards in the usual way or thorough the action of a third party (for example Pay pal);
- Standing order – An instruction a bank account holder (the payer) gives to their bank to pay a set amount at regular intervals to another party's (the payee's) account;
- Direct debit – A method of payment in which, a person (payee) instructs their bank to collect funds from another party's (payer's) bank account. The payer must have instructed their bank to allow this before it can happen; and
- Banker's draft – A cheque from a bank. The payer transfers funds to the bank (either from its account at the bank or in cash) and the bank issues the draft which can then be used to pay a third party. The third party presents the draft to a bank and receives funds immediately.

Both standing orders and direct debits are very common methods of making monthly payments. A standing order allows for payment of the same amount on each payment date as the payer instructs the bank to pay this amount. A direct debit allows for different payments at each payment date as the payer instructs the bank to pay the amount the payee asks for.

Banker's drafts have certain advantages for the payee. Firstly, the payee does not have to wait for a cheque to clear as payment is immediate. Furthermore, the receipt is less risky as the draft is to be paid by a bank. Banker's drafts continue to be useful for large commercial purchases especially in new trading relationships but the advent of electronic banking (including cash transfers) is reducing their importance.

Posting

Periodically, totals are posted from the cash book to the general ledger accounts. One of these accounts is the cash account. For the purposes of this section we will describe this more specifically as the cash at bank account. (A business usually also has a cash in hand account to record cash amounts physically held but the majority of cash receipts and payments are usually through the cash at bank account).

The cash at bank account in the general ledger is used to record receipts and payments of cash through the bank account. The balance on this account is the amount that the business believes that it has in its bank account (debit balance) or the size of its bank overdraft (credit balance).

The bank sends regular bank statements to a business entity. A bank statement lists all the transactions that the bank has recorded in the account for the entity since the previous statement and the current balance on the account.

Many businesses now have on-line access to their bank statements so can access a bank statement at any time.

Reconciliation

The term reconciliation refers to a process that compares two sets of records (usually the balances of two accounts, in this case the balance on the cash at bank account and the balance on the bank statement) and explains the reason for any difference between them.

A bank reconciliation compares the balance on the general ledger cash at bank account to the balance on the bank statement at a given point in time. This should be done at regular intervals (say at the end of each month).

Often the balance on the cash at bank account is referred to as the balance on the cash book. This can be confusing but remember that the reconciliation always agrees the balance on the cash at bank account to the balance on the bank statement.

Bank reconciliations are a useful check on the accuracy of accounting records for cash. In principle, the balance in the cash at bank account or cash book in the general ledger and the balance shown in the bank statement should be the same but there are often differences and some of these might relate to transactions which the business has not yet accounted for or errors which must be corrected.

1.2 Differences and the need for a reconciliation

The balance on the general ledger cash at bank account and that shown for the business in its bank statement, at a point in time, will rarely be the same.

Differences between might be caused by any of the following:

- Items recorded in the cash at bank account are not (yet) shown in the bank statement.
- Items in the bank statement that have not been recorded in the cash at bank account.
- Errors by the bank (these are quite rare but do happen).
- Errors in the cashbook.

Each of these will be considered in turn.

Items recorded in the cash at bank account that have not (yet) shown in the bank statement

Some transactions might have been recorded in the cash at bank account in the general ledger, but have not yet been recorded by the bank.

Cheques received from customers, recorded in the cash book and paid into the bank and may not have been processed yet by the bank. Processing payments through the banking system might take two or three days, perhaps even longer. These are known as outstanding lodgements.

Cheques paid to suppliers are recorded as payments in accounting system of the business but they may not yet have been presented to the bank for payment (i.e. paid into the bank by the business's supplier). These are known as unpresented cheques.

Even if the cheques have been presented for payment by our supplier the bank may not have processed the deduction from the business's account yet.

These are timing differences. The transactions will eventually be processed by the bank. There are no errors or omissions in the cash book, and no further action is needed.

Items in the bank statement that have not been recorded in the cash at bank account

A business might not know about some items until they receive a bank statement.

Examples include:

- Bank charges;
- bank interest on an overdrawn balance;
- a payment from a customer that has been rejected by the bank (for example, the customer's cheque has been dishonoured);
- a bank transfer where a payment has been made directly into the business's account; and
- a bank might make a mistake either crediting or debiting an incorrect amount into an account (these are rare but they do happen).

The general ledger cash at bank account should be amended to include these transactions.

When a cheque is dishonoured the business must reverse the entries that were made originally when the business thought that an amount had been received.



Illustration: Double entry for dishonoured cheque

Write back of receivable	Debit	Credit
General ledger:		
Receivables	X	
Cash at bank		X
Receivables ledger:		
Individual customer accounts	X	

The business should also consider whether the receivable should be written off as a bad debt or whether an allowance should be recognised for a doubtful debt (see chapter 7)

Errors by the bank

The bank might sometimes make an error. If so, it should be notified and asked to correct its mistake. No further action is then needed.

Errors in the cash book

Possibly, an error has been made in the cash book. This should be identified during the reconciliation of the bank statement with the cash at bank account balance. Any such errors must be corrected when discovered.

1.3 Possible cause of confusion

The bank statement presents information as recorded in the accounting system of the bank. It always shows the banks view of things.

When a business has a positive cash balance that is an asset and as far as the business is concerned it is a debit balance. From the bank's point of view they owe the business money. Therefore they show the business as having a credit balance on the bank statement.

Similarly a bank account is overdrawn, the business owes money to the bank and shows this as a liability (a credit balance) in its financial statements. However, from the bank's point of view they have an asset and show this as a debit balance on the bank statements.

1.4 Format of a bank reconciliation statement

The purpose of a bank reconciliation is to show that the cash at bank account balance in the general ledger agrees with the bank statement balance after taking account of timing differences and making adjustments for any omissions or errors.

There is no single correct format for a bank reconciliation.

A useful approach is to correct the cash at bank balance for any omissions or errors and then adjust the balance per the bank statements for uncredited lodgements and unpresented cheques. The resultant balances should be the same.



Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank account:

Items in bank statement not in cashbook:

Bank charges

Dishonoured cheques

X

(X)

(X)

X

(X)

X/(X)

X¹

Error (made by business)

Corrected cash at bank figure

Balance per bank statement

X

Items in general ledger not in bank statement Add:

Outstanding lodgements

X

Deduct: Unpresented cheques

(X)

Corrected balance per bank statement

X¹

The balances (X¹) should now agree

Alternative presentations are possible.



Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of ₦4,500.

Cheques for ₦2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling ₦6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged ₦700 in bank charges.

A cheque for ₦300 from a customer, customer X, has been dishonoured. The balance in the account according to the bank statement is ₦7,700. A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank account:	₦
Items in bank statement not in cash book	
Bank charges	(700)
Dishonoured cheques	(300)
Corrected cash at bank figure	3,500
Balance per bank statement	7,700
Items in general ledger not in bank statement	
Add: Outstanding lodgements	2,000
Deduct: Unpresented cheques	(6,200)
Corrected balance per bank statement	3,500

Alternative format

This approach corrects the general ledger cash at bank account and then shows the differences between that figure and the balance as per the bank statement.



Illustration: Bank reconciliation

The following assumes that the cash balance is positive (i.e. the business has a debit cash balance).

Balance per general ledger cash at bank:	X
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
Error (made by business)	(X)
Corrected cash at bank figure	X/(X)
Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(X)
Add: Unpresented cheques	X
Balance per bank statement	X ¹

Example

The bank statement and cash book of Junior Ltd were provided to you on March 31, 2019. It was found that there is a difference in the balances of both documents. You are required to prepare a bank reconciliation statement as at March 31, 2019. Below is the extract for cash book and bank statement for the month of March 2019.

Cash book (Bank column) as at March 31, 2019 for Junior Ltd

Date	Particulars	Amount ₦'000	Date	Particulars	Amount ₦'000
March 1	Balance b/f	1000	March 3	Gadafi	400
March 10	Wahum	300	March 20	Keaton	200
March 21	Tera culture	100	March 29	Shoprite	400
March 30	Samantha	600	March 31	Balance c/d	1000

Bank statement as at March 31, 2019 for Junior Ltd

Date	Details	Dr ₦'000	Cr ₦'000	Balance ₦'000
March 1				1000
March 7	Cheque 0451	400		600
March 10	Dividend		100	700
March 14	Cheques		300	1000
March 24	Cheque 0452	200		800
March 24	Cheques		100	900
March 25	Insurance premium	200		700
March 31	Bank charges	100		600

Solution**Step 1 : identify the common items in both the cash book and bank statement**

Particulars	Amount ₦'000
Wahum	300
Tera culture	100
Gadafi	400
Keaton	200

Step 2: The balance items which do not appear on the above table would appear in the bank reconciliation statement**Junior Ltd****Bank reconciliation statement as at March 31, 2019**

Particulars	Amount ₦'000	Amount ₦'000
Balance as per bank statement		600
Add cheque deposited but not collected (Samantha)	600	
Insurance premium	200	
Bank charges	100	
		900
Less: Cheques issued but not presented for payment (Shoprite)	400	
Dividend recorded only in bank statement	100	
		(500)
Balance as per cash book as at March 31, 2019		1,000



Example: Bank reconciliation

The cash at bank account of a business shows a debit balance of ₦4,500.

Cheques for ₦2,000 from customers that were recently paid into the bank have not yet been processed.

Payments totalling ₦6,200 made by the business to its suppliers and others have not yet been presented to the bank for payment.

The bank has charged ₦700 in bank charges.

A cheque for ₦300 from a customer, customer X, has been dishonoured. The balance in the account according to the bank statement is ₦7,700.

A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank:

Items in bank statement not in cash book

Bank charges

Dishonoured cheques

Corrected cash at bank figure

₦	4,500
(700)	
(300)	
(1,000)	
	3,500

Items in general ledger not in bank statement

Deduct: Outstanding lodgements (2,000)

Add: Unpresented cheques 6,200

Balance per bank statement 7,700

1.5 Bank reconciliations and overdrawn balances

For a company with a bank account, money in the bank is an asset and the cash balance in the cash book is a debit balance. If there is a bank overdraft, the cash book has a credit balance, indicating that money is owed to the bank.

For the bank, the situation is the opposite way round.

- Money held by the bank in a bank account for a customer is money that belongs to the customer. For the bank, deposits are therefore liabilities and an account is said to be in credit when there is money in it.
- If a bank allows an overdraft to a customer, the customer owes the bank. The amount of the overdraft is a form of receivable for the bank, and is an asset. To the bank, an overdraft balance on a customer's account is therefore a debit balance (=asset).

A bank statement might therefore indicate that a customer's account has a 'debit balance', such as **#5,250 Dr.** This debit balance means 'overdraft' and for the customer it is a liability and credit balance item in their financial records.

Preparing a bank reconciliation with an overdraft balance

If you are given a question in which there is an overdraft balance in the bank statement, it is useful to make the negative balance clear by putting brackets around the balance.



Illustration: Bank reconciliation

The following assumes that the cash balance is negative (i.e, the business has a credit cash balance).

Balance per general ledger cash at bank:	(X)
Items in bank statement not in cash book:	
Bank charges	(X)
Dishonoured cheques	(X)
Interest received	X
	(X)
Error (made by business)	X/(X)
Corrected cash at bank figure	(X ¹)
Balance per bank statement	(X)
Items in general ledger not in bank statement Add:	
Outstanding lodgements	X
Deduct: Unpresented cheques	(X)
Corrected balance per bank statement	(X ¹)
The balances (X ¹ should now agree)	



Example: Bank reconciliation

A company receives a bank statement showing an overdraft balance of ₦20,000. The balance recorded in the company's cashbook is accredit balance of ₦12,100.

- (1) Lodgements not yet cleared by the bank (i.e. payments into the account but not recorded in the bank statement) ₦24,300
- (2) Cheques not yet presented (i.e. payments from the account recorded in the cashbook but not yet processed through the bank) ₦18,900
- (3) Bank charges of ₦1,300
- (4) A dishonoured cheque from a customer ₦1,200.

Items (3), (4) and (5) have not yet been recorded in the cashbook. A bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank:	₦
Items in bank statement not in cash book	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	<hr/>
Corrected cash at bank figure	(2,500)
	<hr/>
	(14,600)
 Balance per bank statement	(20,000)
Items in general ledger not in bank statement	
Add: Outstanding lodgements	24,300
Deduct: Unpresented cheques	(18,900)
	<hr/>
Corrected balance per bank statement	(14,600)



Example: Bank reconciliation

Alternatively, the bank reconciliation statement could be prepared as follows:

Balance per general ledger cash at bank:	₦
Items in bank statement not in cash book	
Bank charges	(1,300)
Dishonoured cheques	(1,200)
	<hr/>
Corrected cash at bank figure	(2,500)
	<hr/>
	(14,600)
 Items in general ledger not in bank statement	
Deduct: Outstanding lodgements	(24,300)
Add: Unpresented cheques	18,900
	<hr/>
Balance per bank statement	(20,000)

**Practice question****1**

On June 30, the cash account of Akachi's business showed a balance at bank of ₦1,500,000.

The balance in Austin's cash account at June 30, showed an asset of ₦1,660,000.

His bank statement showed an overdraft of ₦450,000.

On reconciling the cash account, he discovers the following bank statements showed that cheques for ₦70,000, ₦90,000 and ₦100,000 had not been presented for payment and that lodgements totalling ₦210,000 had not been cleared.

The balance on the bank statement at June 30, was ₦1,550,000.

Prepare a bank reconciliation.

**Practice question****2**

The balance in Austin's cash account at 30 June showed an asset of ₦1,660,000.

His bank statement showed an overdraft of ₦450,000.

On reconciling the cash account, he discovers the following:

- The debit side of the cash account had been undercast by ₦200,000.
- A total on the receipts side of the cash account of ₦2,475,000 had been brought forward as ₦4,275,000.
- A cheque received by Austin for ₦220,000 had bounced.
- Bank charges of ₦184,000 had been omitted from the cash account.
- Unpresented cheques totalled ₦520,000 and uncleared lodgements ₦626,000.

Prepare a bank reconciliation.

2 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Identify the main reasons for differences between the cash book and bank statements;
- Prepare a bank reconciliation from information provided; and
- Post journal entries to correct cash book errors identified by the bank reconciliation.

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions	1	₦
Balance per general ledger - cash at bank:		1,500,000
Balance per bank statement		1,550,000
Items in general ledger not in bank statement		
Add: Outstanding lodgements	210,000	
Deduct: Unpresented cheques	(260,000)	
Corrected balance per bank statement	1,500,000	
Alternative presentation:		
Balance per general ledger - cash and bank account:		1,500,000
Corrected cash at bank figure		
Items in general ledger not in bank statement		
Deduct: Outstanding lodgements	(210,000)	
Add: Unpresented cheques	260,000	
Balance per bank statement	1,550,000	

Solutions**2**

Balance per general ledger cash at bank account: 1,660,000

Items in bank statement not in cash book

(a) Correction of undercast

(b) Correction of mistake

$$(2,475,000 - 4,275,000)$$

(c) Dishonoured cheque

(d) Bank charges

200,000

(1,800,000)

(220,000)

(184,000)

(2,004,000)

(344,000)

Corrected cash at bank figure

(450,000)

Balance per bank statement

Add: Outstanding lodgements

626,000

Deduct: Unpresented cheques

(520,000)

Corrected balance per bank statement

(344,000)

Alternative presentation:

Balance per general ledger cash at bank account: 1,660,000

Items in bank statement not in cash book

(a) Correction of undercast

200,000

(b) Correction of mistake

(1,800,000)

(c) Dishonoured cheque

(220,000)

(d) Bank charges

(184,000)

(2,004,000)

(344,000)

Corrected cash at bank figure

Items in general ledger not in bank statement

Deduct: Outstanding lodgements

(626,000)

Add: Unpresented cheques

520,000

Balance per bank statement

(450,000)

Correction of errors

Contents

- 1 Trial balance
- 2 Correcting errors
- 3 Suspense accounts
- 4 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

C Reconciliation in financial accounting	
1 Errors and omissions	
a	Identify errors in the double entry system.
b	Identify errors not highlighted by the extraction of the trial balance.
c	Correct book keeping errors for given transactions.
d	Determine the effect of errors on profit or loss/surplus or deficit.
e	Explain the use of suspense account.

Exam context

This chapter distinguishes between how errors that cause a break down in double entry and are identified by the extraction of a trial balance and errors that will not be found in this way.

The chapter goes onto explain the use of suspense accounts as a temporary means of completing incorrect or incomplete double entry and how this is cleared as mistakes are corrected.

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

- Identify the types of error which may occur in a record keeping system;
- Calculate and understand the impact of errors on the financial statements within a reporting period;
- Complete incorrect or incomplete double entry to a suspense account; and
- Prepare journal entries to correct errors including those that led to the creation of a suspense account and others.

1 TRIAL BALANCE

Section overview

- The purpose of a trial balance
- Errors in the double entry accounting system
- Errors highlighted by the extraction of a trial balance
- Errors not highlighted by the extraction of a trial balance

1.1 The purpose of a trial balance

A trial balance is a list of all the debit balances and all the credit balances on the accounts in the general ledger. A trial balance can be 'extracted' from the general ledger simply by listing the balances on every account. The normal method of presentation is to present the balances in two columns, one for debit balances and one for credit balances.

- Accounts with debit balances will be asset accounts and expense accounts
- Accounts with credit balances will be liability accounts, capital account (or share capital and reserve accounts in the case of a company) and income accounts.

Since the accounting system uses double entry principles, the total of debit balances and the total of credit balances should be equal, because for every debit entry in the general ledger there should be a matching credit entry.

A trial balance has two main purposes.

It is a **starting point for producing a statement of profit or loss and a statement of financial position** at the end of an accounting period. A trial balance is extracted from the general ledger, and various year-end adjustments are then made to the accounts (which are recorded as journal entries before being entered in the general ledger). Year-end adjustments include adjustments for opening and closing inventory, depreciation charges, accruals and prepayments, writing off bad debts and adjusting the allowance for irrecoverable debts.

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

A second purpose of a trial balance is **to check for errors in the accounting system**. Errors must have occurred if the total of debit balances and total of credit balances on the general ledger accounts are not equal. Having identified that an error (or more than one error) exists, the task of the bookkeeper is to find the cause of the error and correct it.

1.2 Errors in the double entry accounting system

Errors can occur in a book-keeping system, because individuals make mistakes.

The types of error that will appear in the accounting records can be classified into four broad categories:

- Errors of transposition
- Errors of omission
- Errors of commission
- Errors of principle
- Errors of original entry
- Compensating errors

Errors of transposition (transposition errors)

This involves getting the digits in a number the wrong way round, for example recording ₦9,700 as ₦7,900.

Error of original entry

Sometimes, the error will be made in both the debit and the credit entries in the ledger. For example a purchase invoice might be recorded as ₦1,650 instead of ₦1,560 in both the purchases account and the payables ledger control account. The trial balance will not reveal this sort of error.

Compensating error

Sometimes, the error of transposition will be made in one account but not the other. For example, a payment of ₦1,980 from a customer might be recorded correctly in the cash book but posted incorrectly as ₦1,890 in the receivables ledger control account.

Errors of omission

This is where a transaction or entry is missed out. Sometimes a transaction is missed out of the ledger entirely because the bookkeeper forgets about it or is not informed about it.

A transaction may be omitted from one location only.

Errors of commission

This means putting an entry in the wrong account, for example recording a telephone expense in the electricity expenses account.

Errors of principle

This is where an entry is recorded in the wrong type of account, e.g. recording capital expenditure as revenue expenditure.

For example the purchase of a machine might be entered in the machinery repairs and maintenance account. Unless corrected, this error will result in an incorrect computation of depreciation charges, running costs, profit and statement of assets for the period.

1.3 Errors highlighted by the extraction of a trial balance

As stated earlier, one way of finding some errors in the accounting records is to extract a trial balance from the general ledger. If the total of the debit balances does not equal the total of the credit balances on the general ledger accounts then an error or several errors have been made.

If the trial balance does not balance then this will be due to an error where the debits and credits are not the same, so that the error results in the debit entry in one account in the general ledger not being equal to the matching credit entry in another account.

Types of error which affect the balancing of the trial balance are as follows:

- A transaction might be recorded with a debit entry in one account, but the corresponding credit entry is omitted. Similarly, a transaction might be recorded with a credit entry in one account, but the corresponding debit entry is omitted. For example a payment might be recorded as a credit entry in the cash book but omitted from the payables ledger control account.
- There could be a transposition error in one account. For example, the debit entry might be ₦1,234 and the corresponding credit entry might be ₦1,324. One of the entries must be incorrect.
- A transaction might be recorded as a debit entry in two accounts, instead of as a debit entry in one account and a credit entry in the other account. For example, rental income might be recorded as a debit entry in the cash book and, in error, as a debit entry in the rental expense account.
- Similarly, a transaction might be recorded as a credit entry in two accounts, instead of being a debit entry in one account and a credit entry in the other. For example, discounts received might be recorded as a credit entry in the discount received account and, in error as a credit entry in the payables ledger control account.
- There might be a mistake in casting one or another side of an account. This would lead to the extraction of an incorrect balance.

You need to be able to:

- identify errors in a double entry accounting system, and
- know how to correct them.

Corrections to errors in an accounting system are recorded as journal entries and then posted from the journal to the relevant accounts in the general ledger.

1.4 Errors not highlighted by the extraction of a trial balance

A trial balance is only useful in helping to identify errors where the debit and credit entries in the general ledger accounts do not match. It does not help with the identification of errors where there has not been a mismatch between debit and credit entries.

There are some types of error that do not result in a difference between total debit and total credit entries and therefore do not affect the balancing of the trial balance. For example:

- A transaction might have been omitted entirely from the general ledger, with no debit entry and no credit entry.
- The wrong figure might be double entered.

- Transactions might be recorded in the wrong account. For example, the cost of repairing a machine might be recorded incorrectly as a debit in the machinery at cost account instead of recording it as a debit in the machine repairs account. The amount of the debit entry is correct; the error is to post the transaction to the wrong account.
- There might be compensating errors. For example one error might result in debits exceeding credits by ₦2,000 but another error might result in credits exceeding debits by ₦2,000. If this happens, the errors will 'cancel each other out' and will not be apparent from a check on the trial balance totals for debits and credits.

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2 CORRECTING ERRORS

Section overview

- An approach to correcting errors
- The effect of errors on profit

2.1 An approach to correcting errors

Errors should be corrected when they are found.

- Transactions that have been omitted from the general ledger entirely should be recorded in the accounts. The omitted item can be recorded in the journal, and posted from the journal to the relevant accounts in the general ledger and, if required, the receivables or payables ledger.
- Entries that have been made incorrectly in the accounts must be corrected by means of suitable debit and credit entries in the accounts. The correction of an error should be recorded in the journal and then posted from the journal to the relevant accounts.

In order to correct errors properly, you need to be able to:

- identify an error;
- recognise what the correct entry in the accounts should have been; and
- work out how to make the correction by means of double entry adjustments.

One approach to correcting errors is to compare the entry that has been processed to the entry that should have been processed. This allows you to see what adjustment is needed. Memorandum T accounts can be used to do this.

For each account affected by an error, you can prepare two sets of memorandum T accounts for:

- (1) What accounting entries have been made in the accounts, and
- (2) What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

Some examples will help to illustrate the approach.

**Example:**

The total from a sales day book was ₦1,800. This has been posted incorrectly as ₦1,080.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded

Receivables	Sales
1,080	1,080

(2) What should have been recorded

Receivables	Sales
1,800	1,800

The receivables control account has a debit entry of ₦1,080 for the transaction but it should have been ₦1,800.

To remove this error and increase the account balance to ₦1,800 for the transaction, we need to debit the receivables control account with ₦920.

The sales account has a credit entry of ₦1,080 for the transaction but it should have been ₦1,800.

To remove this error and increase the account balance to ₦1,800 for the transaction, we need to credit the sales account with ₦920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Sales		920

Or using ledger accounts:

Receivables control account		
Before adjustment	₦ 1,080	₦
Sales account	920	
Sales account		
₦ 920	Before adjustment	₦ 1,080
	Receivables	920

**Example:**

A business has recorded a repair cost of ₦15,000 to a machine as a debit in the machinery at cost account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded

Machinery (at cost) account
15,000

(2) What should have been recorded

Machine (at cost) account
0

Machine repairs account

Machine repairs account
0

Machine repairs account

Machine repairs account
15,000

The machinery (at cost) account has a debit entry of ₦15,000 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to ₦0 for the transaction, we need to credit the machine (at cost) account with ₦15,000.

The machine repairs account has nothing recorded for the transaction, but there should be a debit balance of ₦15,000.

To correct his account, we need to debit the account with ₦15,000. Therefore the correcting entry is:

Machine repairs	Dr	Cr
	15,000	
Machinery cost		15,000

**Example:**

A business has recorded rental income of ₦21,800 as a credit in the rental expense account.

(1) What has been recorded

Rental expense		Rental expense
21,800		0

Rental income

	Rental income
	0

Rental income

21,800

The rental expense account has a credit of ₦21,800 when there should be nothing in the account for the transaction.

To remove this error and reduce the account balance to ₦0 for the transaction, we need to debit the rental expense account with ₦21,800.

The rental income account has nothing recorded for the transaction, but there should be a credit balance of ₦21,800.

To correct his account, we need to credit the account with ₦21,800. Therefore, the correcting entry is:

	Dr	Cr
Rental expense	21,800	
Rental income		21,800

**Example:**

A business recognised a sale to a customer in the amount of ₦515,000, not expecting the customer to take advantage of a 2.5% early settlement discount.

The customer did take advantage of the discount (saving ₦20,600) and the business correctly adjusted the receivables balance but incorrectly recorded the other side of the entry as a debit in the discounts received account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded

Revenue
0
Discounts received
20,600

(2) What should have been recorded

Revenue
20,600
Discounts received
0

The revenue account has nothing recorded for the transaction, but a debit of ₦20,600. A debit of ₦20,600 is required to correct this.

The discounts received account has a debit entry of ₦20,600 when there should be nothing in the account for the transaction. To remove this error and reduce the account balance to ₦nil for the transaction, we need to credit the discounts received account with ₦20,600.

To correct the error, the required double entry is:

	Dr	Cr
Revenue	20,600	
Discounts received		20,600

2.2 The effect of errors on profit

Unless they are corrected, accounting errors will have an effect on the reported profit for the period.

A question might ask you to quantify this effect for a given error. In a typical question of this sort, the error might involve recording a capital expenditure item as a revenue expenditure item, or a revenue expenditure item as capital expenditure.

Alternatively, a capital expenditure item might be recorded at an incorrect amount.



Example:

A bookkeeper in error recorded the purchase cost of a new item of equipment as ₦36,000 when it should have been ₦360,000.

A draft profit of ₦2,560,000 for the period was calculated before the discovery of the error. This included a depreciation charge of 10% (₦3,600) for the equipment.

What is the correct figure for profit?

₦	
Draft profit	2,560,000
Add back: Depreciation incorrectly charged	3,600
	<hr/>
Deduct: Correct depreciation charge (10% × ₦360,000)	2,563,600
Adjusted figure for profit	(36,000)
	<hr/>
Adjusted figure for profit	2,527,600



Example:

A bookkeeper in error recorded the ₦60,000 purchase cost of a new machine as repairs and maintenance costs

A draft profit of ₦300,000 for the period was calculated before the discovery of the error.

Depreciation on machinery is charged at 20% on cost, with a full year's charge in the year of acquisition.

What is the correct figure for profit?

₦	
Draft profit	300,000
Add back: Repair costs incorrectly charged	60,000
	<hr/>
Deduct: Depreciation charge (20% × ₦60,000)	360,000
Adjusted figure for profit	(12,000)
	<hr/>
Adjusted figure for profit	348,000

3 SUSPENSE ACCOUNTS

- Trial balance: differences in total debits and total credits
- Opening a suspense account
- Correcting errors where a suspense account is opened
- Unknown entry

3.1 Trial balance: differences in total debits and total credits

The examples of correcting errors in the previous section involve errors where the amount of the debit entry and the amount of the credit entry were the same. These errors would not be identified by extracting a trial balance.

When errors are made where the amount of the debit entry differs from the amount of the credit entry, total debit balances and total credit balances in the general ledger accounts will differ. A trial balance will demonstrate the existence of such errors.

These errors must be discovered and corrected. Until they are discovered, the first step should be to open a suspense account.

- When errors have resulted in total debit entries and total credit entries being different, the errors are corrected using a suspense account.
- A suspense account is a short-term account that is required only until the errors have been identified and corrected.

3.2 Opening a suspense account

A suspense account is opened with either a debit balance or a credit balance.

The balance entered into the suspense account should be an amount that makes the total debit balances equal to total credit balances on all the general ledger accounts (including the balance on the suspense account).

**Example:**

A business has prepared a trial balance of the general ledger account balances.

This shows total debit balances of ₦456,000 and total credit balances of ₦488,000.

A suspense account must be opened.

The balance on the account to make total debit and total credit balance equal is a debit balance of ₦32,000 (₦488,000 credits less ₦456,000 debits).

Suspense account	
Opening balance	₦ 32,000

Opening the suspense account in effect completes the missing and incorrect double entries but to the wrong place (the suspense account). The errors should be investigated and corrected. This usually involves a double entry to the suspense account.

Once the errors have been fully corrected the balance on the suspense account will be reduced to zero.

3.3 Correcting errors where a suspense account is opened

When it is clear that an error has occurred, it is often helpful to decide the answer to two questions:

- Has the error resulted in different total amounts for debit and credit entries?
 - If the answer is yes, making the correction will involve the suspense account.
 - If the answer is no, the correction should be made, but will not involve the suspense account.
- If the error has resulted in different total amounts for debit and credit entries, think about the general ledger account or accounts containing the error, and decide what needs to be done to correct the balance on that account.

The same approach used in the previous section for correcting errors can be used. For each account affected by an error, you can prepare two sets of memorandum T accounts for:

- (1) What accounting entries have been made in the accounts, and
- (2) What the accounting entries should have been.

By comparing what has been recorded in the accounts with what should have been recorded, you can then work out the double entry adjustments that are needed to get from 'where we are' to 'where we want to be'.

However, when the error involves different total amounts of debits and credits, a debit or credit entry in the suspense account is needed as a 'balancing figure' to make the total debits and credits equal.



Example:

A debit entry in the rent expense account has been entered as ₦5,000 when it should have been ₦5,500, but the entry in the cash book (bank account) for the payment was entered correctly as ₦5,500.

The debit entry in the rent account is ₦500 too low, resulting in a difference between total debits and total credits. The first step is to open a suspense account and enter a balance to make total debits and total credits equal.

Suspense account		
	₦	₦
Opening balance	500	

Note that this completes the entry by recognising the missing debit of 500 in the suspense account

We can now look at ‘where we are’ and ‘where we want to be’

(1) What has been recorded

(2)What should have been recorded

Rent expense account		Rent expense account	
5,000		5,500	
Suspense account		Suspense account	
500		0	

The correcting double entry is:

	Dr	Cr
Rent account	500	
Suspense account		500

Using ledger accounts

Suspense account			
	₦		₦
Opening balance	500	Rent account	500
Rent expense account			
	₦		₦
Opening balance	5,000		
Suspense account	500		

**Example:**

The total from a sales day book was ₦1,800.

This has been posted correctly to the sales account but ₦1,080 has been posted in error to the receivables control account.

If you cannot see immediately what double entry adjustments are needed to correct the error, you could prepare the following memorandum accounts.

(1) What has been recorded

Receivables
1,080
Sales
1,800
Suspense
920

(2) What should have been recorded

Receivables
1,800
Sales
1,800
Suspense
0

The sales account has the correct entry but the receivables control account has a debit entry of ₦1,080, which should be ₦1,800.

To remove this error and increase the account balance to ₦1,800 for the transaction, we need to debit receivables control account with ₦920.

Therefore the correcting entry is:

	Dr	Cr
Receivables	920	
Suspense		920

Or using ledger accounts:

Receivables control account		
₦	1,080	₦
Before adjustment		
Suspense account		
₦	920	
Suspense account		
₦		₦
Before adjustment	920	Rent account
		920

**Example:**

A revenue adjustment for an early settlement discount unexpectedly taken by a customer was correctly recorded as a credit to trade receivables but the other side of the entry has been recorded as a credit entry in the discount received account by mistake.

(1) What has been recorded

Revenue
0
Discounts received
4,000

Suspense
8,000

(2) What should have been recorded

Revenue
4,000
Discounts received
0

Suspense
0

As a result of this error, total credits are ₦4,000 higher than they should be, and total debits are ₦4,000 lower than they should be resulting in the total credits balances in the trial balance being 8,000 bigger than the total debits.

A suspense account with a debit balance of 8,000 would be opened.

Both the revenue account and the discount received account must be corrected.

This error is corrected as follows, with an entry in the suspense account to match total debits with total credits:

	Dr	Cr
Discounts received	4,000	
Revenue	4,000	
Suspense		8,000

Or using ledger accounts:

Suspense account

	₦		₦
Before adjustment	8,000	Discounts received	4,000
		Revenue	4,000
			8,000

Discounts received

	₦		₦
Suspense account	4,000	Balance b/d	4,000

Revenue

	₦		₦
Suspense account	4,000		

**Example:**

A payment to a supplier of ₦23,500 has been recorded in the cash book/bank account in the general ledger, but has not been recorded in the trade payables account.

As a result, total credits exceed total debits in the trial balance by ₦23,500 and a suspense account must be opened with a debit balance of ₦23,500.

(1) What has been recorded

Trade payables account	Trade payables account
0	23,500
Suspense account	Suspense account
23,500	0

(2) What should have been recorded

This error would be corrected as follows.

Trade payables	Dr	Cr
Suspense	23,500	23,500

Practice question

1



A trial balance has been prepared, and total debits are ₦459,100 and total credits are ₦459,700.

On investigation, the following errors are found:

- 1 Sales returns of ₦800 were recorded correctly in the receivables account in the general ledger, but they have been recorded incorrectly as a credit entry in the purchases returns account.
- 2 In the sales day book, the column for total sales has been added up incorrectly. The total should be ₦26,420, but the total was undercast by ₦1,000. (The total was added up as ₦25,420).

The correct total amount receivable was entered in the receivables account in the general ledger.

Open a suspense account and record the book-keeping entries required to correct the errors.

3.4 Unknown entry

A suspense account is opened in order to make a trial balance have equal debits and credits until the errors have been discovered.

In some instances however a suspense account will be opened deliberately by the bookkeeper if the bookkeeper is uncertain of where to post one side of the double entry.



Example:

A bookkeeper has received a cheque for ₦1,000 but does not know who the cheque is from or what it relates to.

Rather than putting the cheque to one side until it is known what it is for the bookkeeper may decide to record the debit entry in the cash book/bank account and then, not knowing where the credit entry should go, to credit the suspense account instead.

This can then be cleared at a later date.

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Identify the types of error which may occur in a record keeping system
- Calculate and understand the impact of errors on the financial statements within a reporting period
- Complete incorrect or incomplete double entry to a suspense account
- Prepare journal entries to correct errors including those that led to the creation of a suspense account and others

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

The opening balance on the suspense account is a debit balance, since total credits are higher than total debits by ₦600.

Error 1

Purchase returns	Purchase returns
	800

Sales returns	Sales returns
	800

Error 2

Sales	Sales
25,420	26,420

The correcting double entries are:

Error 1

Sales returns

800

Suspense account

800

Purchases returns

800

Error 2

Suspense account

1.000

Sales

1 000

The suspense account is cleared as follows:

Suspense account			
Balance b/d	600	Purchase returns	800
		Sales returns	800
Sales	1,000		
	1,600		1,600

Preparing financial statements

Contents

- 1 Financial statements
- 2 Preparing financial statements
- 3 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

F	Financial statements
1	State and explain the purpose, nature and relationships among the main components of financial statements.
4	Preparation of simple financial statements and supporting notes
	a Prepare statement of profit or loss and other comprehensive income in accordance with IAS 1.
	b Prepare statement of financial position in accordance with IAS 1.
	d Prepare simple statement of change in equity.

Exam context

This chapter revises the need for financial statements and the structure of basic statements of financial position and financial performance.

It continues by explaining different approaches which might be adopted to answer preparation of accounts questions.

The chapter closes by explaining the meaning of, and demonstrating an extended trial balance.

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

- Understand the purpose of the statement of financial position
- Understand the purpose of the statement of profit or loss
- Prepare financial statements from a trial balance after adjusting it for information provided
- Prepare and explain an extended trial balance

1 FINANCIAL STATEMENTS

Section overview

- Purpose of financial statements
- Statement of financial position
- Statement of profit or loss

1.1 Purpose of financial statements

This section is a brief revision of topics covered in more detail in chapter 1.

Financial statements are prepared to provide information that is useful for decision making. The information is useful in different ways to different user groups.

User	Possible area of interest
Owners	How the business has performed in the period. How much can be extracted from the business as drawings (or dividends for a company). How management has performed if the owners have appointed others to run the business for them.
Government	How much tax may be charged. Analysis of performance of all businesses in a region gives an indication of the health of the economy in that region.
Employees	Whether a pay rise can be supported. Safety of employment
Lenders	The safety of the loan. The ability of the business to meet future payments.
Customers	The level of profit relative to prices charged. The ability of the business to continue to supply the customer in the future
Suppliers	Safety of the amounts owed to them leading to the level of credit that they are willing to give the business. Whether there may be scope to increase share of the businesses purchases.

This is not an exhaustive list.

Components of financial statements

A full set of financial statements would include the following:

- a statement of profit or loss and other comprehensive income or a statement of profit or loss followed by a statement of other comprehensive income;
- a statement of financial position;
- a statement of changes in equity;
- a statement of cash flows; and
- notes to the financial statements (not in this syllabus).

1.2 Statement of financial position

The statement of financial position is a structured presentation of the assets and liabilities of the business. The difference between assets and liabilities is capital (equity).

Assets are resources controlled by the business and liabilities are amounts owed by the business.

In a statement of financial position, non-current assets are shown separately from current assets, and non-current liabilities are shown separately from current liabilities.

As a general rule, assets are current if they will be consumed or converted into cash within the next 12 months. Cash and cash equivalents are also current assets. (Cash equivalents are assets that can be converted into cash very quickly, such as money on deposit in a bank deposit account). There are some exceptions to this general rule but it is a very useful simplification.

Prepayments and accrued income are current assets.

Liabilities are current if they are payable within the next 12 months. It is therefore necessary to check the repayment dates on any bank loans or loan notes. Loans repayable within 12 months become current liabilities.



Illustration:

If a company obtains a five-year bank loan, where none of the loan principal is repayable until the end of the loan period, the loan will be a non-current liability for the first four years and will then become a current liability in fifth year when it is repayable within 12 months.

Accrued expenses (and deferred income) are current liabilities.

**Illustration: Statement of financial position**

Bauchi Trading Company: Statement of financial position as at December 31, 2019

	₦m	₦m	Chapter
Assets			
Non-current assets			6
Land and buildings	56.2		
Plant and machinery	28.0		
	<hr/>		
	84.2		
Current assets			
Inventories	16.4		9
Trade and other receivables	17.0		5 and 7
Prepayments and accrued income	2.0		8
Cash	1.2		
	<hr/>		
Total assets	36.6		
	<hr/>		
Equity and liabilities			
Capital			67.8
Non-current liabilities			
Long-term loans	30.0		
Current liabilities			
Trade and other payables	18.0		5
Accruals (and prepaid income)	1.5		8
Short-term borrowings (bank overdraft)	3.5		
	<hr/>		
Total equity and liabilities	23.0		
	<hr/>		
	120.8		

1.3 Statement of profit or loss

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

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

Note that the statement of other comprehensive income is not in your syllabus.

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



Illustration: Statement of profit or loss

Bauchi Trading Company: Statement of profit or loss for the year-ended December 31, 2019

	₦m	₦m	Chapter
Revenue			120.0
Cost of sales			9
Opening inventory	8.0		
Purchases	80.0		
	<hr/>		
Closing inventory	88.0		
	(10.0)		
	<hr/>		
Gross profit	(78.0)		
	<hr/>		
Other income:			42.0
Rental income			
Expenses:			
Wages and salaries	8.0		
Depreciation	6.0		6
Rental costs	4.0		
Telephone charges	3.0		
Advertising costs	5.0		
Interest charges	1.0		
Bad debts	3.0		7
	<hr/>		
	(30.0)		
	<hr/>		
	12.0		
	<hr/>		

2 PREPARING FINANCIAL STATEMENTS

Section overview

- Financial statements of a sole trader, partnership and company
- Year-end
- Preparation of financial statements: Approach 1
- Preparation of financial statements: Approach 2

2.1 Financial statements of a sole trader, partnership and company

The same basic accounting approach is used in recording the transactions of a sole trader, a partnership or a company. The preparation of the financial statements of all three proceeds along the same lines.

There are some differences.

The capital of each type of entity is different in structure.

- The capital of a sole trader represents his interest in the business.
- A partnership has more than one owner and this must be reflected in the capital where each has their own capital account or accounts (this is explained in detail in the next chapter).
- For companies, equity capital is represented by share capital and reserves, not simply by 'capital'.

Sole traders have no reason to comply fully with the requirements of international accounting standards. The financial statements of a sole trader are therefore usually limited to a statement of profit or loss and a statement of financial position.

This chapter explains approaches that might be used to answer preparation of accounts questions. The approaches apply to all types of entity. Later chapters explain issues of importance to specific types of organisation.

2.2 Year-end

Earlier chapters have explained how transactions are first entered into books of prime entry and how totals from these are transferred into ledger accounts in the general ledger.

At the year-end a trial balance is extracted and various year-end adjustments are then made to the accounts after which a statement of profit or loss and then a statement of financial position can be prepared, using these adjusted balances.

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

At the end of the period there is another exercise performed in order to prepare the general ledger for use in the next accounting period. This involves transferring all income and expense items into a single account (perhaps via intermediate accounts like cost of sales and statement of profit or loss) in order to produce a single figure as profit or loss for the period which is then transferred to capital.

Earlier chapters have covered the year-end adjustments. They explained how each type of adjustment is measured and then explained the double entry

necessary to account for these amounts. The double entry explanation used "T" accounts in order to explain the full workings of the double entry system.

You may be expected to prepare a statement of financial position and statement of profit or loss from a trial balance. These questions are usually quite time pressured so you need to develop a good technique in order to execute such tasks in an effective way.

The rest of this chapter use the following example to illustrate how such questions might be approached. You will need to choose an approach and practice it.



Example:

ABC – Trial balance as at 31 December 2019

	₦	₦
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000	
Inventory as at 1 January 2019	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2019		121,600
	<hr/> 627,600	<hr/> 627,600

Further information:..

- ₦400 is owed for heating and lighting expenses.
- ₦700 has been prepaid for rent.
- It is decided that a bad debt of ₦1,200 should be written off, and that the allowance for doubtful debts should be increased to ₦4,500.
- Depreciation is to be provided for the year at 10% on cost
- Inventory at December 31, 2019 was valued at ₦16,500.

The journals

The business needs to process the following double entries to take account of the “further information” given above.



Example: Closing journals

	Debit	Credit
a) Accrual		
Heating and lighting expense Accrual	400	
Being: Accrual for heating and lighting expense		400
b) Rent prepayment		
Prepayment		700
Rent expense		700
Being: Adjustment to account for rent prepayment		
c) Bad and doubtful debt		
Bad and doubtful debt expense		1,200
Receivables		1,200
Being: Write off of bad debt		
Bad and doubtful debt expense	500	
Allowance for doubtful debts		500
Being: Increase in the allowance for doubtful debts		
d) Depreciation		
Depreciation expense	14,600	
Accumulated depreciation		14,600
Being: Depreciation for the year (10% of 146,000)		
e) Closing inventory		
Inventory(asset)	16,500	
Inventory (cost of sales)		16,500
Being: Recognition of inventory at the year-end		

These journals are only given to explain the double entry required. You should never write something like this in a preparation of financial statements question. It uses up too much time. You want to do double entry rather than write journals.

The chapter continues to show two possible approaches that you might follow. You do not have to do either. If you decide on a way that suits you then use it.

If you attend courses your lecturers will show you how to do this. They are very experienced. Do as they advise.

2.3 Preparation of financial statements: Approach 1

Step 1: Perform double entry on the face of the question and open up new accounts as you need them in any space that you have.
(DO NOT COPY OUT THE TRIAL BALANCE).

After this your question paper should look something like the following (with the double entries are shown in bold italics):

Example: ABC-Trial balance as at December 31, 2019

	₦	₦
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000 + <i>400^a</i>	
Inventory as at 1 January 2019	15,000	
Drawings	22,000	
Allowance for doubtful debts		<i>4,000+ 500^c</i>
Non-current assets	146,000	
Accumulated depreciation:		<i>32,000+ 14,600^d</i>
Trade receivables	51,000	<i>1,200^c</i>
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2019		121,600
	<hr/> 627,600	<hr/> 627,600
Accruals		<i>400^a</i>
Prepayments	<i>700^b</i>	
<i>Bad and doubtful debt expense</i>	<i>1200^c + 500^c</i>	
<i>Depreciation expense</i>	<i>14,600^d</i>	
<i>Closing inventory (asset)</i>	<i>16,500^e</i>	
<i>Closing inventory (cost of sales)</i>		<i>16,500^e</i>

Step 2: Draft pro-forma financial statements including all of the accounts that you have identified. (A pro-forma is a skeleton document into which you can copy numbers later)

Step 3: Copy the numbers from the trial balance into the pro-forma statements. Note that if a number copied onto the financial statements is made up of a number provided in the original trial balance that has been adjusted, you must show the marker what you have done. This may involve adding in an additional explanation below the main answer or may be shown on the face of the statements.

Step 4: Calculate profit for the year.

Step 5: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:



Example: ABC – Statement of financial position

	₦	₦
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	(46,600)	<u>99,400</u>
		99,400
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	(4,500)	
	45,300	
Prepayments	700	
Cash	6,200	
	<u>68,700</u>	
Total assets		<u>168,100</u>
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	(22,000)	
	<u>125,700</u>	
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
	<u>42,400</u>	
Total equity and liabilities		<u>168,100</u>

**Example: ABC – Statement of profit or loss**

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	<hr/>	
	319,400	
Closing inventory	(16,500)	
	<hr/>	
	(302,900)	
Gross profit		125,100
Expenses:		
Wages and salaries	64,000	
Depreciation (W1)	14,600	
Rent (14,000 – 700)	13,300	
Heating an lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
	<hr/>	
	(99,000)	
	<hr/>	
	26,100	

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

2.4 Preparation of financial statements: Approach 2

Step 1: Draft pro-forma financial statements including all of the accounts that you have identified from reading the question. Leave spaces in case you have missed an account that you might need to insert later.

Step 2: Copy the numbers from the trial balance into the pro-forma statements. If you know that a number is not to be adjusted then you can copy it straight to its destination. Otherwise set up bracketed workings next to the narrative in the pro-forma.

After step 2 your answer might look like this:



Example: ABC – Statement of financial position

Assets

Non-current assets

Cost	₦ 146,000
Accumulated depreciation (32,000)	<hr/>

Current assets

Inventories	
Trade receivables (51,000)	
Allowance for doubtful debts (4,000)	
Prepayments	
Cash	₦ 6,200

Total assets

Equity and liabilities

Capital

At start of year	₦ 121,600
Profit for the year	
Drawings	(22,000)

Current liabilities

Trade payables	₦ 42,000
Accruals (and prepaid income)	<hr/>

Total equity and liabilities


Example: ABC – Statement of profit or loss

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	<hr/>	
Closing inventory	319,400	
	<hr/>	
Gross profit		
Expenses:		
Wages and salaries	64,000	
Depreciation	<hr/>	
Rent (14,000)	<hr/>	
Heating and lighting (5,000)	<hr/>	
Bad and doubtful debts	<hr/>	
	<hr/>	
	<hr/>	
	<hr/>	

Step 3: Perform double entry on the face of your answer.

Step 4: Complete the bracketed workings and copy totals into their final destinations.

Step 5: Calculate profit for the year.

Step 6: Complete statement of financial position by adding profit to the opening capital, deducting drawings to find the closing capital.

The final answer might look like this:



Example: ABC – Statement of financial position

	₦	₦
Assets		
Non-current assets		
Cost	146,000	
Accumulated depreciation (32,000 + 14,600)	<u>(46,600)</u>	
	99,400	
Current assets		
Inventories	16,500	
Trade receivables (51,000 – 1,200)	49,800	
Allowance for doubtful debts (4,000 + 500)	<u>(4,500)</u>	
	45,300	
Prepayments	700	
Cash	6,200	
	<u>68,700</u>	
Total assets	<u>168,100</u>	
Equity and liabilities		
Capital		
At start of year	121,600	
Profit for the year	26,100	
Drawings	<u>(22,000)</u>	
	125,700	
Current liabilities		
Trade payables	42,000	
Accruals (and prepaid income)	400	
	<u>42,400</u>	
Total equity and liabilities	<u>168,100</u>	

**Example: ABC – Statement of profit or loss**

	₦	₦
Revenue		428,000
Cost of sales		
Opening inventory	15,000	
Purchases	304,400	
	<hr/>	
	319,400	
Closing inventory	(16,500)	
	<hr/>	
Gross profit		(302,900)
		<hr/>
Expenses:		125,100
Wages and salaries	64,000	
Depreciation (W1)	14,600	
Rent (14,000 – 700)	13,300	
Heating and lighting (5,000 + 400)	5,400	
Bad and doubtful debts (1,200 + 500)	1,700	
	<hr/>	
	(99,000)	
	<hr/>	
	26,100	
		<hr/>

Workings

W1 – Depreciation: 10% of 146,000 = 14,600

2.5 Preparation of financial statements using an extended trial balance

The syllabus also requires knowledge of the role of extended trial balances in the preparation of accounts.

An extended trial balance is a working paper that starts with one trial balance (the original as extracted from the accounting records) and then records double entries as appropriate alongside existing accounts or in new accounts opened for the purpose.

The various accounts can then be cross cast to produce a new trial balance which includes the adjustments. Numbers can then be lifted into the final financial statements.

This is best demonstrated with an example.



Example: Extended trial balance

ABC – Trial balance as at 31 December 2019

	₦	₦
Sales		428,000
Purchases	304,400	
Wages and salaries	64,000	
Rent	14,000	
Heating and lighting	5,000	
Inventory as at 1 January 2019	15,000	
Drawings	22,000	
Allowance for doubtful debts		4,000
Non-current assets	146,000	
Accumulated depreciation:		32,000
Trade receivables	51,000	
Trade payables		42,000
Cash	6,200	
Capital as at 1 January 2019		121,600
	<hr/> 627,600	<hr/> 627,600

Further information:

- ₦400 is owed for heating and lighting expenses.
- ₦700 has been prepaid for rent.
- It is decided that a bad debt of ₦1,200 should be written off, and that the allowance for doubtful debts should be increased to ₦4,500.
- Depreciation is to be provided for the year at 10% on cost
- Inventory at December 31, 2019 was valued at ₦16,500.

An extended trial balance can be prepared as follows:

Example: ABC – Extended trial balance as at 31 December 2013						New trial balance
	Trial balance		Adjustments			
	Dr (₦)	Cr (₦)	Dr (₦)	Cr (₦)	Dr (₦)	Cr (₦)
Sales		428,000				428,000
Purchases	304,400				304,400	
Wages and salaries	64,000				64,000	
Rent	14,000			700*	13,300	
Heating and lighting	5,000				5,400	
Inventory as at 1 January 2013	15,000				15,000	
Drawings	22,000				22,000	
Allowance for doubtful debts		4,000			500*	4,500
Non-current assets	146,000				146,000	
Accumulated depreciation:		32,000			14,600*	46,600
Trade receivables	51,000				1,200*	49,800
Trade payables		42,000				42,000
Cash	6,200				6,200	
Capital as at 1 January 2013		121,600				121,600
New accounts opened						
Accruals				400*		400
Prepayments				700*	700	
Bad debts expense				1,200* + 500*	1,700	
Depreciation				14,600*	14,600	
Closing inventory (asset)				16,500*	16,500	
Closing inventory (P and L)						16,500
	627,600	627,600			659,600	659,600



The numbers can then be extracted to produce a statement of financial position and a statement of profit or loss as before.

Example**JBH Enterprises had the following trial balance as at December 31, 2018:**

	DR ₦'000	CR ₦'000
Capital 1/1/18		85,000
Drawings:	5,500	
Purchases and revenue	100,000	160,000
Inventory 1/1/18	5,000	
Receivables and payables	27,500	15,780
Bad debts	500	
Electricity	300	
Postages and stamps	100	
Allowance for doubtful debts 1/1/18		3,000
Premises at cost	70,000	
Salaries and wages	10,000	
Leasehold property at cost	25,000	
Motor vehicles at cost	42,000	
3% bank loan		25,000
Furniture	3,200	
Provision for depreciation of furniture	_____ -	320
1/1/18		
	289,100	289,100

Additional information:

- 1) Closing inventory as at 31/12/18 was ₦3,000,000
- 2) Allowance for doubtful debts is to be adjusted to 10% of debtors
- 3) Expenses accrued were: Electricity ₦100,000 postages and stamps ₦50,000
- 4) Depreciation of the furniture is at 10% per annum
- 5) The leasehold property is to be written off over ten years
- 6) Bank loan interest for the year is outstanding

Required:

With the aid of an extended trial balance, prepare the adjustments, trading, profit or loss account and statement of financial position as at 31/12/18.

**Solution
JBH LTD**

Extended trial balance as at December 31, 2018

	Original trial balance		Note	Adjustments		Statement of profit or loss		Statement of financial position	
	DR	CR		DR	CR	DR	CR	DR	CR
	₦'000	₦'000		₦'000	₦'000	₦'000	₦'000	₦'000	₦'000
Capital 1/1/18		85,000							85000
Drawings:	5,500							5000	
Purchases and revenue	100,000	160,000				100000	160,000		
Inventory 1/1/18	5,000					5000			
Receivables and payables	27,500	15,780						27,500	15,780
Bad debts	500					500			
Electricity	300		3	100		400			
Postages and stamps	100		3	50		150			
Allow. for doubtful debts		3,000	2	250					2750
Decrease in allow. for doubtful debts			2		250	250			
Premises at cost	70,000							70000	
Salaries and wages	10,000					10000			
Leasehold property at cost	25,000							25000	
Motor vehicles at cost	42,000							42000	
3% bank loan		25,000							25000
Loan interest			6	750		750			
Accrued loan interest			6		750				750
Furniture	3,200							3200	
Depreciation-furniture			4	320		320			
Dep.- leasehold property			5	2500		2500			
Provision for dep. leasehold property			5		2500				2500
Provision for dep. furniture	-	320	4		320				640
Closing inventory			1	3,000				3000	
Inventory 31/12/18			1		3,000		3000		
Accrued electricity			3		100				100
Accrued postage & stamp			3		50				50
Net profit						43130			43130
	289100	289100		6970	6970	163000	163000	175700	175700

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Understand the purpose of the statement of financial position
- Understand the purpose of the statement of profit or loss
- Prepare financial statements from a trial balance after adjusting it for information provided
- Prepare and explain an extended trial balance

ICAN 2021

Preparation of company financial statements

Contents

- 1 The components of financial statements
- 2 Structure and content of the statement of financial position
- 3 Structure and content of the statement of profit or loss
- 4 Accounting for taxation
- 5 Accounting for share issues
- 6 Financial statements – specimen formats
- 7 IAS 8: Accounting policies, changes in accounting estimates and errors
- 8 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

F	Financial statements	
	1	State and explain the purpose, nature and relationships among the main components of financial statements.
	4	Preparation of simple financial statements and supporting notes
	a	Prepare statement of profit or loss and other comprehensive income in accordance with IAS 1.
	b	Prepare statement of financial position in accordance with IAS 1.
	c	Prepare simple statement of cash flows in accordance with IAS 7 (see chapter 18).
	d	Prepare simple statement of change in equity.
	2	Accounting policies, change in accounting estimates and errors (IAS 8)
	a	Define accounting policies.
	b	Explain the guidance on the selection of accounting policies.
	c	Account for changes in accounting policies.
	d	Differentiate between accounting policies and accounting estimates.
	e	Explain how to account for changes in estimates.
	f	Identify and correct prior year errors.

IAS 1: Presentation of Financial Statements and **IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors** are examinable documents.

Exam context

This chapter explains aspects of company financial statements.

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

- Prepare a simple statement of financial position in accordance with the guidance in IAS 1 from data and information provided;
- Prepare a simple statement of profit or loss in accordance with the guidance in IAS 1 from data and information provided;
- Account for taxation expense; and
- Account for share issues.

1 THE COMPONENTS OF FINANCIAL STATEMENTS

Section overview

- Preparing financial statements
- The format of published accounts

1.1 Preparing financial statements

The basic approach to preparing a statement of financial position and a statement of profit or loss in practice can be summarised as follows.

- The balances on all the accounts in the general ledger (nominal ledger or main) are extracted into a trial balance (a list of balances on all ledger accounts for assets, liabilities, capital, income and expenses).
- Adjustments are made for 'year-end' items, such as:
 - depreciation charges for non-current assets;
 - accruals and prepayments for expense items;
 - adjusting the allowance for bad (irrecoverable) debts;
 - closing inventory; and
 - other items and transactions not yet recorded or incorrectly recorded.
- The adjusted income and expense balances are entered into a statement of profit or loss to establish the profit or loss for the period.
- The adjusted asset, liability and capital balances, together with the retained profit for the year, are entered into a statement of financial position as at the end of the reporting period.

It is likely that you will be given a trial balance with information about missing or incorrectly treated items. You will then be asked to construct a statement of financial position and a statement of profit or loss.

The same process is used to prepare the statement of profit or loss and statement of financial position of a sole proprietor, a partnership or a company. However, companies are subject to greater regulation in many areas including financial reporting. This chapter explains the more specific financial reporting demands placed on companies.

The chapter also explains certain double entry that is specific to companies.

1.2 The format of published accounts

Some entities must publish financial statements in accordance with ***International Financial Reporting Standards*** and ***International Accounting Standards***.

IAS 1: Presentation of Financial Statements, sets out the rules on the form and content of financial statements which such entities must comply with.

IAS 1 specifies what published general-purpose financial statements should include, and provides a format for a statement of financial position, statement of profit or loss and other comprehensive income and a statement of changes in equity.

The objective of general-purpose financial statements is to provide information about the financial position of the company, and its financial performance and cash flows that is useful to a wide range of users in making economic decisions.

A complete set of financial statements consists of:

- a statement of financial position as at the end of the period;
- a statement of profit or loss and other comprehensive income for the period (made up of a statement of profit or loss and a statement of other comprehensive income);
- a statement of changes in equity for the period;
- a statement of cash flows (dealt with in a later chapter); and
- notes to these statements, consisting of a summary of significant accounting policies used by the entity and other explanatory notes.

Further requirements include:

- Financial statements should present fairly the financial position, financial performance and cash flows of the entity.
- Comparative information for the immediately preceding accounting period should be disclosed (you will not be asked to provide comparative information).
- Each component of the financial statements must be properly identified with the following information displayed prominently:
 - the name of the reporting entity
 - the date of the end of the reporting period or the period covered by the statement, whichever is appropriate
 - the currency in which the figures are reported
 - the level of rounding used in the figures (for example, whether the figures are in thousands of naira or millions of naira).

Note: IAS 1 does not specify what the statements must be called and allows the use of other terminology. For example a statement of financial position is often called a balance sheet and a statement of profit or loss is often called an income statement.

2 STRUCTURE AND CONTENT OF THE STATEMENT OF FINANCIAL POSITION

Section overview

- Introduction
- Current and non-current assets and liabilities
- Current assets
- Current liabilities
- Information to be presented on the face of the statement of financial position

2.1 Introduction

IFRS uses terms which are incorporated into this study text. However, it does not forbid the use of other terms and you might see other terms used in practice.

IAS 1 sets out the requirements for information that must be presented in the statement of financial position or in notes to the financial statements, and it also provides implementation guidance. This guidance includes an illustrative format for a statement of financial position. This format is not mandatory but you should learn it and use it wherever possible.

2.2 Current and non-current assets and liabilities

Current and non-current items should normally be presented separately in the statement of financial position, so that:

- current and non-current assets are divided into separate classifications; and
- current and non-current liabilities are also classified separately.

As a general rule, an amount is 'current' if it is expected to be recovered or settled no more than 12 months after the end of the reporting period.

2.3 Current assets

IAS 1 states that an asset should be classified as a current asset if it satisfies **any** of the following criteria:

- The entity expects to realise the asset, or sell or consume it, in its normal operating cycle.
- The asset is held for trading purposes.
- The entity expects to realise the asset within 12 months after the reporting period.
- It is cash or a cash equivalent unless the asset is restricted from being used for at least 12 months after the reporting date. (Note: An example of 'cash' is money in a current bank account. An example of a 'cash equivalent' is money held in a term deposit account with a bank.)

All other assets should be classified as non-current assets.

This definition allows inventory or trade receivables to qualify as current assets, even if they may not be realised into cash within 12 months, provided that they will be realised in the entity's normal operating cycle or trading cycle.

The operating cycle of an entity is the time between the acquisition of assets for processing and their realisation in cash or cash equivalents. When the entity's normal operating cycle is not clearly identifiable, it is assumed to be twelve months. This is almost always the case.

2.4 Current liabilities

IAS 1 also states that a liability should be classified as a current liability if it satisfies **any** of the following criteria:

- The entity expects to settle the liability in its normal operating cycle.
- The liability is held primarily for the purpose of trading. This means that all trade payables are current liabilities, even if settlement is not due for over 12 months after the end of the reporting period.
- It is due to be settled within 12 months after the end of the reporting period.
- 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.

All other liabilities should be classified as non-current liabilities.

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

IAS 1 provides a list of items that, **as a minimum**, must be shown on the face of the statement of financial position as a 'line item' (in other words, on a separate line in the statement):

Assets

- (a) Property, plant and equipment
- (b) Intangible assets
- (c) Inventories
- (d) Trade and other receivables
- (e) Cash and cash equivalents.

Liabilities

- (f) Trade and other payables
- (g) Financial liabilities (for example, bank loans)
- (h) Liabilities (but possibly assets) for current tax

Equity

- (i) Issued capital and reserves attributable to the **owners** of the entity. (The term 'owners', refers to the **equity holders**.)

Note that IAS 1 requires more detail than this but other areas mentioned are not covered in this syllabus.

Additional line items should be included in the statement of financial position when presenting them separately and is 'relevant to an understanding of the entity's financial position.'

Information to be shown on the face of the statement of financial position or in notes

Some of the line items in the statement of financial position should be sub-classified into different categories, giving details of how the total figure is made up. This sub-classification may be presented either:

- as additional lines on the face of the statement of financial position (adding up to the total amount for the item as a whole) or
- in notes to the financial statements.

For example:

- Tangible non-current assets should be divided into sub-categories, as required by **IAS 16: Property, Plant and Equipment**.
- Receivables should be sub-classified into trade receivables, prepayments and other amounts.
- Inventories are sub-classified in accordance with **IAS 2: Inventories** into categories such as merchandise, materials, work-in-progress and finished goods.


Example: statement of financial position of an individual entity

IAS 1 does not specify what the exact format of the statement of financial position should be. However, it includes an illustrative statement of financial position in Guidance to implementing the Standard (which is an appendix to the Standard).

The example below is based on that example. Illustrative figures are included.

Statement of financial position of ABCD Entity as at December 31, 20XX

	₦m	₦m
Assets		
Non-current assets		
Property, plant and equipment	205.1	
Intangible assets	10.7	
Investments	6.8	
	<hr/>	222.6
Current assets		
Inventories	17.8	
Trade and other receivables	13.3	
Other current assets	2.0	
Cash and cash equivalents	0.7	
	<hr/>	33.8
Total assets	<hr/>	256.4
Equity and liabilities		
Share capital	50.0	
Retained earnings (accumulated profits)	60.6	
Other components of equity	31.9	
	<hr/>	142.5
Non-current liabilities		
Long-term borrowings	30.0	
Deferred tax	4.5	
Total non-current liabilities	<hr/>	34.5
Current liabilities		
Trade and other payables	67.1	
Short-term borrowings (bank overdraft)	3.2	
Current portion of long-term borrowing	5.0	
Current tax payable	4.1	
	<hr/>	79.4
Total current liabilities	<hr/>	113.9
Total liabilities	<hr/>	256.4
Total equity and liabilities	<hr/>	256.4

3 STRUCTURE AND CONTENT OF THE STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME

Section overview

- A single statement or two statements
- Information to be presented on the face of the statement of profit or loss
- Analysis of expenses by their function
- Analysis of expenses by their nature

3.1 A single statement or two statements

The statement of profit or loss and other comprehensive income provides information about the performance of an entity in a period. It consists of two parts:

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

IAS 1 allows an entity to present the two sections in a single statement or in two separate statements. If two separate statements are used they should include all the information that would otherwise be included in the single statement of profit or loss and other comprehensive income.

The statement of profit or loss shows the components of profit or loss, beginning with 'Revenue' and ending with 'Profit (or Loss)' for the period after tax.

Definition of total comprehensive income

Total comprehensive income during a period is the sum of:

- the profit or loss for the period and
- other comprehensive income.

Items which must be recognised as other comprehensive income are not in your syllabus. This means that statements of comprehensive income at this level include only the statement of profit or loss.

3.2 Information to be presented on the face of the statement of profit or loss

As a **minimum**, IAS 1 requires that the statement of profit or loss should include line items showing the following amounts for the financial period:

- (a) revenue
- (b) finance costs (for example, interest costs)
- (c) tax expense
- (d) profit or loss
- (e) each component of 'other comprehensive income'
- (f) total comprehensive income.

Additional line items should be presented on the face of the statement of profit or loss when it is relevant to an understanding of the entity's financial performance.



Example: statement of profit or loss of an individual entity

IAS 1 does not specify formats.

The example below is based on a suggested presentation included in the implementation guidance to IAS 1.

XYZ Entity: Statement of profit or loss for the year ended December 31, 20XX

	₦000
Revenue	678
Cost of sales	250
	<hr/>
Gross profit	428
Other income	44
Distribution costs	(98)
Administrative expenses	(61)
Other expenses	(18)
Finance costs	(24)
	<hr/>
Profit before tax	271
Taxation	(50)
	<hr/>
PROFIT FOR THE YEAR	221
Other comprehensive income	46
Gains on property revaluation	46
	<hr/>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	267
	<hr/>

Information to be shown on the face of the statement of profit or loss (or the statement of profit or loss, if separate) or in the notes

The following information may be shown either on the face of the statement of profit or loss or in a note to the financial statements:

- material items** of income and expense
- an analysis of expenses**, providing either:
 - expenses analysed by their nature, or
 - expenses analysed by the function that has incurred them.

IAS 1 encourages entities to show this analysis of expenses on the face of the statement of profit or loss, rather than in a note to the accounts.

Material items that might be disclosed separately include:

- a write-down of inventories from cost to net realisable value, or a write-down of items of property, plant and equipment to recoverable amount
- disposals of items of property, plant and equipment
- litigation settlements

3.3 Analysis of expenses by their function

When expenses are analysed according to their function, the functions are commonly 'cost of sales', 'distribution costs', 'administrative expenses' and 'other expenses'. This method of analysis is also called the 'cost of sales method'.

In practice, most entities use this method.

An example of a statement of profit or loss, showing expenses by function (cost of sales, distribution costs, administrative expenses) is as follows.



Example: Analysis of expenses by function

The following is an extract from the accounts of Entity Red for the year to June 30, 20X5, after the year-end adjustments had been made:

	Debit	Credit
	₦000	₦000
Cost of sales	6,214	
Distribution costs	3,693	
Revenue		14,823
Other expenses	248	
Administrative expenses	3,901	
Other income		22

Required

Show the first part of Entity Red's statement of profit or loss using the 'cost of sales' analysis method.

Entity Red: Statement of profit or loss for the year ended June 30, 20X5

	₦000
Revenue	14,823
Cost of sales	6,214
Gross profit	8,609
Other income	22
Distribution costs	(3,693)
Administrative expenses	(3,901)
Other expenses	(248)
Profit before tax	<u>789</u>

The basis for separating these costs between the functions would be given in the question.

3.4 Analysis of expenses by their nature

When expenses are analysed according to their nature, the categories of expenses will vary according to the nature of the business.

In a manufacturing business, expenses would probably be classified as:

- raw materials and consumables used;
- staff costs ('employee benefits costs'); and
- depreciation.

Items of expense that on their own are immaterial are presented as 'other expenses'.

There will also be an adjustment for the increase or decrease in inventories of finished goods and work-in-progress during the period.

Other entities (non-manufacturing entities) may present other expenses that are material to their business.

An example of a statement of profit or loss, showing expenses by their nature, is shown below, with illustrative figures included.



Example: Analysis of expenses by nature

The following is an alternative method of presenting the accounts of Entity Red.

	₦000
Increase in inventories of finished goods and work-in-progress	86
Revenue	14,823
Raw materials and consumables	5,565
Depreciation	1,533
Other income	22
Staff costs	4,926
Other operating expenses	2,118

Required

Show the first part of Entity Red's statement of profit or loss using the 'nature of expenditure' method, down to the operating profit level.

Entity Red: Statement of profit or loss for the year ended June 30, 20X5

	₦000	₦000
Revenue	14,823	
Other income		22
		<hr/>
		14,845
Changes in inventories of finished goods and work-in-progress (reduction=expense, increase=negative expense)	(86)	
Raw materials and consumables used	5,565	
Staff costs (employee benefits costs)	4,926	
Depreciation and amortisation expense	1,533	
Other operating expenses	<u>2,118</u>	
		<hr/>
Profit before tax		14,056
		<hr/>
		789

4 ACCOUNTING FOR TAXATION

Section overview

- Taxation on profits
- Taxation in the statement of profit or loss
- Taxation in the statement of financial position

4.1 Taxation on profits

A company is a legal person, and is liable to pay tax on the profits that it makes. This tax is called income tax in international accounting standards.

The statement of profit or loss and statement of financial position of a sole trader or partnership are prepared without any concern for taxation on profits. The taxation of the income of sole traders and partners is not a concern of their businesses, and is not recorded in the financial accounts of the business.

Companies are different, because the company has a liability for taxation that is reported in its statement of profit or loss and statement of financial position.

- The statement of profit or loss reports the amount of taxation on the profit of the company for the year. This is deducted in reaching a figure for profit after taxation.
- The statement of financial position reports the amount of taxation that the company owes to the tax authorities as at the end of the reporting period.

4.2 Taxation in the statement of profit or loss

Taxation in the statement of profit or loss might relate to the profit or loss section or to other comprehensive income. Tax is recognised in each section as appropriate.

The tax charge that relates to profit or loss is a charge against profits after interest. The profit after tax is added to the retained earnings reserve.



Example:

	₦
Profits from operations	460,000
Interest	<u>(60,000)</u>
Profit before tax	400,000
Tax	<u>(100,000)</u>
Profit after tax	300,000

The profit after tax is added to the retained earnings (accumulated profits) brought forward at the start of the year to give a total which appears on the face of the statement of financial position at the year end (unless there are any other transfers into or out of this amount, for example, dividend payments).

Over-estimate or under-estimate of tax from the previous year

When the financial statements are prepared, the tax charge on the profits for the year is likely to be an estimate. The figure for tax on profits in the statement of profit or loss is therefore not the amount of tax that will eventually be payable, because it is only an estimate. The actual tax charge, agreed with the tax authorities some time later, is likely to be different.

In these circumstances, the tax charge for the year is adjusted for any under-estimate or over-estimate of tax in the previous year.

- An under-estimate of tax on the previous year's profits is added to the tax charge for the current year.
- An over-estimate of tax on the previous year's profits is deducted from the tax charge for the current year.

Example:

Profit from operations	₦	460,000
Interest		(60,000)
Profit before tax		400,000
Tax:		
Adjustment for under-estimate of tax in the previous year	3,000	
Tax on current year profits	100,000	
Tax charge for the year		(103,000)
Profit after tax		297,000

4.3 Taxation in the statement of financial position

The taxation charge for the year is the liability that the company expects to pay. The timing of tax payments on profits varies from one country to another, depending on the tax rules in each country. The actual amount of tax payable, and reported in the statement of financial position as a current liability (taxation payable), is calculated as follows:

Illustration:

Tax payable at the beginning of the year	₦	X
Tax charge for the year		X
		X
Tax payments made during the year		(X)
Tax payable at the end of the year		X

**Example:**

Fresh Company has a financial year ending on December 31. At December 31, Year 5 it had a liability for income tax (tax on its profits) of ₦77,000. The tax on profits for the year to December 31, Year 6 was ₦114,000.

The tax charge for the year to December 31, Year 5 was over-estimated by ₦6,000.

During the year to December 31, Year 6, the company made payments of ₦123,000 in income tax.

Required

Calculate:

- The tax charge for the year to December 31, Year 6, to include in the statement of profit or loss
- The liability for income tax as at December 31, Year 6, to include in the balance sheet.

**Answer**

(a)

Tax:	₦
Adjustment for over-estimate of tax in the previous year	(6,000)
Tax on current year profits	114,000
Taxation charge for the year	<u>108,000</u>

(b)

	₦
Tax payable at the beginning of the year	77,000
Tax charge for the year	<u>108,000</u>
	185,000
Tax payments made during the year	(123,000)
Tax payable at the end of the year	<u>62,000</u>

The tax payable will appear as a current liability in the statement of financial position.

5 ACCOUNTING FOR SHARE ISSUES

Section overview

- Issue of equity shares

5.1 Issue of equity shares

When an entity issues new ordinary shares:

- the issued shares become a part of equity, and
- the entity receives cash from the issue, or possibly assets other than cash (for which a carrying value is determined).

The issue price of new equity shares is usually higher than their face value or nominal value. The difference between the nominal value of the shares and their issue price is accounted for as share premium, and credited to a share premium reserve. (This reserve is a part of equity).

Illustration: Share issue double entry

	Debit	Credit
Bank (cash received)	X	
Share capital (nominal value of shares issued)	X	
Share premium (with the excess of the issue price of the shares over their nominal value)		X

Transaction costs of issuing new equity shares for cash should be debited directly to equity.

The costs of the issue, net of related tax benefit, are set against the share premium account. (If there is no share premium on the issue of the new shares, issue costs should be deducted from retained earnings).

Example: Share issue

A company issues 200,000 shares of ₦25 each at a price of ₦250 per share. Issue costs are ₦3,000,000.

The share issue would be accounted for as follows:

	Dr (₦000)	Cr (₦000)
Cash (200,000 × 250)	50,000	
Share capital (200,000 × 25)		5,000
Share premium (200,000 × 250 – 25)		45,000
Share premium		3,000
Cash		3,000

6 FINANCIAL STATEMENT—SPECIMEN FORMATS

Section overview

- Statement of profit or loss (analysis of expenses by function)
- Statement of profit or loss (analysis of expenses by nature)
- Statement of financial position

IAS 1 does not specify formats for financial statements. However, it includes illustrative statements in an appendix to the Standard).

The illustrations below are based on the illustrative examples but have been modified to exclude some items not in this syllabus.

6.1 Statement of profit or loss (analysis of expenses by function)



Illustration: Statement of profit or loss (analysis of expenses by function)

Statement of profit or loss for the year ended 31 December 2019

	₦m
Revenue	X
Cost of sales	(X)
Gross profit	X
Other income	X
Distribution costs	(X)
Administrative expenses	(X)
Other expenses	(X)
Finance costs	(X)
Profit before tax	X
Taxation	(X)
PROFIT FOR THE YEAR	X
Other comprehensive income	
Gains on property revaluation	X
Other gains and losses	X
Other comprehensive income for the year	X
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	X

6.2 Statement of profit or loss (analysis of expenses by nature)



Illustration: Statement of profit or loss (analysis of expenses by function)

Statement of profit or loss for the year ended 31 December 2019

Revenue	X
Other income	X
Changes in inventories of finished goods and work-in-progress	<u>X</u>
Raw materials and consumables used	X
Staff costs (employee benefits costs)	(X)
Depreciation and amortisation expense	(X)
Other expenses	(X)
Finance costs Profit	(X)
before tax Taxation	<u>X</u>
PROFIT FOR THE YEAR	<u>(X)</u>
 Other comprehensive income	
Gains on property revaluation	X
Other gains and losses	X
Other comprehensive income for the year	<u>X</u>
TOTAL COMPREHENSIVE INCOME FOR THE YEAR	<u>X</u>

6.3 Statement of financial position



Illustration: Statement of financial position format

Statement of financial position as at 31 December 2019

	₦m	₦m
Assets		
Non-current assets		
Property, plant and equipment	X	
Intangible assets	X	
Investments	X	
<i>Total non-current assets</i>	X	
Current assets		
Inventories	X	
Trade and other receivables	X	
Other current assets	X	
Cash and cash equivalents	X	
<i>Total current assets</i>	X	
Total assets	X	
Equity and liabilities		
Share capital	X	
Retained earnings (accumulated profits)	X	
Other components of equity	X	
<i>Total equity</i>	X	
Non-current liabilities		
Long-term borrowings	X	
Deferred tax	X	
<i>Total non-current liabilities</i>	X	
Current liabilities		
Trade and other payables	X	
Short-term borrowings (bank overdraft)	X	
Current portion of long-term borrowing	X	
Current tax payable	X	
<i>Total current liabilities</i>	X	
Total liabilities	X	
Total equity and liabilities	X	

7 IAS 8: ACCOUNTING POLICIES, CHANGES IN ACCOUNTING ESTIMATES AND ERRORS

Section overview

- Introduction to IAS 8
- Changes in accounting policies
- Retrospective application of a change in accounting policy
- Disclosure of a change in accounting policy
- Accounting estimates
- Changes in accounting estimates
- Errors
- The correction of prior period errors

7.1 Introduction to IAS 8

IAS 8 Accounting policies, changes in accounting estimates and errors deals with several different issues in financial reporting:

- selecting and applying accounting policies (dealt with in an earlier chapter)
- accounting for changes in accounting policies
- changes in accounting estimates
- corrections of errors in a prior accounting period.

Much of IAS 8 is therefore concerned with how changes or corrections should be reported in the financial statements.

7.2 Changes in accounting policies

Users of financial statements need to be able to compare financial statements of an entity over time, so that they can identify trends in its financial performance or financial position. Frequent changes in accounting policies are therefore undesirable because they make comparisons with previous periods more difficult. IAS 8 therefore states that a change in accounting policy is permitted only in the following circumstances:

- When a change in accounting policy is required by an IFRS or revised IAS (or an Interpretation of an IFRS), or
- If a change in accounting policy results in the financial statements providing reliable and more relevant financial information.

When a change in accounting policy is required by a new Standard, the Standard will often include specific '**transitional provisions**'. These explain how the change should be introduced.

In the absence of specific transitional provisions, a change in policy should be applied retrospectively.

Determining when there is a change in accounting policy

How should an entity decide whether it would be introducing a change in accounting policy, if it decided to account for a particular type of transaction in a particular way?

IAS 8 specifies that when a new accounting policy is applied for transactions or events that did not occur previously, in earlier financial periods, this is **not** a change of accounting policy; it would simply be the application of a suitable accounting policy to a new type of transaction.

A change in accounting policy can be established as follows. The accounting policies chosen by an entity should reflect transactions and events through:

- recognition (e.g. capitalising or writing off certain types of expenditure)
- measurement (e.g. measuring non-current assets at cost or valuation)
- presentation (e.g. classification of costs as cost of sales or administrative expenses)

If at least one of these criteria is changed, then there is a change in accounting policy.



Example: Accounting policy

A company has previously written off borrowing costs as incurred in the statement of profit or loss. It is now proposed that any relevant finance costs should be capitalised as required IAS 23 Borrowing Costs.

This affects:

- recognition—the interest cost is now recognised as an asset rather than an expense
- presentation – the interest cost is now presented in the statement of financial position rather than the statement of profit or loss.

In this example, there has been no change to the measurement of the finance costs but this is still a change in accounting policy due to a change in recognition and presentation.

7.3 Retrospective application of a change in accounting policy

When a change in accounting policy is required by a new accounting standard and there are no transitional provisions relating to the introduction of that new standard, the change in policy should be applied retrospectively.

The entity should adjust the opening balance for each item of equity affected by the change, for the earliest prior period presented, and the other comparative amounts for each prior period, as if the new accounting policy had always been applied. For example, suppose that a change in accounting policy is required from Year 3 onwards, and the earliest prior period presented in the Year 3 financial statements is Year 2, for which comparative prior year figures are presented. In that case, the change in accounting policy should be applied retrospectively. This means that the change should be applied to the opening balances at the start of Year 2 (in the comparative prior period information), as if the new policy had always been applied.

Similarly, any other comparative amounts in previous periods should be adjusted as if the new accounting policy had always been applied.

If this is impracticable, retrospective application should be applied from the earliest date that is practicable.

7.4 Disclosure of a change in accounting policy

When an entity makes a change in an accounting policy, a note to the financial statements should disclose the following information about the change:

Disclosures required	Change due to a new Standard or Interpretation	Voluntary change
The nature of the change in accounting policy	Yes	Yes
For the current and previous period(s), to the extent practicable, the amount of the adjustment to each item in the financial statements and the adjustment to the basic and fully diluted earnings per share	Yes	Yes
To the extent practicable, the adjustment relating to accounting periods before those presented in the financial statements	Yes	Yes
If retrospective application is impracticable, an explanation of how the accounting policy change has been applied	Yes	Yes
The title of the Standard or Interpretation	Yes	na
A description of any transitional provisions	Yes	na
The reason why the new accounting policy provides reliable and more relevant information	na	Yes

7.5 Accounting estimates

An accounting estimate is made for an item in the financial statements when the item cannot be measured with precision, and there is some uncertainty about it. An estimate is therefore based, to some extent, on management's judgement. Management estimates might be required, for example, for the following items:

- Bad debts
- inventory obsolescence
- the fair value of financial assets or liabilities
- the useful lives of non-current assets
- the most appropriate depreciation pattern (depreciation method) for a category of non-current assets
- warranty obligations.

It is important to distinguish between an accounting policy and an accounting estimate.

As an example a company may have an accounting policy to depreciate plant and equipment over its useful life. However whether the company uses the

straight line method of depreciation or the reducing balance method will be a choice of accounting estimate.

IAS 8 requires a change in an accounting policy to be accounted for retrospectively whereas **a change in an accounting estimate is normally recognised in the current period** (and there is no requirement for retrospective application).

7.6 Changes in accounting estimates

A change in accounting estimate may be needed if changes occur in the circumstances on which the estimate was based, or if new information becomes available. A change in estimate is **not** the result of discovering an error in the way an item has been accounted for in the past and it is **not** a correction of an error.

The effect of a change in accounting estimate should be recognised prospectively, by including it:

- in profit or loss for the period in which the change is made, if the change affects that period only, or
- in profit or loss for the period of change and future periods, if the change affects both.

Prospective application of a change in estimate

A **change in accounting estimate is not applied retrospectively**. There is prospective application of the change. This means that the effect of the change is recognised in the current period and the future periods affected by the change.

To the extent that a change in estimate results in a change in assets and liabilities, it should be recognised by adjusting the carrying amount of the affected assets or liabilities in the period of change.

**Example: Change in accounting estimate**

A non-current asset was purchased for ₦200,000 two years ago, when its expected economic life was ten years and its expected residual value was nil. The asset is being depreciated by the straight-line method.

A review of the non-current assets at the end of year 2 revealed that due to technological change, the useful life of the asset is only six years in total, and the asset therefore has a remaining useful life of four years.

The original depreciation charge was ₦20,000 per year ($\frac{\text{₦}200,000}{10 \text{ years}}$) and at the beginning of Year 2, its carrying value was ₦180,000 ($\text{₦}200,000 - \text{₦}20,000$).

The change in the estimate occurs in Year 2. The change in estimate should be applied prospectively, for years 2 onwards (years 2–6). From the beginning of year 2, the asset has a revised useful remaining life of five years.

The annual charge for depreciation for year 2 (the current year) and for the future years 3 – 6 will be changed from ₦20,000 to ₦36,000 ($\frac{\text{₦}180,000}{5 \text{ years}}$).

**Example: Change in accounting estimate**

The carrying value of an item of inventory is \$7,000. The inventory is no longer used due to a change in materials specifications for the products that used to contain the inventory item. The inventory has no scrap value and is now considered worthless.

A change in accounting estimate should reduce the value of the inventory to zero. The change affects the current year only, and the write-off of \$7,000 should be treated as an expense for the year.

7.7 Errors

Errors might happen in preparing financial statements. If they are discovered quickly, they are corrected before the finalised financial statements are published. When this happens, the correction of the error is of no significance for the purpose of financial reporting.

A problem arises, however, when an error is discovered that relates to a prior accounting period. For example, in preparing the financial statements for Year 3, an error may be discovered affecting the financial statements for Year 2, or even Year 1.

Errors might be:

- the effect of a mathematical mistake
- a mistake in applying an accounting policy
- an oversight
- a misinterpretation of facts
- caused by fraud.

Prior period errors are defined in IAS 8 as: ‘omissions from, and misstatements in, the entity’s financial statements for one or more prior periods arising from a failure to use, or misuse of, reliable information that:

- was available when financial statements for those periods were authorised for issue; and

- could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements.'

7.8 The correction of prior period errors

IAS 8 states that all material prior period errors should be **corrected retrospectively** in the first set of financial statements following the discovery of the error.

Comparative amounts for the previous period should be restated at their corrected amount.

If the error occurred before the previous year, the opening balances of assets, liabilities and equity for the previous period should be restated at their corrected amount.

The correction of a prior period error is excluded from profit or loss in the period when the error was discovered.

For example, suppose that an entity preparing its financial statements for Year 3 discovers an error affecting the Year 2 financial statements. The error should be corrected in the Year 3 financial statements by restating the comparative figures for Year 2 at their correct amount. If the error had occurred in Year 1, the comparative opening balances for the beginning of Year 2 should be restated at their correct amount. The reported profit for Year 3 is not affected.



Example: Correction of prior period errors

Kano Transport Company (KTC) is preparing its financial statements for 20X4. The draft statement of changes in equity is as follows:

	Share capital ₦000	Share premium ₦000	Retained earnings ₦000	Total ₦000
Balance at 31/12/X2	500	50	90	640
Profit for the year	-	-	150	150
Balance at 31/12/X3 20X4	500	50	240	790
Profit for the year			385	385
Balance at 31/12/X4	500	50	625	1,175

KTC has now discovered an error in its inventory valuation. Inventory was overstated by ₦70,000 at 31 December 20X4 and by ₦60,000 at 31 December 20X3.

The error in 20X4 is corrected against the current year profit.

The error in 20X3 is corrected against the prior year profit. (Note that the 20X3 closing inventory is the opening inventory in 20X4 so the 20X3 adjustment will impact both periods statements comprehensive income (reducing 20X3 profit but increasing 20X4 profit).



Example (continued): Correction of prior period errors

The necessary profit adjustments are as follows:

Profit adjustments:	20X4 ₦000	20X3 ₦000
Profit (20X4 draft and 20X3 actual)	385	150
Deduct error in closing inventory	(70)	(60)
Add error in opening inventory	60	(60)
	(10)	(60)
Adjusted profit	375	90

The statement of changes in equity as published in 20X4 becomes:

	Share capital ₦000	Share premium ₦000	Retained earnings ₦000	Total ₦000
Balance at 31/12/X2	500	50	90	640
Profit for the year (restated)	-	-	90	90
Balance at 31/12/X3	500	50	180	730
20X4				
Profit for the year			375	375
Balance at 31/12/X4	500	50	555	1,105

8 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Prepare a simple statement of financial position in accordance with the guidance in IAS 1 from data and information provided
- Prepare a simple statement of profit or loss in accordance with the guidance in IAS 1 from data and information provided
- Account for taxation expense
- Account for share issues
- Accounting for changes in policies and estimates - IAS 8

ICAN 2021

Preparation of partnership accounts

Contents

- 1 Features of partnerships
- 2 Sharing the profits between the partners
- 3 Changes in partnerships
- 4 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

E Accounting for partnership, not-for-profit entities and incomplete records		
1 Partnership accounts		
	a	Discuss partnership business.
	b	Prepare partners' current and capital accounts.
	c	Determine partners' share of profits.
	d	Account for changes in partnership (excluding amalgamation and piece meal realisation).

Exam context

This chapter explains aspects of partnership accounts.

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

- Describe the main features of a partnership;
- Prepare partners' current and capital accounts;
- Account for partners' shares of profit at the end of a period; and
- Account for changes in a partnership.

1 FEATURES OF PARTNERSHIPS

Section overview

- Partnerships
- Partnership accounts
- Partners' capital

1.1 Partnerships

A partnership is a type of business structure.



Definition: Partnership

The relation which subsists between persons carrying on a business in common with a view of profit.

The partners are carrying on a business in common with a view to making a profit.

Partnerships in Nigeria are subject to rules set out in UK Partnership Act 1890.

The partnership Deed

The Partnership Act 1890 provides certain rules to be observed in the absence of any agreement among partners. However, the circumstances must determine whether these rules are applicable in the particular case.

The Partnership Act 1890 provides, among other things, that:

- (a) All profits and losses are to be shared equally between the partners;
- (b) No interest is allowed on capital and current accounts;
- (c) No remuneration will be paid to a partner; and
- (d) Any advance or loan made by a partner in excess of his agreed share of capital will attract interest at 5% per annum.

Note that in 2011 the Lagos state government amended the Act for use in Lagos.

Persons who have entered into partnership with one another are called individually **partners** and collectively a **firm** and the name under which their business is carried on is called the **firm name**.

Features of a partnership

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

There must be an agreement entered into by all the persons concerned.

The agreement must be to share the profits of a business.

The business must be carried on by all or any of the persons concerned acting for all.

Change in partners

The composition of a partnership might change on occasion with new partners being admitted or an existing partner leaving or through two separate partnerships amalgamating into a single new partnership.

Sometimes a partnership might dissolve (known as dissolution of the partnership)

Later sections explain the accounting treatment to reflect these events.

1.2 Partnership accounts

Partnership accounts are the financial accounts of a partnership business.

The financial statements of partnerships are the same as those of a sole proprietor with the exception of capital. The major difference between a partnership and a sole proprietor business is that a partnership has several joint owners.

Ownership is reflected in the capital of a business so whereas there is a single capital account in the statement of financial position of a sole proprietor the capital section of the statement of financial position of a partnership must reflect the fact that there is more than one owner.

The accounts of the partnership must record the capital and profits that are attributable to each individual partner.

The profit of a sole proprietor is simply added to the capital balance brought forward. In the case of a partnership the profit belongs to the partners so there must be a mechanism by which this is shared. Partners' shares are then added to their personal capital accounts.

1.3 Partners' capital

Each partner contributes capital to the business and shares in the profit (or loss) of the business. The capital of each partner must be identified separately.

The capital of each partner is usually contained in two accounts.

- Capital account
- Current account

Capital account

The partnership agreement usually specifies that each partner must contribute a minimum amount of 'fixed' capital and that partners cannot draw out any of their fixed capital.

In addition, each partner might retain some of his or her share of accumulated profits in the business. The partnership agreement should allow partners to draw out their share of accumulated profits, if they wish to do so.

The capital account records the fixed capital or long-term capital of the partner that the partner must retain in the business and cannot take out in drawings.

The balance on this account does not change very often.

Current account

A current account is used to record the accumulated profits of the partner and the partner's drawings.

- The profits of the business are shared between the partners. The share of each partner is credited to (added to) his or her current account.
- Each partner may take drawings out of the business. Drawings are a withdrawal of profit. These are recorded by debiting the current account of the partner (and crediting the Bank account).



Illustration: Partner X: current account

Partner X: current account

Opening balance

Partner's share of profit for the year

Drawings by the partner during the year

Closing balance

₦
X
X
(X)
<hr/>
X

2 SHARING THE PROFITS BETWEEN THE PARTNERS

Section overview

- Profit-sharing ratio
- Notional salaries for partners
- Notional interest on long-term capital
- Guaranteed minimum profit share
- Changes in the partnership agreement on profit-sharing
- Profits, drawings and the partners' current accounts

2.1 Profit-sharing ratio

The profit or loss for the financial period is calculated according to the normal rules (as described already for a sole trader). This total profit or loss figure is then divided between the partners and credited to their current account.

The partners are free to decide on how the profit (or loss) of the partnership is shared between the partners. The profit sharing arrangements are set out in the partnership agreement.

- The profit for the period might be shared in agreed profit sharing ratio. This is sometimes abbreviated as PSR. (The term profit sharing ratio covers the sharing of both profit and loss).
- Alternatively, there might be other means of allocating a first share of profit with the residual profit being shared in the agree profit sharing ratio. Methods of allocating a first share of profit include:
 - Notional salaries;
 - Notional interest on long term capital.

The first example shows the use of a profit sharing ratio without any other method of allocating a first share of profit.



Example:

The WXY Partnership has three partners, W, X and Y, who share profits and losses in an agreed ratio of 3:5:8.(Profit is divided into 16 parts {3+5+8} and W, X and Y receives 3 parts, 5 parts and 8 parts respectively).

Profits for the year were ₦1,920,000.

The total profits are divided between the partners as follows:

Partner		₦
W	$\text{₦1,920,000} \times \frac{3}{16}$	360,000
X	$\text{₦1,920,000} \times \frac{5}{16}$	600,000
Y	$\text{₦1,920,000} \times \frac{8}{16}$	960,000
		$\underline{\text{1,920,000}}$

This might be recorded using an appropriation account.

The profit would first be transferred into the appropriation account:



Illustration:

	Debit	Credit
Statement of comprehensive income account	1,920,000	
Appropriation account		1,920,000

The profit would then be transferred from the appropriation account to the partners' current accounts:



Illustration:

	Debit	Credit
Appropriation account	1,920,000	
Partner W's current account		360,000
Partner X's current account		600,000
Partner Y's current account		960,000

2.2 Notional salaries for partners

A partnership agreement might recognise the different amount of work done by partners by awarding one or more of the partners with a notional salary.

A notional salary is an agreed amount awarded to the individual partner from the partnership profits.

Note that a notional salary is not a business expense in the same way that salary to employees is. It is a share of the partnership profits.

Also note that notional salary may not be paid to a partner in the same way that salary is paid to employees. A partner takes cash out of the business through drawings.

The salary is awarded to each partner from the profits, and the residual profit after deduction of notional salaries is then divided between the partners in the agreed profit-sharing ratio.

**Example:**

The PQR Partnership has three partners, P, Q and R.

The partnership agreement provides for the residual profit (or loss) to be shared between the minthe ratio 4:3:2, after allowing a notional salary of ₦30,000 to R.

The profit for the year is ₦345,000.

Residual profits = ₦345,000 – ₦30,000 = ₦315,000.

Profits are shared as follows:

	Total	P	Q	R
	₦	₦	₦	₦
Notional salary	30,000			30,000
Residual profit:				
P share	₦315,000 × 4/9	140,000	140,000	
Q share	₦315,000 × 3/9	105,000		105,000
R share	₦315,000 × 2/9	70,000		70,000
Profit share	345,000	140,000	105,000	100,000

The profit share of each partner is added to the balance on their individual current accounts.

**Practice question**

1

A, B and C are in partnership sharing profits and losses in the ratio of 2:2:1.

B is allowed a salary of ₦100,000 per annum and C is allowed a salary of ₦150,000 per annum.

The net profit for year was ₦1,000,000.

Show how profit should be shared between the partners.

2.3 Notional interest on long-term capital

The partnership agreement might provide for the partners to obtain notional interest on the long-term capital they have invested in the business. This is interest on the balance in their capital account.

Notional interest on long-term capital is not interest expense, because the capital in the partners' capital account is equity, not a liability of the business.

The notional interest is a share of the partnership profits. Like notional salaries, the notional interest is awarded to each partner in accordance with the partnership agreement.

The residual profit shared between the partners in the profit-sharing ratio is the profit after notional salaries and notional interest on capital are deducted.



Example:

Partnership DEF has three partners, D, E and F.

Partner D has contributed ₦100,000 of fixed capital, Partner E ₦120,000 and Partner F ₦60,000.

They have agreed to share profits in the following way.

1. Partner D to receive a salary of ₦4,000 and Partner F a salary of ₦7,000.
2. All three partners receive interest at 5% on the fixed capital contributed.
3. Residual profit or loss to be shared between D, E and F in the ratio 3:5:2. The profit of the partnership for the year is ₦95,000.

The partnership profits would be shared between the partners as follows:

	Total	Profit share		
	₦	D	E	F
Notional salary	11,000	4,000		7,000
Notional interest at 5%	14,000	5,000	6,000	3,000
Residual profit (balance):				
Dshare	₦70,000 $\times^{3/10}$	21,000	21,000	
Eshare	₦70,000 $\times^{5/10}$	35,000		35,000
Fshare	₦70,000 $\times^{2/10}$	14,000		14,000
		70,000		
Profit share	95,000	30,000	41,000	24,000

**Practice question****2**

G, H and I are in partnership.

The profit of the partnership for the year is ₦1,146,000.

Partner G has contributed ₦500,000 of fixed capital, Partner H ₦400,000 and Partner I ₦300,000.

The partners have agreed to share profits in the following way.

- 1** Partner H should receive a salary of ₦50,000 and Partner I a salary of ₦100,000.
- 2** All three partners should receive interest at 8% on the fixed capital contributed.
- 3** Residual profit (or losses) should be shared between G, H and I in the ratio 3: 2:1.

Show how the partnership profits should be shared between the partners

2.4 Guaranteed minimum profit share

A partnership agreement might guarantee a minimum profit share for one (or more) of the partners.

In these cases:

- The partnership profits are shared according to the partnership agreement, ignoring the minimum profit agreement.
- If the normal sharing mechanism does not result in a partner receiving the minimum guaranteed profit the other partners must make up the shortfall out of their profit share, in their profit-sharing ratio.

**Example:**

The XYZ Partnership has three partners, X, Y and Z.

The partnership agreement provides for Partner X to receive a notional salary of ₦20,000 and residual profits or losses are shared between X, Y and Z in the ratio 2:4:6.

In addition, the agreement guarantees a minimum profit share of ₦32,000 to Partner Y.

The partnership profit for the current year is ₦80,000.

The partnership profits would be shared between the partners as follows:

	Total ₦	X ₦	Y ₦	Z ₦
Notional salary	20,000	20,000		
Residual profit (balance)				
Xshare ₦60,000 $\times 2/12$	10,000	10,000		
Yshare ₦60,000 $\times 4/12$	20,000		20,000	
Zshare ₦60,000 $\times 6/12$	30,000			30,000
	60,000			
	<u>80,000</u>	30,000	20,000	30,000
Transfer to meet shortfall:				
Xshare ₦12,000 $\times 2/8$		(3,000)	3,000	
Zshare ₦12,000 $\times 6/8$			9,000	(9,000)
			12,000	
Profit share	80,000	27,000	32,000	21,000

2.5 Changes in the partnership agreement on profit – sharing

The agreement on how the partners should share the profits of the business may be changed during a financial year. When this happens, the total profits for the year should be apportioned, on a time basis, between:

- profits of the business during the time of the 'old' profit-sharing arrangements, and
- profits of the business during the time of the 'new' profit-sharing arrangements.

The profits for each time period are then shared between the partners in accordance with the agreement for that period.

**Example:**

The DEF Partnership has three partners, D, E and F.

In the first half of year 1, to 30 June Year 1, Partner D and Partner F each received an annual salary of ₦30,000.

Residual profits or losses are shared between D, E and F in the ratio 3:5:2. (There is no interest on capital).

In the second half of the year, from July 1, to December 31, Partner D's salary was increased to ₦40,000, and the partners altered the profit-sharing ratio to 1:3:1 for D:E:F). The salary of Partner F was unchanged at ₦30,000 per year.

The profit for the year was ₦220,000 (arising evenly throughout the year).

The annual profit would be shared as follows:

	Total	D	E	F
First six months	₦	₦	₦	₦
Notional salary (6 months)	30,000	15,000		15,000
Residual profit (balance)				
Dshare	₦80,000 × 3/10	24,000	24,000	
Eshare	₦80,000 × 5/10	40,000		40,000
Fshare	₦80,000 × 2/10	16,000		16,000
		80,000		
	110,000	39,000	40,000	31,000
Second six months				
Notional salary (6 months)	35,000	20,000		15,000
Residual profit (balance)				
Dshare	₦75,000 × 1/5	15,000	15,000	
Eshare	₦75,000 × 3/5	45,000		45,000
Fshare	₦75,000 × 1/5	15,000		15,000
	75,000			
	110,000	35,000	45,000	30,000
Total for the year	220,000	74,000	85,000	61,000

2.6 Profits, drawings and the partners' current accounts

For each partner, the share of the annual profit is added to the partner's current account. Any drawings during the year are deducted.



Example:

There are three partners in the ABC Partnership, A, B and C. The capital and current accounts of the partners at the beginning of the year were as follows:

Partner	Capital account (₦)	Current account (₦)
A	100,000	6,000
B	200,000	3,000
C	160,000	8,000

The profit for the year was ₦103,000.

Profit sharing agreement:

Partner A is given a salary of ₦17,000 and Partner C has a salary of ₦15,000

The partners pay themselves interest on capital at 5% per year

The residual profit or loss is shared between A, B and C in the ratio 1:3:2.

During the year, drawings by each partner were:

A	₦20,000
B	₦25,000
C	₦40,000

The profit share is as follows:

	Total	A	B	C
	₦	₦	₦	₦
Notional salary	32,000	17,000		15,000
Notional interest at 5%	23,000	5,000	10,000	8,000
Residual profit (balance)				
A share ₦48,000 x 1/6	8,000		8,000	
B share ₦48,000 x 3/6	24,000			24,000
C share ₦48,000 x 2/6	16,000			16,000
	48,000			
Profit share	103,000	30,000	34,000	39,000

**Example (continued):**

The partners' capital accounts are the same at the end of the year as at the beginning of the year.

The current accounts are as follows (all amounts in ₦000):

			Current accounts		
	A	B	C	A	B
Drawings	20	25	40	Balance b/d 6	3 8
Balance c/d 16	16	12	7	Profit share 30	34 39
	36	37	47		36 37 47
				Balance b/d 16	12 7

The current accounts can also be set out in columnar form as follows:

Current accounts	Partner A	Partner B	Partner C
	₦	₦	₦
Beginning of the year	6,000	3,000	8,000
Add share of profit	30,000	34,000	39,000
	36,000	37,000	47,000
Deduct drawings	(20,000)	(25,000)	(40,000)
End of the year	16,000	12,000	7,000

Practice question

3

X, Y and Z are in partnership.

Partner	Capital account at The start of the year	Current account at the start of the year	Drawings during the year
	₦	₦	₦
X	1,000,000	20,000	780,000
Y	800,000	50,000	580,000
Z	600,000	10,000	350,000

The profit for the year was ₦1,944,000.

Profits are shared as follows:

- 1 The partners pay themselves interest on capital at 6% per year.
- 2 The residual profit or loss is shared between X, Y and Z in the ratio 4:3:2.

Show how the profits should be shared between the partners, and show their capital and current accounts as at the end of the year.

3 CHANGES IN PARTNERSHIPS

Section overview

- Introduction
- Goodwill
- Accounting for a change in partnership
- Admitting a new partner
- Retirement or death of a partner

3.1 Introduction

A partnership may change due to one of the following:

- Admission of a new partner to the firm.
- Death or retirement of a partner
- Amalgamation of a partnership with another business (maybe a sole proprietor or another partnership).

The accounting problems are similar in each case (though amalgamation does have an extra dimension which will be discussed later).

In each case the old partnership comes to an end and a new partnership is formed. Usually the records of the old partnership continue as those of the new partnership with adjustments to reflect the change of ownership.

The main objective of these adjustments is to establish the capital of each partner in the old partnership. This is important in each of the above cases.

Case	
Admission of a new partner	<p>The existing partners will want the new partner to introduce a share of capital.</p> <p>The size of the amount of capital the new partner must introduce depends on the existing capital of the business.</p>
Retirement (or death) of an existing partner	<p>The retiring partner will want to withdraw his capital so this must be measured at the date of retirement.</p> <p>A deceased partner's capital must be paid to his estate so that his family or other beneficiaries may benefit.</p>
Amalgamation	<p>It is important to establish the capital worth of each partner in the new business; to show what each partner is bringing to the new business.</p>

This may sound straight forward as capital and current accounts already exist.

However, the balance on the accounts is the partners' share of the net assets of the firm as recorded in the statement of financial position. The statement of financial position is a list of assets and liabilities, not a statement of value.

The assets of the business will be stated at cost. This may be very different to their value at the date of the change in partnership.

**Illustration:**

A, B and C were in partnership sharing profits or losses equally.

The firm bought a plot of land in 2001 for ₦2,500,000.

A left the partnership on 30 June 2019.

The land was worth ₦4,000,000 at that date. (This is known as its fair value).

The land has risen in value by ₦1,500,000 but this is not reflected in the financial statements. This means that A's capital does not include his share of the gain but clearly ₦500,000 of the gain belongs to him.

Some how the extra amount must be accounted for so that A can benefit from this.

The firm's net assets are not the same as the value of the firm and each partner will be more concerned with this latter figure.

**Illustration:**

A, B and C were in partnership sharing profits or losses equally.

A left the partnership on June 30, 2019.

At this date the net assets of the firm were ₦6,000,000. The value of the firm was estimated at ₦9,000,000. (The difference of ₦3,000,000 is called goodwill and this will be explained shortly).

A's share of the net assets might be 2,000,000 but his share of the value of the firm is ₦3,000,000.

Some how the extra amount must be accounted for so that A can benefit from this.

The solution to the above problems is as follows:

- The net assets must be revalued so that the partners share in any adjustment; and
- The difference between the value of the firm and the net assets of the firm (goodwill) must be recognised.

3.2 Goodwill

Goodwill is the amount by which the value of a business exceeds the value of all its net assets (its assets less liabilities).

Goodwill is an intangible asset of a business, but normally it is not recognised as an asset in the financial statements.

The value of a business is usually more than the net assets of the business because it reflects the trading potential that the business possesses, i.e. its ability to generate profits in the future. All successful businesses have goodwill, which means that buyers will be prepared to pay more to acquire the business than the value of its net assets.

Illustration: Goodwill

Value of the firm (what another party would pay for it)	X
Assets less liabilities of the firm (net assets)	(X)
Goodwill	X

Strictly speaking the assets and liabilities of the firm should be restated to their fair value in order to measure goodwill. Fair value is a very important concept in financial reporting but that is beyond the scope of this syllabus. For the purposes of this chapter it is sufficient to think of it as the market value of an asset, that is, how much it is worth.

Example:

A firm has net assets of ₦1,000,000.

One of the assets held by the firm is a property at cost less accumulated depreciation of ₦400,000. This property has a market value of ₦600,000 ($\text{₦}200,000$ above its book value).

The firm is valued at ₦1,800,000.

Goodwill calculation:	Without revaluing the asset	With revaluation of the asset
Value of the firm	1,800,000	1,800,000
Assets less liabilities as per the accounts	(1,000,000)	
Assets less liabilities (at fair value)		(1,200,000)
1,000,000 + 200)		
Goodwill	800.000	600.000

Amount shared by the partners:

Goodwill	800.000	600.000
Revaluation gain	-	200,000
Amount shared by the partners in the profit sharing ratio:	800.000	800.000

In the above example the figure of ₦600,000 for goodwill is the value that most closely fits the guidance given in IFRS. However, for the purpose of measuring adjustments to partners' capital at a time of change the example demonstrates that whether the net assets are revalued or not might be irrelevant as the overall gain to each partner is not affected.

The above example implies that there may be no point in revaluing assets in questions involving change. This is not true because questions on this topic usually provide the goodwill figure and revaluation rather than the value of the firm.

Valuing goodwill

The method of arriving at total value of the firm might be based on a formula set out in the partnership agreement.



Example:

The XYZ Partnership has an agreed method to value the firm for purposes of change in partnership as 10 times the average annual profit for the last three years for which financial statements are available.

Profit for the last three years has been as follows:

Year 3	₦100,000
Year 2	₦90,000
Year 1	₦80,000

The average annual profit is: $\frac{100,000 + 90,000 + 80,000}{3} = ₦90,000$

The valuation of the firm is: $10 \times ₦90,000 = ₦900,000$

Alternatively, a partnership agreement might specify a method for valuing goodwill directly. One such method is measuring goodwill as a multiple of average annual profits or a multiple of its average annual 'excess' profits.



Example:

The XYZ Partnership values its goodwill as two times the average of the annual profits in excess of ₦60,000 each year for the last three years.

Profit for the last three years has been as follows:

Year 3	₦100,000
Year 2	₦90,000
Year 1	₦80,000

The profits in excess of ₦60,000 have been:

$$₦40,000 + ₦30,000 + ₦20,000 = ₦90,000$$

The average annual excess profit is: $\frac{90,000}{3} = ₦30,000$

The valuation of goodwill is: $2 \times ₦30,000 = ₦60,000$

It is very unlikely that you will have to calculate goodwill in this exam but you will have to account for it.

3.3 Accounting for a change in partnership

As previously stated, the old partnership comes to an end and a new partnership begins but the records of the old partnership continue as those of the new partnership with adjustments to reflect the change of ownership.

The adjustments aim to establish each partner's share of the worth of the firm in the old partnership. This is done by recognising goodwill and any revaluation gains (or losses).



Illustration: Journal to recognise goodwill of old partnership

	Debit	Credit
Goodwill	X	
Partners' capital (in old partnership profit sharing ratio)		X
Being: Recognition of goodwill prior to a change in partnership		

The goodwill figure is not usually retained in the accounts after the change in the partnership. It is removed as follows:



Illustration: Journals to remove goodwill from books of the new partnership

	Debit	Credit
Partners' capital (in new partnership profit sharing ratio)	X	
Goodwill		X
Being: Removal of goodwill after a change in partnership		

Similar entries to those necessary to record goodwill might also be required to recognise revaluation of a specific asset.

Other entries will involve the recognition of capital introduced by a new partner or the removal of capital by a retiring partner or taken on behalf of a deceased partner.

3.4 Admitting a new partner

When a new partner is admitted to a partnership the following steps are required when accounting for this admission:

Steps	Detail
1	Measure goodwill of the old partnership (this figure will usually be given to you)
2	Recognise goodwill sharing the credit entry to the partners of the old partnership in the old profit sharing ratio.
3	Remove the goodwill in the books of the new partnership sharing the debit entry to the partners of the new partnership in the new profit sharing ratio.
4	Account for capital introduced by the new partner

**Example:**

R and S are in partnership sharing profits or losses equally.

R has ₦80,000 of capital and S has contributed ₦60,000 of capital.

T is to be admitted to the partnership and will introduce capital of ₦50,000.

Profits or losses are to be shared in the new partnership in the ratio of 2:2:1.

Step 1: The goodwill of the partnership at the date of admission is agreed to be ₦30,000.

Step 2: Recognise goodwill

	Debit	Credit
Goodwill	30,000	
Capital – Partner R ($\frac{1}{2}$ of 30,000)		15,000
Capital – Partner S ($\frac{1}{2}$ of 30,000)		15,000

Goodwill account (₦000)

Capital accounts			Capital accounts (₦000)		
R	S	T	R	S	T
			Balance b/d	80	60
			Goodwill	15	15

Step 3: Remove the goodwill

	Debit	Credit
Capital – Partner R ($\frac{2}{5}$ of 30,000)	12,000	
Capital – Partner S ($\frac{2}{5}$ of 30,000)	12,000	
Capital – Partner T ($\frac{1}{5}$ of 30,000)	6,000	
Goodwill		30,000

Goodwill account (₦000)

Capital accounts			Capital accounts		
R	S	T	R	S	T
			Balance b/d	80	60
Goodwill	12	12	Goodwill	15	15

Step 4: Recognise new partner's capital introduced

	Debit	Credit
Cash	50,000	
Capital – Partner T		50,000

**Example (continued)**

The capital accounts now look like this:

			Capital accounts (₦000)		
	R	S	T	R	S
Goodwill	12	12	6	Balance b/d	80
				Goodwill	15
				Cash	50
Balance c/d	83	63	44		
	95	75	50		
				Balance b/d	83
					63
					44

Note that the balance on partner T's capital account is only ₦44,000 even though he has introduced ₦50,000. This is because he has paid for his share of the goodwill of the business.

**Practice question****4**

P and Q are in partnership sharing profits or losses in the ratio of 2:1. P has contributed ₦600,000 of capital and Q has contributed ₦500,000 of capital.

They are about to admit a new partner, M, to the partnership and M has agreed to pay the partnership ₦400,000 of capital.

After the admission of M profits or losses will be shared between P, Q and M in the ratio of 2:2:1.

The goodwill of the partnership at the date of admission is estimated to be ₦150,000.

Write up the capital accounts of the partners to show the admission of M to the partnership.

3.5 Retirement or death of a partner

When a partner leaves a partnership the following steps are required when accounting for his leaving:

Steps	Detail
1	Measure goodwill of the old partnership (this figure will usually be given to you)
2	Recognise goodwill sharing the credit entry to the partners of the old partnership in the old profit sharing ratio.
3	Remove the goodwill in the books of the new partnership sharing the debit entry to the partners of the new partnership in the new profit sharing ratio.
4	Account for capital taken



Example:

P, Q and R are in partnership sharing profits or losses equally.

P has ₦80,000 of capital and Q has ₦60,000 of capital and R has ₦75,000 of capital.

Risto retire. He will be paid cash in the amount of ₦50,000 and he will leave the rest as a loan to the company.

Profits or losses are to be shared equally in the new partnership.

Step 1: The goodwill of the partnership at the date of retirement is agreed to be ₦60,000.

Step 2: Recognise goodwill

	Debit	Credit
Goodwill	60,000	
Capital – Partner P ($\frac{1}{3}$ of 60,000)		20,000
Capital – Partner Q ($\frac{1}{3}$ of 60,000)		20,000
Capital – Partner R ($\frac{1}{3}$ of 60,000)		20,000

Goodwill account (₦000)

Capital accounts	60	
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Capital accounts (₦000)

P	Q	R	P	Q	R
			Balance b/d	80	60
			Goodwill	20	20

**Example (continued)****Step3:** Remove the goodwill

	Debit	Credit
Capital – Partner P ($\frac{1}{2}$ of 60,000)	30,000	
Capital – Partner Q ($\frac{1}{2}$ of 60,000)	30,000	
Goodwill		60,000

Goodwill account (₦000)								
Capital accounts			60	Capital accounts			60	
Capital accounts (₦000)								
	P	Q	R		P	Q	R	
Goodwill	30	30		Balance b/d	80	60	75	
				Goodwill	20	20	20	

Step 4: Recognise amount paid to retiring partner and any other arrangement

	Debit	Credit
Cash		50,000
Capital – Partner T		50,000

The capital accounts now look like this:

Capital accounts (₦000)									
P			Q	R	P			Q	R
Goodwill	30	30			Balance b/d	80	60	75	
Cash				50	Goodwill	20	20	20	
Loan				45					
Balance c/d	70	50	–						
	100	80	95						
					Balance b/d	100	80	95	
						70	50	–	

**Practice question****5**

J, K and L are partners sharing profits or losses equally.

Capital account balances at 31 December 2019 are ₦320,000, ₦210,000 and ₦120,000.

K is to retire, leaving the amounts due to her as a loan to the partnership.

The land and buildings were revalued by ₦1,800,000 and goodwill was valued at ₦900,000.

After the change the profit share is revised to 3:1 and goodwill is not to be recorded in the books.

Show how the retirement of K should be shown in the capital accounts.

ICAN 2021

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Describe the main features of a partnership
- Prepare partners' current and capital accounts
- Account for partners' shares of profit at the end of a period
- Account for changes in a partnership

ICAN 2021

SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

Profit share

	Total ₦	A ₦	B ₦	C ₦
Notional salary	100,000		100,000	
	150,000			150,000
Residual profit:				
P share		300,000	300,000	
₦75,000 × 2/5	300,000			
Q share		300,000		300,000
₦75,000 × 2/5	300,000			
R share		150,000		150,000
₦75,000 × 1/5	150,000			
	750,000			
Profit share	1,000,000	300,000	400,000	300,000

Solutions

2

Profit share

	Total ₦	G ₦	H ₦	I ₦
Notional salary	150,000		50,000	100,000
Notional interest				
Fixed capital		500,000	400,000	300,000
Interest @ (8%)	96,000	40,000	32,000	24,000
Residual profit:				
G share		450,000	450,000	
₦900,000 × 3/6	450,000			
H share		300,000		300,000
₦900,000 × 2/6	300,000			
I share		150,000		150,000
₦900,000 × 1/6	150,000			
	900,000			
Profit share	1,146,000	490,000	382,000	274,000

Solutions

The profit share is as follows:

	Total ₦(000)	X ₦	Y ₦	Z ₦
Notional interest				
Fixed capital			1,000,000	800,000
Interest @ (6%)	144,000	60,000	48,000	36,000
Residual profit (balance)				
X share ₦1.8m x $\frac{4}{9}$		800,000	800,000	
Y share ₦1.8m x $\frac{3}{9}$		600,000		600,000
Z share ₦1.8m x $\frac{2}{9}$		400,000		400,000
	1,800,000			
Profit share	1,944,000	860,000	648,000	436,000

Current accounts (₦000)

	X	Y	Z		X	Y	Z
				Balance b/d	20	50	10
Drawings	780	580	350	Profit share	860	648	436
Balance c/d	100	118	96		880	698	446
	880	698	446	Balance b/d	100	118	96

The current accounts can also be set out in columnar form as follows:

Current accounts	Partner X			Partner Y			Partner Z		
	₦	₦	₦	₦	₦	₦	₦	₦	₦
Beginning of the year		20,000		50,000		10,000			
Add share of profit		860,000		648,000		436,000			
		880,000		698,000		446,000			
Deduct drawings		(780,000)		(580,000)		(350,000)			
End of the year		100,000		118,000		96,000			

Solutions**4**

			Capital accounts (₦000)		
	P	Q	R	P	Q
				Balance b/d	600 500
				Recognise goodwill (2:1)	100 50
Remove goodwill (2:2:1)	60	60	30	Cash	400
Balance c/d	640	490	370		700 550 400
	700	550	400	Balance b/d	640 490 370

The capital accounts can also be set out in columnar form as follows:

Capital accounts	Partner P	Partner Q	Partner R
	₦	₦	₦
Beginning of the year	600,000	500,000	
Recognise goodwill (2:1)	100,000	50,000	
Removal of goodwill (2:2:1)	(60,000)	(60,000)	(30,000)
Capital introduced			400,000
End of the year	640,000	490,000	370,000

Solutions**5**

			Capital accounts (₦000)				
	J	K	L	J	K	L	
				Balance b/d	320	210	120
				Revaluation (1:1:1)	600	600	600
Remove goodwill (3:1)	675	–	225	Recognise goodwill (1:1:1)	300	300	300
Transfer to loan	–	1,110	–				
Balance c/d	545	–	795				
	1,220	1,110	1,020		1,220	1,110	1,020
				Balance b/d	545	–	795

The capital accounts can also be set out in columnar form as follows:

Capital accounts	Partner J	Partner K	Partner L
	₦	₦	₦
Beginning of the year	320,000	210,000	120,000
Revaluation (1:1:1)	600,000	600,000	600,000
Recognise goodwill (1:1:1)	300,000	300,000	300,000
Removal of goodwill (3:1)	(675,000)	–	(225,000)
Transfer to loan	–	(1,110,000)	–
End of the year	545,000	–	795,000

Preparation of accounts from incomplete records

Contents

- 1 The nature of incomplete records
- 2 Techniques for incomplete records
- 3 chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

E Accounting for partnership, not-for-profit entities and incomplete records		
3 Incomplete records		
	a	State the need for preparation of accounts from incomplete records.
	b	Determine profit from the opening and closing capital balances.
	c	Explain the use of accounting equation, gross profit percentage, cash book summaries, memoranda and control accounts to determine missing figures for financial statements.

Exam context

This chapter explains how financial statements and financial information might be generated when the accounting records are incomplete.

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

- Understand situations that might necessitate the preparation of accounts from incomplete records (stock or assets destroyed, cash misappropriation or lost, accounting record destroyed, etc.);
- Use the accounting equation as an approach to producing accounting information when accounting records are incomplete;
- Use memorandum control accounts to identify missing information; and
- Use cost structures to identify missing information.

1 THE NATURE OF INCOMPLETE RECORDS

Section overview

- The meaning of incomplete records
- Dealing with incomplete records

1.1 The meaning of incomplete records

Incomplete records, as the term suggests, are accounting records where information is missing.

Problems of incomplete records may arise with small businesses where the owner of the business has not kept up-to-date accounting records or does not have a double entry book-keeping system. He might simply keep invoices or receipts for expenses and copies of invoices to customers. In addition, details of bank transactions can be obtained from a bank statement or other banking records.

The task of the accountant is to use these invoices, receipts and banking records, together with other information obtained from the business owner, to prepare financial statements for the year (and in particular a statement of profit or loss, which provides a basis for calculating the taxable income of the business owner from his or her business).

Other circumstances that cause problems include loss of records because of some kind of disaster, for example a fire in the office.

Another scenario is where records have not been maintained because a dishonest employee has stolen cash or inventory.

Whatever the cause of the problem the accountant's task involves piecing together information that is available in order to produce a set of financial statements or to calculate missing figures.

1.2 Dealing with incomplete records

Questions on incomplete records are a good test of knowledge and understanding of book-keeping and accounts. The task is often to identify the missing figures that the incomplete records do not provide.

Possible approaches to establishing missing numbers include:

- establishing the value of assets and liabilities to calculate the business capital, particularly opening capital at the start of the financial period;
- using memorandum control accounts, for receivables or payables, to calculate the sales or purchases for the period;
- using a memorandum account for bank and cash transactions, to establish a missing figure for cash income or cash payments, such as a missing figure for cash taken from the business by the owner as drawings; and
- using cost structures (gross profit percentage or mark-up) to establish a cost of sales, or a missing figure such as the value of inventory stolen or lost in a fire.

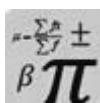
2 TECHNIQUES FOR INCOMPLETE RECORDS

Section overview

- The accounting equation
- Memorandum control accounts
- Memorandum cash and bank account
- Cost structures
- Missing inventory figure

2.1 The accounting equation

The accounting equation is:



Formula: Accounting equation

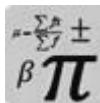
$$\text{Assets} = \text{Liabilities} + \text{Equity} \quad \text{or} \quad \text{Assets} - \text{Liabilities} = \text{Equity}$$

$$A = L + E \quad A - L = E$$

Net

The accounting equation is an equation. Therefore changes in one side are matched by changes in the other side.

Profit or loss for a period can be calculated from the difference between the opening and closing net assets after adjusting for any drawings during the period.



Formula:

$$\text{Increase in net assets} = \text{Profit} + \text{capital introduced} - \text{drawings}$$

The profit figure can be calculated as follows:



Illustration: Using the accounting equation to calculate profit

Closing assets – liabilities	N
Opening assets – liabilities	X
Increase/(decrease) in net assets in the period	<hr/>
Add drawings	X
Subtract new capital introduced by the owner(s)	<hr/>
Balance = profit /(loss) for the year	X
	<hr/>

**Example: Using the accounting equation to calculate profit**

At 1 January 2019, Tom's business had assets of ₦214,000 and liabilities of ₦132,000.

At 31 December 2019, the business had assets of ₦281,000 and liabilities of ₦166,000.

Tom took ₦25,000 in cash and ₦3,000 in goods out of the business during the year for his personal use. He did not introduce any new capital.

The profit of the business in the year to December 31, 2019 is calculated as follows:

	₦	₦
Assets at 31 December 2019	281,000	
Liabilities at 31 December 2019	(166,000)	
Net assets at 31 December 2019	<u>115,000</u>	
Assets at 1 January 2019	214,000	
Liabilities at 1 January 2019	(132,000)	
Net assets at 1 January 2019	<u>(82,000)</u>	
Increase in net assets during the year	33,000	
Add: Drawings (25,000 + 3,000)	28,000	
Balance = Profit /(loss) for the year	<u>61,000</u>	

Alternatively the profit figure could be calculated using the equation:

$$\begin{aligned} \text{Increase in net assets} &= \text{Profit} + \text{Capital introduced} - \text{Drawings} \\ ₦33,000 &= \text{Profit} + 0 - ₦28,000 \\ \text{Profit} &= ₦61,000 \end{aligned}$$

**Practice question**

1

The accountant for a sole trader has established that the total assets of the business at December 31, Year 4 were ₦376,000 and total liabilities were ₦108,000.

Checking the previous year's financial statements, he was able to establish that at December 31, Year 3 total assets were ₦314,000 and total liabilities were ₦87,000.

During Year 4 the owner has taken out drawings of ₦55,000.

In December 31, Year 4 the owner had been obliged to input additional capital of ₦25,000.

What was the profit of the business for the year to December 31, Year 4?

Identifying missing balances

The approach can also be used to identify a missing balance at the end of a period.



Example: Missing balance

At the start of the year a business had opening capital of ₦350,000.

Profit for the year was ₦200,000 and the owner had taken ₦120,000 as drawings. No capital was introduced in the period.

At the end of the year the company cashier disappeared with an amount of cash. The owner was able to identify the following balances at the year end:

	₦
Property, plant and equipment	95,000
Inventory	85,000
Receivables	65,000
Liabilities	(55,000)

The missing cash balance can be calculated as follows:

Step 1: Work out what closing net assets should be:

	₦
Capital (net assets) at the start	350,000
Profit for the year	200,000
Less: Drawings	(120,000)
Capital (net assets) at the end should be:	<u>430,000</u>

Step 2: Work out what closing net assets are:

	₦
Property, plant and equipment	95,000
Inventory	85,000
Receivables	65,000
Liabilities	(55,000)
	<u>190,000</u>

Step 3: Identify the missing amount:

240,000

The cashier has stolen cash in the amount of ₦240,000.

Calculation of opening capital

It might be necessary to establish the opening capital of a sole trader. This can be done simply by obtaining figures for the assets and liabilities of the business at the beginning of the financial period.

Opening capital is the difference between total assets and total liabilities. (Non-current assets for this purpose are measured at their carrying amount, i.e. net book value.)



Example: Calculation of opening capital

A sole trader does not keep any accounting records, and you have been asked to prepare a statement of profit or loss and statement of financial position for the financial year just ended. To do this, you need to establish the opening capital of the business at the beginning of the year.

The following information about assets and liabilities at the beginning of the year is available:

	₦
Motor van (balance sheet valuation)	1,600
Bank overdraft	560
Cash in hand	50
Receivables	850
Trade payables	370
Payables for other expenses	90
Inventory	410

Required

The capital of the business as at the beginning of the year can be calculated as follows:

	₦	₦
Assets		
Motor van (balance sheet valuation)	1,600	
Inventory	410	
Receivables	850	
Cash in hand	50	
Total assets	<u>2,910</u>	
Liabilities		
Bank overdraft	560	
Trade payables	370	
Payables for other expenses	90	
Total liabilities	<u>1,020</u>	
Net assets = Capital	<u>1,890</u>	

2.2 Memorandum control accounts

A memorandum account is an account that is not a part of a proper ledger accounting system. When there are incomplete records, a memorandum account can be used to calculate a 'missing' figure, such as a figure for sales or purchases and expenses in the period.

Calculating a missing figure for sales

The records of a sole trader might be incomplete because the trader does not keep any record of sales in the period. However, it might be possible to obtain the following figures:

- receivables at the beginning of the year (from last year's balance sheet);
- receivables at the end of the year, from copies of unpaid sales invoices;
- money banked during the year (assumed to be money from customers for sales);
- any bad debts written off.

Where a business makes some sales for cash, there might also be a figure for cash sales where the money has not been banked. The amount of these cash sales might be calculated from the sum of:

- the increase in cash in hand at the end of the year; plus
- any expenses paid in cash, for which receipts are available.



Example: Using memorandum control account to calculate a missing sales figure

An accountant is looking through the records of a sole trader who does not have a book keeping system. He has established the following information.

	₦
Receivables at the beginning of the year	650
Receivables at the end of the year	720
Bad debt written off during the year	800
Money paid into the business bank account	58,600
Cash sales where the money was not banked	300

The sales for the year can be calculated as the balancing figure in a receivables memorandum account.

Receivables memorandum account			
	₦	₦	
Opening balance	650	Money banked	58,600
Sales (balancing figure, 60,420 – 650)	59,770	Cash sales, money not banked	300
		Bad debt written off	800
		Closing balance	720
	60,420		60,420

The same calculation could be presented in a vertical format, as follows:

	₦
Receivables at the beginning of the year	650
Receivables at the end of the year	720
Increase/(decrease) in receivables	70
Money paid into the business bank account	58,600
Cash sales where the money was not banked	300
Bad debt written off during the year	800
Sales for the year	59,770



Practice question

2

Calculate sales for the period from the following information.

	₦
Receivables at the start of the period	2,400
Receivables at the end of the period	1,800
Cash banked during the period	12,500
Bad debt written off	200

Calculating a missing figure for purchase

A similar approach can be taken using knowledge of the payables control account.



Example: Using memorandum control account to calculate a missing purchases figure

An accountant is looking through the records of a sole trader who does not have a book-keeping system. He has established the following information.

	₦
Payables at the beginning of the year	1,200
Payables at the end of they ear	1,800
Money paid out of the business bank account to suppliers	18,700

The purchases for the year can be calculated as the balancing figure in a payables memorandum account.

Payables memorandum account

	₦		₦
Cash paid	18,700	Opening balance	1,200
Closing balance	1,800	Purchases (balancing figure)	19,300
	<hr/> 20,500		<hr/> 20,500

The same calculation could be presented in a vertical format, as follows:

	₦
Payables at the beginning of the year	1,200
Payables at the end of the year	1,800
Increase/(decrease) in payables	<hr/> 600
Money paid out of the business bank account	18,700
Purchases for the year	<hr/> 19,300



Practice question

Calculate purchases for the period from the following information.

3

	₦
Payables at the start of the period	1,400
Payables at the end of the period	1,900
Cash paid to suppliers during the period	11,300

2.3 Memorandum cash and bank account

A memorandum account may also be used to record transactions in cash (notes and coins) and through the bank account, in order to establish a missing figure for a cash payment or possibly a cash receipt.

You might be given figures for:

- cash in hand and in the bank account at the beginning of the year;
- cash in hand and in the bank account at the end of the year;
- cash receipts (cash, cheques and other forms of receiving money);
- payments during the period for purchases, salaries and other cash expenses.

If there is a missing figure for a cash payment, this should emerge as a balancing figure.

Note: Cash in hand consists of banknotes and coins. Often, it is just petty cash. However, some businesses hold a large amount of cash in hand because they sell goods for cash; for example, retail stores may hold fairly large quantities of cash in hand.



Example: Memorandum cash and bank account

An accountant is trying to prepare the financial statements of a sole trader from incomplete records.

A problem is that the owner of the business admits to having taken cash from the business, but he has not kept a record of how much he has taken.

The accountant has established the following information:

	₦
Cash in hand at the beginning of the year	200
Bank balance at the beginning of the year	2,300
Cash in hand at the end of the year	500
Bank balance at the end of the year	3,500
Receipts	42,800
Payments to employees	12,800
Payments to suppliers	17,100
Payments of interest/bank charges	400

The cash drawn by the owner during the year can be calculated as follows.


Example (continued): Memorandum cash and bank account

The drawings for the year can be calculated as the balancing figure in a cash and bank memorandum account.

Cash and bank memorandum account	
₦	₦
Opening balance, cash in hand	200
Opening balance, bank	2,300
Receipts	42,800
	45,300
	Payments to suppliers
	17,100
	Payments to employees
	12,800
	Payments of interest/bank charges
	400
	Drawings (= balancing figure)
	11,000
	Closingbalance,cashin hand
	500
	Closing balance, bank
	3,500
	45,300

The same calculation could be presented in a vertical format, as follows:

₦	₦
Cash in hand and bank at the beginning of the year	2,500
Receipts during the year	42,800
	45,300
Payments to suppliers	17,100
Payments to employees	12,800
Payments for interest/bank changes	400
Total payments recorded	(30,300)
	15,000
Cash in hand and bank at the end of the year	(4,000)
Difference = missing figure = drawings	11,000


Practice question

4

Calculate drawings for the period from the following information.

₦	₦
Cash in hand at the beginning of the year	100
Bank balance at the beginning of the year	2,400
Cash in hand at the end of the year	150
Bank balance at the end of the year	5,200
Receipts	51,700
Payments to employees	3,400
Payments to suppliers	38,200

2.4 Cost structures

Missing figures can sometimes be estimated by using cost structures which describe the relationship that exists between sales, cost of sales and gross profit.

The relationship between revenue and cost of sales can be expressed as a percentage.

There are two ways of doing this:

- Gross profit is expressed as a percentage of cost of sales – this is known as mark-up; or
- Gross profit is expressed as a percentage of sales – this is known as profit margin.

Example: Cost structures

	₦	Mark-up	Profit margin
Revenue	100,000	125%	100%
Cost of sales	(80,000)	100%	80%
Gross profit	20,000	25%	20%

Example: Cost structures

A sole trader does not keep a record of sales. However, she does keep a record of purchases. The accountant has established that the gross profit margin is 20%, and that:

- a) Opening inventory was ₦700 at the beginning of the year
- b) Closing inventory is ₦1,200 at the end of the year
- c) Purchases during the year were ₦23,500.

Sales for the year can be calculated by first calculating the cost of sales figure and then adding the mark up to it.

20% (gross profit/sales), the mark-up on cost is 25% of cost ($20/(100 - 20)$).

	₦
Opening inventory	700
Purchases	23,500
	24,200
Closing inventory	(1,200)
Cost of sales	23,000
Gross profit (25% of cost)	5,750
Sales	28,750

**Practice question****5**

A business operates on the basis of a mark-up on cost of 40%.

Calculate the sales figure for the year from the following information:

	₦
Opening inventory	3,100
Closing inventory	4,000
Purchases	42,100

**Practice question****6**

Complete the following table.

	₦	₦	₦	₦
Opening inventory	1,000	2,000	1,000	?
Closing inventory	(1,200)	(1,500)	(500)	(2,000)
Purchases	5,000	8,700	?	15,000
Sales	8,000	15,000	?	20,000
Cost of sales	?	?	8,000	?
Gross profit	?	?	?	5,000
GP as a % of sales	?	?	?	?
GP as a % of cost	?	?	25%	33.3%

More than one cost structure

A question might explain that a business has more than one cost structure.

You have to work carefully through the information to establish missing numbers.



Example: Multiple cost structures

A company has sales of ₦1,000.

The company sells three types of good.

60% of sales are of type A which is sold at a mark-up of 20%.

Type B goods are sold at a margin of 30%. The cost of type B sold in the year was ₦154.

Total gross profit for the year was ₦184.

Prepare sales, cost of sales and gross profit workings for each product and in total for the business and show the margin for type C goods.

Step 1: Set up a table and enter the known facts

	Type A%	Type B%	Type C%	Total
Sales	600	100		1,000
Cost of sales	100	154		
Gross profit	20	30		184

Step 2: Fill in the easy figures

	Type A %	Type B %	Type C %	Total
Sales	600	120	100	1,000
Cost of sales	100	154	70	816
Gross profit	20	30		184

Step 3: Apply the cost structures to calculate cost of sales and gross profits

	Type A %	Type B %	Type C %	Total
Sales	600	120	220	1,000
Cost of sales	500	100	154	816
Gross profit	100	20	66	184

Step 4: Complete the table

	Type A %	Type B %	Type C %	Total
Sales	600	120	220	1,000
Cost of sales	500	100	154	816
Gross profit	100	20	66	184

2.5 Missing inventory figure

The gross profit margin (or mark-up) can also be used to establish the value of inventory that is missing or lost, for example due to theft or a fire. In these situations, you might know the value of sales in the period, purchases during the period and opening and closing inventory.

By calculating the cost of sales from sales and the gross profit margin, it should be possible to establish the value of missing inventory that is unaccounted for, as a balancing figure.



Example: Calculating missing inventory

A sole trader operates his business from a warehouse, which has been damaged by a fire, which occurred at the end of the financial year. After the fire, the remaining inventory that is undamaged amounts to ₦2,000 (cost).

The accountant establishes the following information:

- a) Inventory at the beginning of the year was ₦16,000
- b) Purchases during the year were ₦115,000
- c) Sales during the year were ₦140,000
- d) The trader sells his goods at a mark-up of 25% of cost.

The cost of the inventory lost in the fire may be calculated as follows: Gross profit = 25% of cost.

As a proportion of sales, gross profit = $(25/(25+100)) = 0.20$ or 20%.

Sales = ₦140,000.

Therefore gross profit = $20\% \times ₦140,000 = ₦28,000$

Cost of sales = $80\% \times ₦140,000 = ₦112,000$.

	₦
Opening inventory	16,000
Purchases	115,000
	<hr/>
	131,000
Cost of sales	(112,000)
	<hr/>
Closing inventory should be	19,000
Actual closing inventory	(2,000)
	<hr/>
Balancing figure = inventory lost in the fire	17,000

**Practice question****7**

A business operates on the basis of a mark-up on cost of 40%.

Calculate the closing inventory from the following information:

	₦
Opening inventory	5,000
Purchases	71,200
Sales	98,000

**Practice question****8**

A fire on March 31, destroyed some of the inventory of a company, and its inventory records were also lost. The following information is available.

The company makes a standard gross profit of 30% on its sales.

	₦
Inventory at March 1	127,000
Purchases for March	253,000
Sales for March	351,000
Inventory in good condition at March 31	76,000

What was the cost of the inventory lost in the fire?

3 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Understand situations that might necessitate the preparation of accounts from incomplete records (inventory or assets destroyed, cash misappropriation or lost, accounting record destroyed etc.)
- Use the accounting equation as an approach to producing accounting information when accounting records are incomplete
- Use memorandum control accounts to identify missing information
- Use cost structures to identify missing information
- Prepare a statement of assets and liabilities

SOLUTIONS TO PRACTICE QUESTIONS

Solution 1

Net assets at 31 December ($376,000 - 108,000$)	₦ 268,000
Net assets at 1 January ($314,000 - 87,000$)	<u>(227,000)</u>
Increase in net assets	41,000
Drawings	55,000
New capital introduced in the year	<u>(25,000)</u>
Profit for the year	<u>71,000</u>

Solution 2

Receivables memorandum account			
	₦		₦
Opening balance	2,400	Money banked	12,500
Sales (bal fig)	12,100	Bad debt written off	200
	<u>14,500</u>	Closing balance	<u>1,800</u>
			14,500

Solution 3

Payables memorandum account			
	₦		₦
Cash paid	11,300	Opening balance	1,400
Closing balance	<u>1,900</u>	Purchases (bal fig)	<u>11,800</u>
	<u>13,200</u>		<u>13,200</u>

Solution**4**

Cash and bank memorandum account

₦	₦
Opening balance, cash in hand	100
Opening balance, bank	2,400
Receipts	51,700
	<hr/>
	54,200
Payments to suppliers	38,200
Payments to employees	3,400
Drawings (= balancing figure)	7,250
Closing balance, cash in hand	150
Closing balance, bank	5,200
	<hr/>
	54,200

Solution**5**

Cost of sales	₦	
Opening inventory	3,100	
Purchases	42,100	
Less: closing inventory	(4,000)	
	41,200	
Mark-up at 40%	16,480	
Sales ($41,200 \times 140\%$)	57,680	

Solution**6**

	₦	₦	₦	₦
Sales	8,000	15,000	10,000	20,000
Opening inventory	1,000	2,000	1,000	2,000
Purchases	5,000	8,700	7,500	15,000
	6,000	10,700	8,500	17,000
Closing inventory	(1,200)	(1,500)	(500)	(2,000)
Cost of sales	(4,800)	(9,200)	(8,000)	(15,000)
Gross profit	3,200	5,800	2,000	5,000
GP as a % of sales	40%	38.7%	20%	25%
GP as a % of cost	66.7%	63%	25%	33.3%

Solution**7**

	₦	%
Sales	98,000	140
Cost of sales		
Opening inventory	5,000	
Purchases	71,200	
Less: closing inventory (balancing figure)	(6,200)	
	70,000	100

Working:

$$\text{Cost of sales} = \frac{100}{140} \times \text{Sales} \Rightarrow \frac{100}{140} \times 98,000 = 70,000$$

Solution**8**

	₦
Inventory at 1 March	127,000
Purchases for March	253,000
	380,000
Closing inventory	(76,000)
Cost of sales + cost of lost inventory	304,000
Cost of sales ($\text{₦}351,000 \times 70\%$)	(245,700)
Inventory lost in the fire	58,300

Preparation of not for profit accounts

Contents

- 1 Not for profit organisations
- 2 Receipt and payment accounts
- 3 Income and expenditure account
- 4 Chapter review

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INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

E Accounting for partnership, not-for-profit entities and incomplete records		
2 Not-for-profit entities' accounts		
	a	Prepare receipts and payments account.
	b	Prepare income and expenditure account.
	c	Prepare statement of assets and liabilities

Exam context

This chapter explains the nature of not for profit organisations and how to compile the financial statements of not for profit organisations.

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

- Explain what a not for profit organisation is;
- Prepare a receipt and payment account from information provided; and
- Prepare an income and expenditure account from information provided.

1 NOT FOR PROFIT ORGANISATIONS

Section overview

- Introduction
- Accounting by not for profit organisations

1.1 Introduction

Many organisations exist to achieve other objectives than making profit. Such organisations are called not for profit organisations. Examples of such organisations include:

- clubs and societies;
- charities;
- hospitals; and
- government bodies.

Not for profit organisations have income (revenue) which they raise (or are given) and costs which must be paid just like other organisations. A not for profit organisation will try to operate at a level where its income is slightly bigger than its costs. This sounds very much as if the not for profit organisation is trying to make a profit but that is not the case.

- A not for profit organisation might try to operate at a slight surplus so that it can continue to provide its service in the future.
- A profit making entity tries to make as much surplus as possible in order to enhance the wealth of its owners.

Not for profit organisations need accounting records. They could not continue to operate if their costs were consistently bigger than their income

1.2 Accounting by not for profit organisations

Not for profit organisations might be subject to less regulation than profit making organisations (though this is by no means true of all not for profit organisations).

Some organisations may not be required to prepare accruals based financial information. These may prepare a cash based, receipt and payment account instead. Organisations that do this might include clubs, societies and perhaps some charities.

Other not for profit organisations prepare an income and expenditure account (I & E account) instead of a statement of comprehensive income. This is similar to a statement of comprehensive income in that it is prepared on the accruals basis but there are differences.

Different terminology is used.

- What a statement of comprehensive income would describe as profit for the period, an income and expenditure account describes as a ***surplus of income over expenditure***.
- What a statement of comprehensive income would describe as loss for the period, an income and expenditure account describes this as a ***deficit of income over expenditure***.

- In the statement of financial position a company has equity reserves whereas a not for profit organisation has equity fund accounts.
- In the statement of financial position a company would add the profit for the year (deduct a loss) to an equity account called retained profits. A not for profit organisation would add the surplus (deduct a deficit) to an equity account called an accumulated fund (or accumulated surplus of income over expenditure).

Comment on charities



Some charities are very large organisations and are run very professionally. Such charities may be subject to separate accounting regulation in some jurisdictions and may maintain detailed accounting records to the same standard as those expected of a company.

Charities are only mentioned above for completeness. This chapter proceeds to explain more about income and expenditure account using the circumstances of clubs and societies.

Comment on government bodies



Public sector organisations often administer very large sums of money in order to provide services that the government believes to be beneficial to citizens.

Such bodies are subject to separate accounting regulation and must maintain detailed accounting records to the same standard as those expected of a company.

Government bodies might use a separate set of accounting standards called IPSAS (International Public Sector Accounting Standards). These are based on IFRS but also include other standards to cover topics that are not relevant to profit making entities. IPSAS will be covered in a later paper.

These bodies are only mentioned above for completeness. This chapter proceeds to explain more about income and expenditure account using the circumstances of clubs and societies.

2 RECEIPT AND PAYMENT ACCOUNTS

Section overview

- Introduction
- Features of a receipt and payment account
- Subscriptions calculation

2.1 Introduction

As stated above some organisations may not be required to prepare accruals based financial information but might prepare a receipt and payment account instead.

A receipt and payment account is a summary of cash receipts and payments during the accounting period. The accruals concept is not applied so a receipt and payment account includes all cash receipts and payments in a period including capital and revenue amounts and whether they relate to that period or not.

All cash receipts are recorded on debit side (receipts side) and all cash payments are recorded on credit side (payments side) of receipts and payments account.

2.2 Features of a receipt and payment account

Feature	Comment
Summary of cash transactions	All cash receipts and payments made by the concern during the accounting period are recorded in this book. Therefore, the receipts and payments account is a summary of cash transactions.
Cash and bank items in one column.	All receipts either cash or bank are recorded in receipts column of receipts side where all cash and bank payments are recorded in one column of payment column of receipts and payments account. The cash and bank transactions are merged to avoid contra entries of cash and bank transactions.
No distinction between capital and revenue.	All cash receipts and cash payments irrespective of capital and revenue nature are recorded in receipts and payments account. No distinction is made for capital receipts, revenue receipts, capital expenditures and revenue expenditures.
Opening and closing balance of cash	A receipts and payments account shows the opening and closing balances of cash and bank. All cash and cheque receipts are recorded on debit side whereas all cash and cheque payments are recorded on credit side of receipts and payments account.

**Illustration**

Receipt and payment account			
Balance b/d	X	Donation	X
Subscriptions	X	Repairs	X
Functions	X	Telephone	X
Sale of land	X	Extension of club house	X
Bank interest	X	Furniture	X
Bequest	X	Heat and light	X
Sundry income	X	Salary and wages	X
		Sundry expenses	X
		Balance c/d	X
Balance b/d			

A receipt and payment account gives far less information than a set of financial statements based on the accruals concept.

For all practical purposes this is a cash account just like those that you have come across in other chapters.

2.3 Subscriptions calculation

The main source of cash for a club will be membership fees. It may be necessary to calculate the cash received from members during the year. This can be complicated by the fact that at each year end there will usually be some members who have paid their subscriptions in advance and some who are in arrears.

- Members who pay their fees in advance are creditors of the club (the club owes them a period of membership).
- Members who are in arrears are debtors of the club.

The amount of cash received in the year can be calculated using a subscriptions T account.

- Opening and closing balances for members who have paid in advance and those who are in arrears are recognised.
- The total membership fees that should have been collected (number of members \times annual fee) are debited to the account.
- The cash received is a balancing figure on the credit side of the account.

**Illustration: Subscription account**

Subscription account		
	₦	₦
Balance b/d (members in arrears)	X	Balance b/d (members Who have prepaid) X
Income and expenditure	X	Cash X
Balance c/d (members who have prepaid)	X	Balance c/d (members in arrears) X
	X	
Balance b/d (members In arrears)	X	Balance b/d (members who have prepaid) X

**Example: Subscription account**

A club has 500 members.

Annual membership fees are ₦1,000.

Therefore membership fees for the year should be ₦500,000.

The club's subscription records for the year ended 31 December 2019 show the following:

	At 31 December 2018	At 31 December 2018
Subscriptions received in advance	10,000	6,000
Subscriptions in arrears	18,000	22,000

Cash received is calculated as follows:

Subscriptions

	₦	₦	
Balance b/d: Members in arrears	18,000	Balance b/d: Advance payments	10,000
Membership fees for the year	500,000	Cash (balancing figure)	492,000
Balance c/d: Advance payments	6,000	Balance c/d: Members in arrears	22,000
	<u>524,000</u>		<u>524,000</u>
Balance b/d:	22,000	Balance b/d:	6,000

3 INCOME AND EXPENDITURE ACCOUNT

Section overview

- Format
- Subscriptions account
- Life membership fees
- Donations

3.1 Format

An income and expenditure account is an accruals based statement listing the different types of income of a club followed by the different categories of expenditure of the club.

A club may have several categories of income including:

- Membership fees and subscriptions;
- Life membership fees;
- Donations to the club;
- Investment income;
- Surplus from running a coffee bar or a shop;
- Surplus from running an event;

Note that if a club has a coffee bar or shop or runs an event the “profit” from these is general calculated separately (in an account known as a trading account) and presented as a line in the income and expenditure account.

Illustration: Coffee bar trading account

	₦	₦
Income		
Sales		X
Opening inventory	X	
Purchases	X	
	<hr/>	
Closing inventory	(X)	
Cost of sales		(X)
Gross profit (this figure to the face of the income and expenditure account)		<hr/>
		X

There are no mandatory formats for such a statement. A typical format is illustrated below.

**Illustration: Income and expenditure account for the year ending XX/XX/XX**

	₦	₦
Income		
Subscription income		X
Donations		X
Interest on bank deposit		X
Coffee bar/shop profit		X
Tournament income	X	
Less: Prizes	(X)	
		X
		X
Expenditure		
Club expenses	X	
Rent	X	
Electricity	X	
Depreciation	X	
Repairs	X	
	X	
Surplus (deficit) of income over expenditure		X
		X

3.2 Subscriptions account

At each year end there will usually be some members who have paid their subscriptions in advance and some who are in arrears. These are both included as balances brought down and carried down on a single subscription account. Cash received is credited to this account and the balance on the account is transferred to the income and expenditure account (as income for the year).

The subscription account illustration is reproduced here for your convenience.



Illustration: Subscription account

Subscription account			
	₦	₦	
Balance b/d (members in arrears)	X	Balance b/d (members who have prepaid)	X
Income and expenditure	X	Cash	X
Balance c/d (members who have prepaid)	X	Balance c/d (members in arrears)	X
	<hr/>		<hr/>
Balance b/d (members In arrears)	X	Balance b/d(members who have prepaid)	X



Example: Subscription account

At 31 March 2018 a football club had membership subscriptions in arrears amounting to ₦48,000 and had received ₦12,000 subscriptions in advance.

During the year to 31 March 2019 the club received ₦624,000 including 26 memberships for the year to 31 March 2020 at ₦1,200 per annum.

At 31 March 2019 16 members owed subscriptions of ₦1,200 each.

The transactions would be recorded in the subscriptions ledger account for the year to 31 March 2019 as follows:

Subscriptions			
	₦	₦	
Balance b/d:		Balance b/d:	
Members in arrears	48,000	Advance payments	12,000
Membership fees for the year (to I&E)	576,000	Cash	624,000
Balance c/d:		Balance c/d:	
Advance payments (26 × 1,200)	31,200	Members in arrears (16 × 1,200)	19,200
	<hr/>		<hr/>
Balance b/d:	655,200	Balance b/d:	655,200
	<hr/>		<hr/>
Balance b/d:	19,200	Balance b/d:	31,200

3.3 Life membership fees

A club should have an accounting policy for these. Possible policies include:

- Recognition as income when received.
- Recognition as income over a specified period.
- Recognition in an equity reserve (an accumulated fund).

Recognition as income when received



Illustration: Double entry for life membership fees

	Debit	Credit
Bank (cash received)	X	
Income and expenditure account		X

Recognition as income over a specified period



Illustration: Double entry for life membership fees

On receipt:

	Debit	Credit
Bank (cash received)	X	
Deferred income (accredit account on the face of the statement of financial position)		X

Each year over the a specified future period:

Deferred income	X
Income and expenditure account	X

This treatment recognises the amount received as income over several years.

Recognition in an equity reserve (an accumulated fund)



Illustration: Double entry for life membership fees

	Debit	Credit
Bank (cash received)	X	
Life membership fund (an accumulated fund account inequity)		X

This might then be transferred to the accumulated surplus of income over expenditure over a pre-defined period or on the death of the member.

3.4 Donations

A club might receive a donation or bequest.

If the donation has not been made for a specific purpose the club might recognise the donation as income in the period in which it is received.

A club might receive a donation for a particular purpose. For example, a member might donate money for a new football pitch. In this case the money is credited to a fund account set up for the purpose.

Illustration: Double entry for donations

Bank (cash received)

Debit Credit

X

Football pitch fund (an accumulated fund account in equity)

X

4 CHAPTER REVIEW

Chapter review

Before moving on to the next chapter check that you now know how to:

- Explain what a not for profit organisation is
- Prepare a receipt and payment account from information provided
- Prepare an income and expenditure account from information provided

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IAS 7: Statement of cash flows

Contents

- 1 Statement of cash flows: Introduction
- 2 Statement of cash flows: Format
- 3 Cash flows from operating activities: The indirect method
- 4 Indirect method: Adjustments for working capital
- 5 Cash flows from operating activities: The direct method
- 6 Cash flows from investing activities
- 7 Cash flows from financing activities
- 8 Statement of cash flows – specimen formats
- 9 Chapter review

INTRODUCTION

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

F Financial statements (continued)		
4	Preparation of simple financial statements and supporting notes	
	c	Prepare simple statement of cash flows in accordance with IAS 7.

IAS 7: Statement of cash flows is an examinable document.

Exam context

This chapter explains how to prepare a statement of cash flows.

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

- prepare part or all of a statement of cash flows from information provided

1 STATEMENT OF CASH FLOWS: INTRODUCTION

Section overview

- Importance of cash flow for business
- Profit and cash flow
- IAS 7: Statement of cash flows
- Overall approach

1.1 Importance of cash flow for business

Businesses must have sufficient cash; otherwise they cannot survive.

- A business can make a loss but still survive if it has sufficient cash or access to liquidity (cash, assets that can be quickly turned into cash and new sources of borrowing).
- On the other hand, a business that is profitable cannot survive if it cannot pay its obligations when they fall due, because it does not have enough cash or access to other sources of liquidity.

Cash flow is therefore extremely important, and it is appropriate that entities should present a statement of cash flows as a financial statement.

The purpose of a statement of cash flows is to show what the cash flows of the entity have been. It can also be used to make assessments of what the cash flows of the entity might be in the future.

1.2 Profit and cashflow

When a business makes a profit of ₦1,000, this does not mean that it receives ₦1,000 more in cash than it has spent. Profit and cash flow are different, for several reasons:

There are items of cost in the statement of comprehensive income that do not represent a cash flow. Examples are:

- depreciation and amortisation charges; and
- the gain or loss on the disposal of non-current assets.

There are items of cash flow that do not appear in the statement of comprehensive income. Examples are:

- Cash flows relating to the acquisition or disposal of investments, such as the purchase of new non-current assets, and cash from the sale of non-current assets. (The statement of comprehensive income includes gains or losses on the disposal of non-current assets, but this is not the same as the cash proceeds from the sale.)
- Cash flows relating to financial transactions, such as obtaining cash by issuing shares or obtaining loans, the repayment of loans and the payment of dividends to ordinary shareholders.

1.3 IAS 7: Statement of cash flows

IAS 1 states that a complete set of financial statements should include a statement of cash flows. IAS 7: **Statement of cash flows** sets out the detailed requirements for the format and content of the statement.

A statement of cash flows provides information about where a business obtained its cash during the financial period, and how it made use of its cash.

A statement of cash flows, groups inflows and outflows of cash, under three broad headings:

- cash from operating activities;
- cash used in (or obtained from) investing activities; and
- cash paid or received in financing activities.

It also shows whether there was an increase or a decrease in the amount of cash held by the entity between the beginning and the end of the period.



Illustration:

Cash from operating activities	X/(X)
Cash used in (or obtained from) investing activities	X/(X)
Cash paid or received in financing activities.	<u>X/(X)</u>
Net cash inflow (or outflow) during the period	X/(X)
Cash and cash equivalents at the beginning of the period	<u>X/(X)</u>
Cash and cash equivalents at the end of the period	<u>X/(X)</u>

Any of the items may be positive **or negative cash flows**.

The cash inflow (or outflow) during the period can be either a positive or a negative amount.

For the purpose of a statement of cash flows, cash and cash equivalents are treated as the same:

- Cash = cash in hand (= petty cash and other cash not in the bank) + cash in the business bank account
- Cash equivalents = items that are the equivalent of cash and could be converted into cash very quickly without risk of loss (= for example cash in a deposit account or a savings account)

1.4 Overall approach

IAS 7 requires that cash flows are analysed over three headings.

Theoretically this could be done by analysing every entry in and out of the cash account(s) over the course of a period. However, the cash account is often the busiest account in the general ledger with potentially many thousands of entries. Documents that summarise the transactions are needed.

These documents already exist! They are the other financial statements (statement of financial position and statement of comprehensive income).



Illustration:

A business might buy 100 new non-current assets over the year. There would be 100 different entries for these in the cash account.

However, it should be easy to estimate the additions figure from comparing the opening and closing balances for non-current assets and isolating any other causes of movement.

For example if we know that property plant and equipment has increased by ₦100,000 and that the only other cause of movement was depreciation of ₦15,000 then additions must have been ₦115,000.

A lot of the numbers in statement of cash flows are derived from comparing opening and closing positions of line items in the statement of financial position. Other causes of movement can then be identified leaving the cash double entry as a balancing figure.

2 STATEMENT OF CASH FLOWS: FORMAT

Section overview

- Format
- The indirect method
- The direct method

2.1 Format

IAS 7 does not include a format that must be followed. However it gives illustrative examples of formats that meet the requirements in the standard.



Illustration: Statement of cash flows

	₦	₦
Net cash flow from operating activities		75,300
Cash flows from investing activities:		
Acquisition of shares (debentures, etc.)	(5,000)	
Purchase of property, plant and machinery	(35,000)	
Proceeds from sale of non-current assets	6,000	
Interest received/dividends received	1,500	
Net cash used in investing activities		(32,500)
Cash flows from financing activities:		
Proceeds from issue of shares	30,000	
Proceeds from new loan	10,000	
Repayment of loan	(17,000)	
Dividends paid to shareholders	(25,000)	
Net cash used in financing activities		(2,000)
Net increase/decrease in cash/cash equivalents		40,800
Cash/cash equivalents at the beginning of the year		5,000
Cash/cash equivalents at the end of the year		45,800

Operating cash flows

The operations of the business are probably the most significant source of cash.

IAS 7 allows two approaches to identifying the cash flows from operating activities:

- Direct method; and
- Indirect method

For clarity, what this means is that there are two approaches to arriving at the figure of **₦75,300** in the above example.

While IAS 7 recognises both direct and indirect methods, it encourages or prefers the direct method.

You are expected to understand both methods.

2.2 The indirect method

The indirect method identifies the cash flows from operating activities by adjusting the profit before tax figure. It arrives at the cash from operating activities figure indirectly by reconciling a profit figure to a cash figure.

The adjustments remove the impact of accruals and non-cash items and also relocate some figures to other positions in the statement of cash flows.

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the indirect method.



Illustration:

Statement of cash flows: indirect method	
Cash flows from operating activities	
Profit before taxation	₦ 80,000
Adjustments for:	₦
Depreciation and amortisation charges	20,000
Interest charges in the statement of comprehensive income	2,300
Gains on disposal of non-current assets	(6,000)
Losses on disposal of non-current assets	4,500
	100,800
Increase/decrease in:	
Increase in trade and other receivables	(7,000)
Decrease in inventories	2,000
Increase in trade payables	3,000
Cash generated from operations	98,800
Taxation paid (tax on profits)	(21,000)
Interest charges paid	(2,500)
Net cash flow from operating activities	75,300

2.3 The direct method

The direct method calculates the cash flow from operating activities by calculating cash received from customers, cash paid to suppliers and so on.

The following illustration shows how the net cash flow from operating activities figure seen in the previous example was arrived at using the direct method.



Illustration:

Statement of cash flows: direct method	
Cash flows from operating activities	
Cash receipts from customers	348,800
Cash payments to suppliers	(70,000)
Cash payments to employees	(150,000)
Cash paid for other operating expenses	(30,000)
Cash generated from operations	98,800
Taxation paid (tax on profits)	(21,000)
Interest charges paid	(2,500)
Net cash flow from operating activities	75,300

The remainder of the statement of cash flows using the direct method is exactly the same as for the indirect method.

3 CASH FLOWS FROM OPERATING ACTIVITIES: THE INDIRECT METHOD

Section overview

- Profit before taxation
- Non-cash items
- Accruals based figures -Interest

3.1 Profit before taxation

The starting point for the statement of cash flows for a company is the operating profit after deducting interest but before taxation.

This profit figure is adjusted to calculate the amount of cash received by the business or the amount of cash paid out as a consequence of its trading operations.

The adjustments are to remove the effect of:

- Non-cash items, for example:
 - Depreciation and amortisation (depreciation of intangible non-current assets);
 - Profit or loss on disposal of non-current assets; and
- Accruals based figures, for example:
 - Interest expense or income;
 - Movement on working capital items (receivables, payables and inventory).

3.2 Non-cash items

Depreciation and amortisation

Depreciation charges and amortisation charges are not cash flows. They are expenses in the statement of comprehensive income, but do not represent payments of cash.

In order to obtain a figure for cash flow from the figure for profit, charges for depreciation and amortisation must therefore be added back to the profit figure.

Gains or losses on disposal of non-current assets

Gains or losses on the disposal of non-current assets are not cash flows. The gain or loss is calculated as the difference between:

- the net cash received from the disposal; and
- the carrying amount (net book value) of the asset at the date of disposal.

The effect of the gain or loss on disposal (a non-cash item) from the operating profit is removed by:

- deducting gain on disposal; and
- adding back losses on disposal.

The relevant cash flow is the net cash received from the sale. This is included in cash flows from investing activities as the net cash flows received from the disposal of non-current assets.

**Example:**

A company disposed of an item of equipment for ₦40,000. The equipment had originally cost ₦60,000 and the accumulated depreciation charged up to the date of disposal was ₦32,000.

	₦
Cost	60,000
Accumulated depreciation	<u>(32,000)</u>
Carrying value at date of disposal	28,000
Cash proceeds from sale	<u>(40,000)</u>
Gain on disposal	12,000

In the statement of cashflows, the gain on disposal of ₦12,000 is deducted as an adjustment to the operating profit.

The cash proceeds of ₦40,000 is included as a cash inflow under the heading: 'Cash flows from investing activities'.

**Practice question**

1

A company made a loss on the disposal of a company motor vehicle of ₦8,000.

The vehicle originally cost ₦50,000 and at the date of disposal, accumulated depreciation on the vehicle was ₦20,000.

What are the items that should be included for the disposal of the vehicle in the statement of cashflows for the year:

- a) In the adjustments to get from operating profit to cashflow from operations?
- b) Under the heading: 'Cashflows from investing activities'?

3.3 Accruals based figures - Interest

The accruals concept is applied in accounting.

Interest charge in the statement of comprehensive income is an accrual based figure. It is added back to profit and the actual cash interest paid is deducted further down the statement of cash flows.

The final items in the operating cash flows part of a statement of cash flows are the amount of interest paid and the amount of tax paid (see later).

This figure must be calculated as follows:



Illustration:

Interest liability at the beginning of the year
 Interest charge for the year (statement of comprehensive income figure)

Interest liability at the end of the year
 Interest paid in the year (cash)

*	
X	
<hr/>	
X	
<hr/>	
X	
<hr/>	
(X)	
<hr/>	
X	

Take a few minutes to make sure that you are happy about this. The same approach is used to calculate other figures.

The interest liability at the start of the year and the interest charge during the year is the most the business would pay. If the business had paid nothing it would owe this figure. The difference between this amount and the liability at the end of the year must be the amount that the business has paid.

An aside – taxation paid

The tax paid is the last figure in the operating cash flow calculation.

There is no adjustment to profit in respect of tax. This is because the profit figure that we start with is profit before tax; therefore tax is not in it to be adjusted! However, there is a tax payment and this must be recognised as a cash flow. It is calculated in the same way as shown above.

**Example:**

A company had liabilities in its statement of financial position at the beginning and at the end of 2019, as follows:

Liabilities	Interest accrual	Taxation
Beginning of 2019	₦4,000	₦53,000
End of 2019	₦3,000	₦61,000

During the year, interest charges in the statement of comprehensive income were ₦22,000 and taxation on profits were ₦77,000.

The amounts of interest payments and tax payments (cash flows) for inclusion in the statement of cash flows can be calculated as follows:

	Tax	Interest
	₦	₦
Liability at the beginning of the year	53,000	4,000
Taxation charge/interest charge for the year	77,000	22,000
	<hr/>	<hr/>
	130,000	26,000
Liability at the end of the year	(61,000)	(3,000)
Cash paid during the year	<hr/>	<hr/>
	69,000	23,000

4 INDIRECT METHOD: ADJUSTMENTS FOR WORKING CAPITAL

Section overview

- Working capital adjustments
- Working capital
- Changes in trade and other receivables
- Possible complication: Allowances for doubtful debts
- Changes in inventory
- Changes in trade payables
- Lack of detail

4.1 Working capital adjustments: introduction



Definition

Working capital is current assets less current liabilities.

The previous section showed that taxation and interest cash flows can be calculated by using a figure from the statement of comprehensive income and adjusting it by the movement on the equivalent balances in the statement of financial position.

This section shows how this approach is extended to identify the cash generated from operations by making adjustments for the movements between the start and end of the year for:

- trade receivables and prepayments;
- inventories; and
- trade payables and accruals.

Assuming that the calculation of the cash flow from operating activities starts with a profit (rather than a loss) the adjustments are as follows:

Balance	Increase in balance from start the end of the year	Decrease in balance from to start to the end of the year
Receivables	Subtract from profit before tax	Add back to profit before tax
Inventory	Subtract from profit before tax	Add back to profit before tax
Payables	Add back to profit before tax	Subtract from profit before tax

These are known as the working capital adjustments and are explained in more detail in the rest of this section.

4.2 Working capital

Working capital is made up of the following balances:



Illustration:

	₦
Inventory	X
Trade and other receivables	X
Cash	X
Trade payables	(X)
Working capital	<u>X</u>

Trade and other receivables include any prepayments.

Trade payables include accrued expenses, provided the accrued expenses do not relate to other items dealt with separately in the statement of cash flows, in particular:

- accrued interest charges; and
- taxation payable.

Interest charges and payments for interest are presented separately in the statement of cash flows, and so accrued interest charges should be excluded from the calculation of changes in trade payables and accruals.

Similarly, taxation payable is dealt with separately; therefore taxation payable is excluded from the calculation of working capital changes.

Accrued interest and accrued tax payable must therefore be deducted from the total amount for accruals, and the net accruals (after making these deductions) should be included with trade payables.

Changes in working capital and the effect on cash flow

When working capital increases, the cash flows from operations are less than the operating profit, by the amount of the increase.

Similarly, when working capital is reduced, the cash flows from operations are more than the operating profit, by the amount of the reduction.

This important point will be explained with several simple examples.

4.3 Changes in trade and other receivables

Sales revenue in a period differs from the amount of cash received from sales by the amount of the increase or decrease in receivables during the period.

When trade and other receivables go up during the year, cash flows from operations are less than operating profit by the amount of the increase.

When trade and other receivables go down during the year, cash flows from operations are more than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for receivables is therefore:

- subtract the increase in receivables during the period (the amount by which closing receivables exceed opening receivables); or
- add the reduction in receivables during the period (the amount by which opening receivables exceed closing receivables).

Prepayments in the opening and closing statement of financial position should be included in the total amount of receivables.



Example: trade and other receivables

A company had receivables at the beginning of the year of ₦6,000 and at the end of the year receivables were ₦9,000.

During the year, sales were ₦50,000 in total. Purchases were ₦30,000, all paid in cash.

The company holds no inventories. The profit before tax for the year was ₦20,000 ($\text{₦}50,000 - \text{₦}30,000$).

The cash flow from operations is calculated as follows:

	₦
Profit before tax	20,000
Adjustments for:	
Increase in receivables ($9,000 - 6,000$)	(3,000)
	<u>17,000</u>

Proof

Cashflow from operations can be calculated as follows:

	₦
Receivables at the beginning of the year	6,000
Sales in the year	<u>50,000</u>
	56,000
Receivables at end of the year	(9,000)
Cash received	<u>47,000</u>
Cash paid (purchases)	(30,000)
Cash flow from operations	<u>17,000</u>

4.4 Possible complication: Allowances for doubtful debts

A question might provide information on the allowance for doubtful debts at the start and end of the year.

There are two ways of dealing with this:

- Adjust the profit for the movement on the allowance as a non-cash item and adjust the profit figure for the movement in receivables using the gross amounts (i.e. the balances before any deduction of the allowance for doubtful debts); or
- Make no adjustments for the movement on receivables as a non-cash item adjust the profit figure for the movement in receivables using the net amounts (i.e. the balances after the deduction of the allowance for doubtful debts).

Example: Allowance for doubtful debts

The following information is available:

	2018 ₦m)	2019 ₦m)
Receivables	5,000	7,100
Allowance for doubtful debts	(500)	(600)
Net-amount	<u>4,500</u>	<u>6,500</u>
	₦m	or ₦m
Profit before taxation	10,000	10,000
Adjustments for non- cash items:		
Increase in allowance for doubtful debts	100	—
	<u>10,100</u>	<u>10,000</u>
Increase in receivables:		
Gross amounts: (7,100 – 5,000)	(2,100)	(2,000)
Net amounts: (6,500 – 4,500)	<u>8,000</u>	<u>8,000</u>

4.5 Changes in inventory

Purchases in a period differ from the cost of sales by the amount of the increase or decrease in inventories during the period.

If all purchases were paid for in cash, this means that cash payments and the cost of sales (and profit) would differ by the amount of the increase or decrease in inventories.

When the value of inventory goes up between the beginning and end of the year, cash flows from operations are less than operating profit by the amount of the increase.

When the value of inventory goes down between the beginning and end of the year, cash flows from operations are more than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for inventories is therefore:

- subtract the increase in inventories during the period (the amount by which closing inventory exceeds opening inventory); or
- add the reduction in inventories during the period (the amount by which opening inventory exceeds closing inventory).



Example: inventory

A company had inventory at the beginning of the year of ₦5,000 and at the end of the year the inventory was valued at ₦3,000.

During the year, sales were ₦50,000 and there were no receivables at the beginning or end of the year.

Purchases were ₦28,000, all paid in cash.

The operating profit for the year was ₦20,000, calculated as follows:

	₦
Sales	50,000
Opening inventory	5,000
Purchases in the year (all paid in cash)	28,000
	33,000
Closing inventory	(3,000)
Cost of sales	(30,000)
Profit before tax	20,000

**Example (continued)**

Profit before tax	₦ 20,000
Adjustments for:	
decrease in inventory (5,000 – 3,000)	2,000
	<hr/>
	22,000

Proof: The cash flow from operations is calculated as follows:

Cash from sales in the year	₦ 50,000
Purchases paid in cash	(28,000)
	<hr/>
Cash flow from operations	22,000

4.6 Changes in trade payables

Payments for purchases in a period differ from purchases by the amount of increase or decrease in trade payables during the period.

When trade payables go up between the beginning and end of the year, cash flows from operations are more than operating profit by the amount of the increase.

When trade payables go down between the beginning and end of the year, cash flows from operations are less than operating profit by the amount of the reduction.

In a statement of cash flows presented using the indirect method, the adjustment for trade payables is therefore:

- add the increase in trade payables during the period (the amount by which closing trade payables exceed opening trade payables); or
- subtract the reduction in trade payables during the period (the amount by which opening trade payables exceed closing trade payables).

Accruals in the opening and closing statement of financial position should be included in the total amount of trade payables.

However, deduct interest payable and tax payable from opening and closing payables, if the total for payables includes these items.



Example: trade payables

A company had no inventory and no receivables at the beginning and end of the year. All its sales are for cash, and sales in the year were ₦50,000.

Its purchases are all on credit. During the year, its purchases were ₦30,000.

Trade payables at the beginning of the year were ₦4,000 and trade payables at the end of the year were ₦6,500.

The operating profit for the year was ₦20,000 ($\text{₦}50,000 - \text{₦}30,000$)

Profit before tax	₦ 20,000
Adjustments for:	
Increase in payables ($6,500 - 4,000$)	₦ 2,500
	<hr/> 22,500

Proof: The cashflow from operations is calculated as follows:

Trade payables at the beginning of the year	₦ 4,000
Purchases in the year	₦ 30,000
	<hr/> 34,000
Trade payables at the end of the year	₦ (6,500)
Cash paid to suppliers	₦ 27,500
Cash from sales	₦ (50,000)
Cash flow from operations	<hr/> 22,500

The cash flow is ₦2,500 more than the operating profit, because trade payables were increased during the year by ₦2,500.

**Example:**

A company made an operating profit before tax of ₦16,000 in the year just ended. Depreciation charges were ₦15,000.

There was a gain of ₦5,000 on disposals of non-current assets and there were no interest charges. Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	₦9,000	₦3,000	₦4,000
End of the year	₦6,000	₦5,000	₦6,500

Taxation paid was ₦4,800.

Required

Calculate the amount of cash generated from operations, as it would be shown in a statement of cashflows using the indirect method.

**Answer**

Cash flows from operating activities	
Profit before taxation	₦ 16,000
Adjustments for:	
Depreciation and amortisation charges	₦ 15,000
Gains on disposal of non-current assets	(₦ 5,000)
	₦ 26,000
Decrease in trade and other receivables	₦ 3,000
Increase in inventories	(₦ 2,000)
Increase in trade payables	₦ 2,500
Cash generated from operations	₦ 29,500
Taxation paid (tax on profits)	(₦ 4,800)
Net cash flow from operating activities	₦ 24,700

**Practice question****2**

During 2019, a company made a profit before taxation of ₦60,000. Depreciation charges were ₦25,000 and there was a gain on the disposal of a machine of ₦14,000.

Interest charges and payments of interest in the year were the same amount, ₦10,000.

Taxation payments were ₦17,000.

Values of working capital items at the beginning and end of the year were:

	Receivables	Inventory	Trade payables
Beginning of the year	₦32,000	₦49,000	₦17,000
End of the year	₦27,000	₦53,000	₦11,000

Calculate the net cash from operating activities, as it would be shown in a statement of cashflows (indirect method).

4.7 Lack of detail

A question might not provide all the detail needed to split out working capital into all of its component parts. If this is the case the adjustment must be made using whatever totals are available in the question.



Example:

A company made an operating profit before tax of ₦16,000 in the year just ended. Depreciation charges were ₦15,000.

There was a gain of ₦5,000 on disposals of non-current assets and there were no interest charges. Values of working capital items at the beginning and end of the year were:

	Current assets	Trade payables
Beginning of the year	₦12,000	₦4,000
End of the year	₦11,000	₦6,500

Taxation paid was ₦4,800.

Required

Calculate the amount of cash generated from operations, as it would be shown in a statement of cashflows using the indirect method.



Answer

Cash flows from operating activities		₦	₦
Profit before taxation		16,000	
Adjustments for:			
Depreciation and amortisation charges	15,000		
Gains on disposal of non-current assets	(5,000)		
		<u>26,000</u>	
Decrease in current assets	1,000		
Increase in trade payables	2,500		
Cash generated from operations	<u>29,500</u>		
Taxation paid (tax on profits)	(4,800)		
Net cash flow from operating activities			24,700

5 CASHFLOWS FROM OPERATING ACTIVITIES: THE DIRECT METHOD

Section overview

- Cash from sales
- Cash paid for materials supplies
- Cash paid for wages and salaries
- Cash paid for other expenses

5.1 Cash from sales

The format for the direct method of presenting a statement of cash flows is as follows:



Illustration:

Statement of cash flows: direct method

Cash flows from operating activities

	₦
Cash receipts from customers	348,800
Cash payments to suppliers	(70,000)
Cash payments to employees	(150,000)
Cash paid for other operating expenses	(30,000)
Cash generated from operations	<u>98,800</u>
Taxation paid (tax on profits)	(21,000)
Interest charges paid	<u>(2,500)</u>
Net cash flow from operating activities	75,300

The task is therefore to establish the amounts for cash receipts and cash payments. In an examination, you might be expected to calculate any of these cash flows from figures in the opening and closing statements of financial position, and the statement of comprehensive income.

The cash receipts from sales during a financial period can be calculated as follows:

**Illustration:**

Trade receivables at the beginning of the year	X
Sales in the year	<u>X</u>
	X
Trade receivables at the end of the year	<u>(X)</u>
Cash from sales during the year	X

A T-account could also be used to calculate the cash receipt

Balanceb /f	X		
Sales	X	Cash (balancing figure)	X
	<u>X</u>	Balance c/f	<u>X</u>

5.2 Cash paid for materials supplies

To calculate the amount of cash paid to suppliers, you might need to calculate first the amount of material purchases during the period.



Illustration: Calculation of purchases in the year

	*
Closing inventory at the end of the year	X
Cost of sales	<u>X</u>
	X
Opening inventory at the beginning of the year	<u>(X)</u>
Purchases in the year	<u>X</u>

Having calculated purchases from the cost of sales, the amount of cash payments for purchases may be calculated from purchases and opening and closing trade payables.



Illustration:

	*
Trade payables at the beginning of the year	X
Purchases in the year (as above)	<u>X</u>
	X
Trade payables at the end of the year	<u>(X)</u>
Cash paid for materials	<u>X</u>

A T-account could also be used to calculate the cash paid

Payables		
	Balance b/f	X
Cash (balancing figure) X	Purchases	X
Balance c/f X		<u>X</u>
		<u>X</u>

Note that if the business had paid for goods in advance at the start or end of the year they would have an opening or closing receivable but this situation would be quite unusual.

5.3 Cash paid for wages and salaries

Cash payments for wages and salaries can be calculated in a similar way.



Illustration:

Accrued wages and salaries at the beginning of the year	X
Wages and salaries expenses in the year	<u>X</u>
	X
Accrued wages and salaries at the end of the year	<u>(X)</u>
Cash paid for wages and salaries	<u>X</u>

A T-account could also be used to calculate the cash paid

Payables		
	Balance b/f	X
Cash (balancing figure) X	Purchases	X
Balance c/f X		<u>X</u>
		<u>X</u>

If wages and salaries had been paid in advance the business would have a receivable and the workings would change to the following.



Illustration:

Wages and salaries paid in advance at the beginning of the year	(X)
Wages and salaries expenses in the year	<u>X</u>
	X
Wages and salaries paid in advance at the end of the year	<u>X</u>
Cash paid for wages and salaries	<u>X</u>
	<u>X</u>

A T-account could also be used to calculate the cash paid

Payables		
Balance b/f	X	
Cash (balancing figure) X	Purchases	X
	Balance c/f X	<u>X</u>
		<u>X</u>

5.4 Cash paid for other expenses

Other expenses in the statement of comprehensive income usually include depreciation charges, which are not cash flows. Depreciation charges should therefore, be excluded from other expenses when calculating cash payments.

Cash payments for other expenses can be calculated as follows.



Illustration:

Payables for other expenses at the beginning of the year	X
Other expenses in the year, excluding depreciation and amortisation	<u>X</u>
	X
	<u>X</u>
Payables for other expenses at the end of the year	(X)
Cash paid for other expenses	<u>X</u>

Payables for other expenses should exclude accrued wages and salaries, accrued interest charges and taxation payable.

**Example:**

The following information has been extracted from the financial statements of Abuja Plastics Limited for the year ended 31 December, 2019.

Sales	₦ 1,280,000
Cost of sales	(400,000)
Gross profit	880,000
Wages and salaries	(290,000)
Other expenses (including depreciation ₦25,000)	(350,000)
	240,000
Interest charges	(50,000)
Profit before tax	190,000
Tax on profit	(40,000)
Profit after tax	150,000

Extracts from the statement of financial position:

**At 1 January
2019**

₦

Trade receivables	233,000
Inventory	118,000
Trade payables	102,000
Accrued wages and salaries	8,000
Accrued interest charges	30,000
Tax payable	52,000

**At 31 December
2019**

₦

Trade receivables	219,000
Inventory	124,000
Trade payables	125,000
Accrued wages and salaries	5,000
Accrued interest charges	45,000
Tax payable	43,000

Required

Present the cash flows from operating activities as they would be presented in a statement of cash flows using:

- a) the direct method; and
- b) the indirect method.

**Answer: Direct method**

Statement of cashflows: direct method	₦
Cashflows from operating activities	
Cash receipts from customers (W1)	1,294,000
Cash payments to suppliers (W3)	(383,000)
Cash payments to employees (W4)	(293,000)
Cash paid for other operating expenses	(325,000)
Cash generated from operations	293,000
Taxation paid (tax on profits) (W5)	(49,000)
Interest charges paid (W5)	(35,000)
Net cash flow from operating activities	<u>209,000</u>

Workings**(W1) Cash from sales**

	₦
Trade receivables at 1 January 2019	233,000
Sales in the year	1,280,000
	<u>1,513,000</u>
Trade receivables at 31 December 2019	(219,000)
Cash from sales during the year	<u>1,294,000</u>

(W2) Purchases

	₦
Closing inventory at 31 December 2019	124,000
Cost of sales	400,000
	<u>524,000</u>
Opening inventory at 1 January 2019	(118,000)
Purchases in the year	<u>406,000</u>

(W3) Cash paid for materials supplies

	₦
Trade payables at 1 January 2019	102,000
Purchases in the year (W2)	406,000
	<u>508,000</u>
Trade payables at 31 December 2019	(125,000)
Cash paid for materials	<u>383,000</u>

**Answer: Direct method (continued)**

(W4) Cash paid for wages and salaries	₦
Accrued wages and salaries at 1 January 2019	8,000
Wages and salaries expenses in the year	290,000
	<hr/>
	298,000
Accrued wages and salaries at 31 December 2019	(5,000)
Cash paid for wages and salaries	<hr/> <hr/> 293,000

(W5) Interest and tax payments	Tax	Interest
	₦	₦
Liability at the beginning of the year	52,000	30,000
Taxation charge/interest charge for the year	40,000	50,000
	<hr/>	<hr/>
	92,000	80,000
Liability at the end of the year	(43,000)	(45,000)
Tax paid/interest paid during the year	49,000	<hr/> 35,000

**Answer: Indirect method**

Statement of cash flows: indirect method	₦
Cash flows from operating activities	
Profit before taxation	190,000
Adjustments for:	
Depreciation and amortisation charges	25,000
Interest charges in the statement of comprehensive income	50,000
	<hr/>
Decrease in receivables (233,000 – 219,000)	14,000
Increase in inventories (124,000 – 118,000)	(6,000)
Increase in trade payables	20,000
(125,000 + 5,000) – (102,000 + 8,000)	
Cash generated from operations	<hr/> 293,000
Taxation paid	(49,000)
Interest charges paid	(35,000)
Net cash flow from operating activities	<hr/> 209,000

6 CASHFLOWS FROM INVESTING ACTIVITIES

Section overview

- Cash paid for the purchase of property, plant and equipment
- Cash from disposals of property, plant and equipment
- Cash paid for the purchase of investments and cash received from the sale of investments

6.1 Cash paid for the purchase of property plant and equipment

This is the second part of a statement of cash flows, after cash flows from operating activities.

The most important items in this part of the statement are cash paid to purchase non-current assets and cash received from the sale or disposal of non-current assets but it also includes interest received and dividends received on investments.

It is useful to remember the following relationship:



Illustration: Movement on non-current assets

Carrying amount at the start of the year	X
Depreciation	(X)
Disposals	(X)
Additions	X
Revaluation	X/(X)
Carrying amount at the end of the year	X

When there are no disposals or revaluations during the year

When there are no disposals or revaluations of non-current assets during the year, purchases of non-current assets (normally assumed to be the amount of cash paid for these purchases) may be calculated as follows:



Illustration:

Using cost:

Non-current assets at the end of the year at cost	₦	X
Non-current assets at the beginning of the year at cost	₦	X
Additions to non-current assets	₦	X

Alternatively carrying amount (NBV) can be used

Non-current assets at the beginning of the year at NBV	₦	X
Non-current assets at the end of the year at NBV	₦	(X)
Depreciation	₦	X
Additions to non-current assets	₦	X



Example: Cash paid for property, plant and equipment

The plant and equipment of PM Company at the beginning and the end of its financial year were as follows:

	At cost	Accumulated depreciation	Net book value
	₦	₦	₦
Beginning of the year	180,000	(30,000)	150,000
End of the year	240,000	(50,000)	190,000

There were no disposals of plant and equipment during the year.

The cash paid for plant and equipment in the year (additions) maybe calculated in either of the following ways.

	₦	₦
At cost at the end of the year	240,000	Carrying amount (NBV) at the end of the year
At cost at the beginning of the year	180,000	190,000 Carrying amount(NBV) at the beginning of the year
Additions	<u>60,000</u>	150,000 Increase in NBV
		40,000 Depreciation charge for the year
		(50,000 – 30,000)
		<u>20,000</u>
		Additions
		<u>60,000</u>

Note that in the above example it is assumed that the purchases have been made for cash. This might not be the case. If the purchases are on credit the figure must be adjusted for any amounts outstanding at the year end.



Example: Cash paid for property, plant and equipment

PM company has purchased various items of property, plant and equipment on credit during the year. The total purchased was ₦60,000.

The statements of financial position of PM company at the beginning and end of 2019 include the following information:

	2018 (₦m)	2019 (₦m)
Payables:		
Suppliers of non-current assets	4,000	12,000

The cash paid to buy property, plant and equipment in the year can be calculated as follows:

	₦m
Additions	60,000
Less: increase in payables that relate to these items	(8,000)
Cash paid in the year	<u>52,000</u>

This can be thought of as the payment of the ₦4,000 owed at the start and a payment of ₦48,000 towards this year's purchases.

If the payables had decreased the movement would be added to the additions figure to find the cash outflow.



Example: Cash paid for property, plant and equipment

PM company has purchased various items of property, plant and equipment on credit during the year. The total purchased was ₦60,000.

The statements of financial position of PM company at the beginning and end of 2019 include the following information:

	2018 (₦m)	2019 (₦m)
Payables		
Suppliers of non-current assets	14,000	4,000

The cash paid to buy property, plant and equipment in the year can be calculated as follows:

	₦m
Additions	60,000
Add: decrease in payables that relate to these items	10,000
Cash paid in the year	<u>70,000</u>

This can be thought of as the payment of the ₦14,000 owed at the start and a payment of ₦56,000 towards this year's purchases.

When there are disposals during the year

When there are disposals of non-current assets during the year, the purchases of non-current assets may be calculated as follows:



Illustration: Movement on non-current assets

Assets at cost at the end of the year	₦	X
Assets at cost at the beginning of the year		X
		X
Disposals during the year: original asset cost		X
Purchases		X



Example: Cash paid for property, plant and equipment with disposals

The motor vehicles of PM Company at the beginning and the end of its financial year were as follows:

	At cost	Accumulated depreciation	Carrying amount
Beginning of the year	₦ 150,000	₦ (105,000)	₦ 45,000
End of the year	₦ 180,000	₦ (88,000)	₦ 92,000

During the year a vehicle was disposed of for a gain of ₦3,000. The original cost of this asset was ₦60,000. Accumulated depreciation on the asset was ₦45,000.

The cash paid for plant and machinery in the year (=purchases) maybe calculated as follows.

Assets at cost at the end of the year	₦ 180,000
Assets at cost at the beginning of the year	₦ 150,000
	30,000
Disposals during the year: original asset cost	₦ 60,000
Purchases	<u>₦ 90,000</u>

Alternatively using carrying amount (NBV):

Assets at carrying amount (NBV) at the end of the year ₦92,000

Assets at carrying amount (NBV) at the beginning of the year
₦45,000

₦47,000

Disposals during the year (carrying amount): (60,000 – 45,000)

₦15,000

Depreciation (88,000 – (105,000 – 45,000))

₦28,000

Purchases

₦90,000

When there are revaluations during the year

When there are revaluations of non-current assets during the year, the purchases of non-current assets should be calculated as follows.



Illustration: Movement on non-current assets

	₦
At cost or valuation, at the end of the year	X
At cost or valuation, at the beginning of the year	X
	<hr/>
Add: Cost/re-valued amount of assets disposed of in the year	X
Subtract: Any upward asset revaluation during the year (or deduct a downward revaluation)	(X)
	<hr/>
Purchases during the year	X
	<hr/>



Example:

The statements of financial position of Grand Company at the beginning and end of 2019 include the following information:

Property, plant and equipment	2018	2019
	₦	₦
At cost/re-valued amount	1,400,000	1,900,000
Accumulated depreciation	350,000	375,000
Carrying value	<hr/> 1,050,000	<hr/> 1,525,000

During the year, some property was re-valued upwards by ₦200,000. An item of equipment was disposed of during the year at a profit of ₦25,000. This equipment had an original cost of ₦260,000 and accumulated depreciation of ₦240,000 at the date of disposal.

Depreciation charged in the year was ₦265,000.

Purchases of property, plant and equipment during the year were as follows:

	₦
At cost/re-valued amount, at the end of the year	1,900,000
At cost/re-valued amount, at the beginning of the year	1,400,000
	<hr/> 500,000
Add: Cost of assets disposed of in the year	260,000
Subtract: Asset revaluation during the year	(200,000)
	<hr/> 560,000
Purchases during the year	

**Example (continued)**

Alternatively using carrying amount (NBV):	₦
Assets at carrying amount (NBV) at the end of the year	1,525,000
Assets at carrying amount (NBV) at the beginning of the year	<u>1,050,000</u>
	475,000
Revaluation during year	(200,000)
Carrying amount of assets disposed of in the year (260,000 – 240,000)	20,000
Depreciation charged during the year	265,000
Purchases during the year	<u>560,000</u>

6.2 Cash from disposals of property, plant and equipment

A statement of cash flows should include the net cash received from any disposals of non-current assets during the period.

This might have to be calculated from the gain or loss on disposal and the carrying amount of the asset at the time of its disposal.

**Illustration: Disposal of property, plant and equipment**

At cost (or re-valued amount at the time of disposal)	₦
Accumulated depreciation, at the time of disposal	X
Net book value/carrying amount at the time of disposal	<u>(X)</u>
Gain or (loss) on disposal	X
Net disposal value (= assumed cash flow)	<u>X</u>

If there is a gain on disposal, the net cash from the disposal is more than the net book value.

If there is a loss on disposal the net cash from the disposal is less than the net book value.

**Example:**

During an accounting period, an entity disposed of some equipment and made a gain on disposal of ₦6,000.

The equipment originally cost ₦70,000 and at the time of its disposal, the accumulated depreciation on the equipment was ₦56,000.

What was the amount of cash obtained from the disposal of the asset?

Disposal of equipment	₦
At cost	70,000
Accumulated depreciation, at the time of disposal	(56,000)
Net book value/carrying amount at the time of disposal	14,000
Gain on disposal	6,000
Net disposal value (assumed cash flow)	<u>20,000</u>

This cashflow would be included in the cashflows from investing activities.

Note that in the above example it is assumed that the cash received for the disposal has been received. This might not be the case. If the disposal was on credit the figure must be adjusted for any amounts outstanding at the year end.

**Practice question****3**

At 1 January 2019, the property, plant and equipment in the statement of financial position of NC Company amounted to ₦329,000 at cost or valuation.

At the end of the year, the property, plant and equipment was ₦381,000 at cost or valuation.

During the year, a non-current asset that cost ₦40,000 (and has not been re-valued) was disposed of at a loss of ₦4,000. The accumulated depreciation on this asset at the time of disposal was ₦21,000.

Another non-current asset was re-valued upwards during the year from ₦67,000 (cost) to ₦102,000.

Calculate the following amounts, for inclusion in the cash flows from investing activities section of the company's statement of cash flows for 2019:

- a) Purchases of property, plant and equipment
- b) Proceeds from the sale of non-current assets

6.3 Cash paid for the purchase of investments and cash received from the sale of investments

A statement of cash flows should include the net cash paid to buy investments in the period and the cash received from the sale of investment in the period.

It is useful to remember the following relationship:



Illustration: Movement on investments

	₦
Carrying amount at the start of the year	X
Disposals	(X)
Additions	X
Revaluation	<u>X/(X)</u>
Carrying amount at the end of the year	<u>X</u>

The issues to be considered in calculating cash paid for investments or cash received on the sale of investments are very similar to those for the purchase and sale of property, plant and equipment except for the absence of depreciation.



Example: Cash paid for investments

The statements of financial position of Grand Company at the beginning and end of 2019 include the following information:

	2018 (₦m)	2019 (₦m)
Non-current asset investments	1,000	1,500

Additional information:

The investments were valued upwards during the year. A revaluation gain of ₦150m has been recognised.

Investments sold for ₦250m resulted in a profit on the sale (measured as the difference between sale proceeds and carrying amount at the date of sale) of ₦50m

The cash paid to buy investments in the period can be calculated as a balancing figure as follows:

	₦m
Investments at the start of the year (given)	1,000
Disposal(carrying amount of investments sold = ₦250m - ₦50m)	(200)
Revaluation gains (given)	150
	<u>950</u>
Additions (as balancing figure):	<u>550</u>
Investments at the end of the year (given)	<u>1,500</u>

7 CASHFLOWS FROM FINANCING ACTIVITIES

Section overview

- Cash from new share issues
- Cash from new loans/cash used to repay loans
- Dividend payments to equity shareholders
- Financing of a sole proprietor or a partnership

7.1 Cash from new share issues

The cash raised from new share issues can be established by comparing the equity share capital and the share premium in the statements of financial position at the beginning and the end of the year.



Illustration:

Share capital + Share premium at the end of the year	₦
Share capital + Share premium at the beginning of the year	X
Cash obtained from issuing new shares in the year	<u>X</u>



Example:

The statements of financial position of P Limited at 1 January and 31 December included the following items:

	1 January 2019	31 December 2019
Equity shares of ₦1 each	600,000	750,000
Share premium	800,000	1,100,000

The cash obtained from issuing shares during the year is calculated as follows.

Share capital+Share premium at the end of 2019	₦
Share capital+Share premium at the beginning of 2019	<u>1,400,000</u>
=Cash obtained from issuing new shares in 2019	450,000

7.2 Cash from new loans/cash used to repay loans

Cash from new loans or cash paid to redeem loans in the year can be calculated simply by looking at the difference between the liabilities for loans and bonds at the beginning and the end of the year.

- An increase in loans or bonds means there has been an inflow of cash.
- A reduction in loans or bonds means there has been a payment (outflow) of cash.

Remember to add any loans, loan notes or bonds repayable within one year (current liability) to the loans, loan notes or bonds repayable after more than one year (non-current liability) to get the total figure for loans, loan notes or bonds.



Illustration:

Loans at end of year (current and non-current liabilities)	X
Loans at beginning of year (current and non-current liabilities)	X
Cash inflow or outflow	X

Note: The same calculation can be applied to bonds or loan notes that the company might have issued. Bonds and loan notes are long-term debt.



Example:

The statements of financial position of Company Qat January 1, and December 31, included the following items:

	January 1 2019	December 31 2019
Loans repayable within 12 months	760,000	400,000
Loans repayable after 12 months	1,400,000	1,650,000

The cashflows relating to loans during the year are calculated as follows.

Loans outstanding at the end of 2019	2,050,000
Loans outstanding at the beginning of 2019	2,160,000
=Net loan repayments during the year (= cash outflow)	<u>110,000</u>

7.3 Dividend payments to equity shareholders

These should be the final dividend payment from the previous year and the interim dividend payment for the current year. The dividend payments during the year are shown in the statement of changes in equity (SOCIE).

You might be expected to calculate dividend payments from figures for retained earnings and the profit after tax for the year.

The equity dividend payments can be calculated as follows:



Illustration:

Retained earnings at the beginning of the year	₦
Profit for the year after tax	X
Any other transfer into the account	X
Increase in the retained earnings reserve	<u>X</u>
Retained earnings at the end of the year	(X)
Equity dividend payments	<u>X</u>



Example:

From the following information, calculate the cash flows from investing activities for Company X in 2019.

	Beginning of 2019	End of 2019
	₦	₦
Share capital (ordinary shares)	400,000	500,000
Share premium	275,000	615,000
Retained earnings	<u>390,000</u>	<u>570,000</u>
	1,065,000	1,685,000
Loans repayable after more than 12 months	600,000	520,000
Loans repayable within 12 months or less	80,000	55,000

The company made a profit of ₦420,000 for the year after taxation.

Required:

Calculate for 2019, for inclusion in the statement of cash flows:

- (a) the cash from issuing new shares
- (b) the cashflows received or paid for loans
- (c) the payment of dividend to ordinary shareholders.



Proceeds from new issue of shares	₦
Share capital and share premium:	
Workings	
At the end of the year (500,000 + 615,000)	1,115,000
At the beginning of the year (400,000 + 275,000)	(675,000)
Proceeds from new issue of shares during the year	<u>440,000</u>

Repayment of loans	₦
Loans repayable:	
At the end of the year (520,000 + 55,000)	575,000
At the beginning of the year (600,000 + 80,000)	(680,000)
Repayment of loans during the year	<u>105,000</u>

Payment of dividends	₦
Retained earnings at the beginning of the year	390,000
Profit after taxation for the year	<u>420,000</u>
Retained earnings at the end of the year	810,000
Dividends paid during the year	<u>(570,000)</u>
	240,000

Cash flows from financing activities can now be presented as follows.

Cash flows from financing activities:	₦	₦
Proceeds from issue of shares	440,000	
Repayment of loans	(105,000)	
Dividends paid to shareholders	(240,000)	
Net cash from financing activities		95,000

7.4 Financing of a sole proprietor or a partnership

You may face a question asking for the preparation of a statement of cash flows for a sole proprietor or partnership. Such a question might require the calculation of cash flows between the owners and the business. These cash flows would be capital introduced and drawings.

It is useful to remember the following relationship:



Illustration:

Capital at the beginning of the year	X
Profit (loss) for the year after tax	X/(X)
Capital introduced	X
Drawings	(X)
Capital at the end of the year	<hr/> X

The drawings and capital introduced figures might be provided in the question in which case you simply have to slot the figures into the cash flow statement.

Other questions might need you to identify one or other of these as balancing figure.

8 STATEMENT OF CASHFLOWS – SPECIMEN FORMATS

Section overview

- Direct method
- Indirect method

IAS 7 does not specify formats for the statement of cash flows. However, it includes illustrative statements in an appendix.

The illustrations below are based on the illustrative examples but have been modified to exclude some items not in this syllabus.

8.1 Direct method



Illustration:

Cash flows from operating activities	
Cash receipts from customers	X
Cash paid to suppliers	(X)
Cash paid employees	(X)
Cash generated from operations	X
Interest paid	(X)
Income taxes paid	(X)
Net cash from operating activities	X
Cash flows from investing activities	
Purchase of property, plant and equipment	(X)
Proceeds from sale of equipment	X
Interest received	X
Dividends received	X
Net cash used in investing activities	X
Cash flows from financing activities	
Proceeds from issue of share capital	X
Proceeds from long-term borrowings	X
Dividends paid	(X)
Net cash used in financing activities	X
Net increase in cash and cash equivalents	X
Cash and cash equivalents at beginning of period	X
Cash and cash equivalents at end of period	X

8.2 Indirect method



Illustration:

Cash flows from operating activities		# #
Profit before taxation		X
Adjustments for:		
Depreciation		X
Investment income		(X)
Interest expense		X
Operating profit before working capital changes		X
Increase in trade and other receivables		(X)
Decrease in inventories		X
Decrease in trade payables		(X)
<i>Cash generated from operations</i>		X
Interest paid		(X)
Income taxes paid		(X)
<i>Net cash from operating activities</i>		X
Cash flows from investing activities		
Purchase of property, plant and equipment		(X)
Proceeds from sale of equipment		X
Interest received		X
Dividends received		X
<i>Net cash used in investing activities</i>		X
Cash flows from financing activities		
Proceeds from issue of share capital		X
Proceeds from long-term borrowings		X
Dividends paid		(X)
<i>Net cash used in financing activities</i>		X
<i>Net increase in cash and cash equivalents</i>		X
<i>Cash and cash equivalents at beginning of period</i>		X
<i>Cash and cash equivalents at end of period</i>		X

9 CHAPTER REVIEW

Chapter review

On completion of this chapter check that you now know how to prepare part or all of a statement of cash flows from information provided

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SOLUTIONS TO PRACTICE QUESTIONS

Solutions

1

- (a) In the adjustments to get from the operating profit to the cash flow from operations, the loss on disposal of ₦8,000 should be added.
- (b) Under the heading 'Cashflows from investing activities', the sale price of the vehicle of ₦22,000 should be included as a cash inflow.

Workings:

Original cost of vehicle	50,000
Accumulated depreciation at date of disposal	(20,000)
Net book value at the time of disposal	30,000
Loss on disposal	(8,000)
Therefore net sales proceeds	22,000

Solutions

2

Profit before taxation	₦ 60,000
Adjustments for:	
Depreciation	25,000
Interest charges	10,000
Gain on disposal of non-current asset	(14,000)
Reduction in trade and other receivables	81,000
Increase in inventories	5,000
Reduction in trade payables	(4,000)
Taxation paid	(6,000)
Interest charges paid	76,000
Cash flows from operating activities	(17,000)
	(10,000)
	49,000

Solutions

Property, plant and equipment purchases	₦
At cost or valuation at the end of the year	381,000
At cost or valuation at the beginning of the year	(329,000)
	<hr/>
Add: Cost of assets disposed of in the year	52,000
Subtract: Asset revaluation during the year (102,000 – 67,000)	40,000
	<hr/>
Purchases during the year	(35,000)
	<hr/>
	57,000
	<hr/>
Disposal of equipment	₦
At cost	40,000
Accumulated depreciation, at the time of disposal	(21,000)
Net book value/carrying amount at the time of disposal	19,000
Loss on disposal	(4,000)
	<hr/>
Net disposal value (= assumed cash flow)	15,000
	<hr/>

9 STATEMENT OF CHANGE IN EQUITY: INTRODUCTION

Section overview

- Importance of statement of change in equity for business
- Overall approach

The following information was extracted from the books of Enofe Ltd for the year ended December 31, 2020:

	₦'000
Profit after tax 31/12/2020	4,200
Share premium	2,000
Accumulated profit	7,500
Revaluation reserve	5,000
Equity capital	21,000

At the end of December 31, the land and building was revalued causing a reserve of ₦5,000,000 but an increase in depreciation by ₦300,000. Enofe Ltd has a policy of transferring the revaluation surplus included in equity to retained earnings as it is realised.

Interim dividend paid during the year was ₦200,000.

Required:

Prepare the statement of changes in equity for the year December 31, 2020.

Solution

Enofe Ltd

Statement of changes in equity for the year ended December 31, 2020

	Share capital ₦'000	Share premium ₦'000	Revaluation reserve ₦'000	Retained profits ₦'000	Total ₦'000
Balance at beginning of year	21,000	2,000	0	7,500	30,500
Dividend paid				(200)	(200)
Profit for the period				4,200	4,200
Other comprehensive income:					
Revaluation of non-current asset			5,000		
Transfer of excess depreciation on revaluation			(300)	300	0
Balance at end of year	21,000	2,000	4,700	11,800	39,500

The following information was extracted from the books of Enofe Ltd for the year ended December 31, 2020:

	₦'000
Profit after tax 31/12/2020	4,200
Share premium	2,000
Accumulated profit	7,500
Revaluation reserve	5,000
Equity capital	21,000

On December 31, the land and building was revalued causing a reserve of ₦5,000,000 but an increase in depreciation by ₦300,000. Enofe Ltd has a policy of transferring the revaluation surplus included in equity to retained earnings as it is realised. Interim dividend paid during the year was ₦200,000.

Required:

Prepare the statement of changes in equity for the year December 31, 2020.

Solution

Enofe Ltd

Statement of changes in equity for the year ended December 31, 2020

	Share capital	Share premium	Revaluation reserve	Retained profits	Total
	₦'000	₦'000	₦'000	₦'000	₦'000
Balance at beginning of year	21,000	2,000	0	7,500	30,500
Dividend paid				(200)	(200)
Profit for the year				4,200	4,200
Other comprehensive income:					
Revaluation of non-current asset			5,000		
Transfer of excess depreciation on revaluation			(300)	300	0
Balance at end of year	21,000	2,000	4,700	11,800	39,500

CHAPTER 19

Virtual Accounting

Contents

1. Digitisation in financial accounting
2. Uses of data structure
3. Block chain technology
4. Virtual accounting principles and practice
5. Fraud opportunities arising from working remotely
6. Chapter review

Introduction

Aim

The purpose of financial accounting is to equip accounting professionals with knowledge of the essential framework of assumptions that underpin reliable reporting and the requisite skills to compile reliable financial statements for sole traders, partnerships, companies and not-for-profit entities.

Detailed syllabus

The detailed syllabus includes the following:

G	Virtual Accounting	
1		Digitisation in financial accounting
2		Uses of data structure
	A	Block chain technology
	B	Virtual accounting principles and practice
	C	Fraud opportunities arising from working remotely

Exam context

This paper requires you to be able to explain the benefits, challenges and practice of virtual accounting. Several terminologies and concepts relating to information technology and accounting are also covered. This chapter explains digitisation, block chain technology, data structures, remote working environment, fraud opportunities and the principles and practice of virtual accounting.

It also explains other fundamental concepts which provide a foundation to understanding the changes in the accounting profession in relation to technological advancements.

19.1 Digitisation in financial accounting

Section overview

- Explain the term digitisation
- Differentiate between digitisation and digitalisation
- Describe the uses of digitisation
- Discuss some of the challenges of digitisation to the accounting profession

19.1.1 Digitisation

Advancement in technology has transformed many aspects of business operations including accounting. The use of technologically advanced software that is faster and can perform more complex functions, has made accounting efficient and easier especially in the area of data analysis, organisation of financial information, and measuring economic activities.

Digitisation is the process of converting information from a physical format into a digital (that is, a computer-readable) format. In accounting, digitisation relates to the use of digital technologies to convert invoices, receipts, all forms of paper files into machine readable format that can be processed with minimal human interface.

19.1.2 Digitisation vs Digitalisation

- (a) Digitisation is the process of converting information from a physical format into a digital one. When this process is leveraged to improve business processes, it is called digitalisation.
- (b) Digitisation is the conversion of analog to digital, whereas digitalisation is the use of digital technologies and digitised data to impact how work gets done, transform how customers and companies engage and interact, and create new (digital) revenue streams.
- (c) For digitalisation to occur, there must be digitisation.

Example of digitisation vs digitalisation

When an invoice is scanned and saved in PDF format, in a computer system perhaps on the desktop, this process is known as digitisation.

If on the other hand, this PDF invoice is saved in the cloud, for example, in a Google drive, then this is digitalisation.

19.1.2 Digital technologies in accounting system

Digital technologies in accounting system include:

- (a) Machine learning and artificial intelligence

Machine learning and artificial intelligence (AI), the fast evolving technologies, enable the software to learn on its own and improve results without requiring human intervention. Additionally, AI-powered accounting applications can:

- i. Perform data entry and data sorting tasks, more efficiently and accurately;
- ii. Automatically reconcile accounts and do the classification of accounting transactions based on patterns in historic data; and
- iii. Utilise machine-learning-powered fraud management applications and expense management systems to flag fraudulent transactions and validate expenses, respectively.

- (b) Data analytics

The deployment of Data Analytics helps in identifying trends, patterns, and insights that can otherwise remain hidden. It uses statistical methods and modelling to analyse data.

- (c) Mobile accounting

With mobile applications dedicated to accounting functions, one can create and send invoices, capture receipts, gather signatures, and create expense claims. Further, one can use customer management software on mobile devices to improve customer communication and support. With the help of customer relations management (CRM) software and increased connectivity, one can build better relationships with clients.

- (d) Specialised accounting software

The rising popularity and easy accessibility to specialised accounting software and more efficient processing tools, has diminished the use of traditional pen, ledger, and desk calculator. These tools allow quicker input and computation of data, with higher degree of accuracy. Now, the accountant is able to focus more on how to protect and grow the client's business.

19.1.3 Impact of digitisation on businesses

- (a) **Economies of scale:** Digitisation of operations is not only beneficial for those working within the organisation, but also for the clients. There is enough evidence that the adoption of digital technologies by organisations not only improves the economies of managerial and operational processes but also mobilises extensive organisational and social effects.

- (b) Digitisation affects the substance, form and provenance of accounting information with consequences on the functioning of enterprises widely.

- (c) Time and cost savings: Digitisation has reduced the need for on-site consultations as both accountants and clients are able to access real-time data remotely, and view, edit, and comment on their statements simultaneously. As a result, a company can connect with its clients in the most convenient ways and serve more clients due to faster and more efficient processes.

- (d) Ease of operations: As organisations face mounting pressure to optimise costs, pricing, and efficiency, they are creating a “paperless office” within their finance functions. With the necessary regulatory frameworks in place, organisations only need to implement the right systems and technologies, to start deriving benefits of digitised business environment in finance and accounting.

19.1.4 Disadvantages of digitisation

Low patronage of accounting professionals:

- (a) The share of accounting tasks done by machines will surge by 80 percent in the year 2025, according to the study, conducted by the Institute of Singapore Chartered Accountants (ISCA), Lee Kuan Yew Centre for Innovative Cities (LKYCIC) at the Singapore University of Technology and Design, and Ernst & Young Advisory Pte Ltd (EY);
- (b) Once tasks are automated, consolidated or outsourced, financial data will be available on demand through self-service portals and as an output from AI; and
- (c) Traditional tasks, such as audit, statutory and regulatory reporting and global business services will be automated and/or procured.

19.1.5 Maintaining the relevance of accounting professionals with digitisation

The next generation of accountancy and finance professionals should understand not just accounting and their industries but also AI, blockchain and advanced analytics/big data, as well as how these technologies work together.

Upscaled skills and knowledge of digital tools: It also suggested that the two most junior roles can be upskilled to assume next-level roles. They may converge or look at moving to the internal audit track to take up the senior internal auditor/internal auditor role. On the other hand, those holding mid-level jobs should focus on upskilling themselves.

With accelerated digitisation ongoing in the accounting and financial space, both employers and employees have to focus on reskilling and associations like Information Systems Audit and Control Association (ISACA) have to also assist and support their learning journeys.

Higher institutions and professional bodies need to educate students and members of the changes in the accounting profession by mapping what skills will be in demand and which will be redundant, and how they can protect their future and build their careers.

19.2 Uses of data structure

Section overview

- Explain the meaning of data structure
- Enumerate four forms of data structure
- Identify the uses of data structure

19.2.1 Data structure

Data structure can be defined as the collection of data objects which provides a way of storing and managing data in the computer so that it can be used. Data structures provide a means to manage large amounts of data efficiently for large databases and internet indexing services. Usually, efficient data structures are vital in designing efficient algorithms.

Data structures are widely used in almost every aspect of computer science for simple as well as complex computations, artificial intelligence, graphics, operating system, etc.

19.2.2 Forms of data structure

Data structure can take different forms. Examples of these forms are:

- (a) Linear - arrays, lists;
- (b) Tree - binary, heaps, space partitioning, etc;
- (c) Hash - distributed hash table, hash tree, etc;
- (d) Graphs - decision, directed, acyclic, etc;
- (e) Stack; and
- (f) Queue.

19.2.3 Uses of data structures

- (a) **Efficient data management:** Data structures are the key part of many computer algorithms as they allow the programmers to do data management in an efficient way.
- (b) **Efficient computer programming:** A right selection of data structure can enhance the efficiency of computer program or algorithm in a better way.
- (c) **Efficient memory use:** Efficient use of data structure causes optimal memory usage.
- (d) **Reusability:** Data structures can be reused at any other place. Implementation of data structures can be compiled into libraries which can be used by different clients.
- (e) **Abstraction:** Data structure serves as the basis of abstract data types, the data structure defines the physical form of abstract data type (ADT). ADT is theoretical and data structure gives physical form to them.
- (f) **Building blocks:** Data structures are the basic building blocks of any programming language, complex computations, etc.

19.3 Blockchain technology

Section overview

- Explain the meaning of block chain technology
- Identify the benefits of block chain technology

19.3.1 Introduction

Disruptions in technology have affected many industries and their operations. After the transition from manual accounting to computerised accounting process, accounting for a while, has been shielded from these technology driven disruptions. The first phase of transition caused accountants to gain relevant computer skills and computer software knowledge to adapt to a machine-driven environment. In recent years, some of the roles of the accountant is being threatened with new innovations in technology. One of these innovations is the blockchain technology.

19.3.2 Definitions of blockchain technology

Several authors have attempted defining the concept of blockchain technology. A few of these definitions are highlighted below:

- (a) In the book, “*Blockchain technology: Beyond bitcoin. ApplInnov Rev 2:6–19*” (2016), Crosby states that “a blockchain is essentially a public ledger of transactions or events recorded and stored in chronologically- and linearly-connected blocks. Later blocks then maintain the hash of previous blocks”.
- (b) In the book, “*Leaderless, Blockchain-Based Venture Capital Fund Raises \$100 Million, And Counting*” (2016), Morris explains “a blockchain as a distributed database that maintains a continuously-growing list of data records secured from tampering and revision. It consists of blocks, holding batches of individual transactions. Each block contains a timestamp and a link to a previous block”.
- (c) In the report, “*Blockchain technology: opportunities and risks*” (2016), Condos states that “Blockchain as a type of distributed, electronic database (ledger) which can hold any information (e.g. records, events, transactions) and can set rules on how this information is updated”.
- (d) In the book, “*Blockchain: Blueprint for a New Economy*” (2015), Swan describes “Blockchain technology as one that enables records to be shared by all network nodes, updated by miners, monitored by everyone, and owned and controlled by no one”.
- (e) In the journal, “*Visions, Part 1: The Value of Blockchain Technology*” (2015), VitalikButerin explains the blockchain “as a magic computer that anyone can upload programs to and leave the programs to self-execute, where the current and all previous states of every program are always publicly visible, and which carries a very strong crypto economically secured guarantee that programs running on the chain will continue to execute in exactly the way that the blockchain protocol specifies”.

- (f) In the article, "Why Bitcoin has value" (2014), Van Alstyne describes Blockchain technology as "a sequential distributed database where the entire earlier transaction history is stored and shared in a (block) chain in a public ledger". .

Summarily, a blockchain is a chain of blocks that contain information. It is a completely open and distributed ledger to record information, once any data is recorded in a blockchain it cannot be changed or tampered with easily. Blockchain in accounting may be defined as an open, distributed database or public ledger that can record all transactions or digital events between two parties efficiently and in a verifiable and permanent way. It is like a giant spreadsheet for registering all assets and an accounting system for transacting on these assets on a global scale.

19.3.3 The origin of blockchain technology

Haber and Stornetta (1991) in their article, 'How to time stamp a digital document', in the Journal of Cryptology, introduced a technological solution to reduce data manipulation or modification by placing a time stamp. Blockchain technology was introduced in order to track the origin of data and any subsequent attempt to modify same. In 1991, they first proposed computationally practical procedures that involved creating cryptographically secured chain of blocks via time stamps, so that it becomes impossible for a user, either to back-date or to forward-date a document. Their procedures claimed to maintain privacy and removed the need for record keeping or time stamping by a third party.

This concept of cryptographically secured chain of blocks laid the foundation of blockchain. Blockchain, in its current form became popular after Satoshi Nakamoto used blockchain as the public transaction ledger for Bitcoin. Since then, blockchain technology has been implemented in recording of events, medical records, transaction processing, among others, in virtually all sectors of the economy.

Blockchain is a ledger that shows the histories of accounts which are replicated and distributed to every participant. It creates authenticity and privacy of identity by using cryptography algorithms. It is also a decentralisation protocol for shared control, tolerating disruption and for transaction validation. The blocks are connected in the order of its chronological occurrence which provides a trail to analyse the transactions. The information are in the form of digital media which eliminates manual and paper documents.

19.3.4 Modus operandi of blockchain

Like the name suggests, in a typical blockchain process, there are peer-to-peer nodes. When a transaction is requested, the request is sent to these nodes. Nodes then verify the transactions with a computer algorithm. If majority of the nodes verify the transaction, a new time stamped block is created and added to the blockchain of all previously verified blocks. This completes the transaction and the ledger is updated.

19.3.5 Benefits of block chain technology in accounting

- (a) Standardisation would allow auditors to verify a large portion of the most important data behind the financial statements automatically.
- (b) The cost and time necessary to conduct an audit would decline considerably. Auditors could spend freed up time on areas they can add more value, for example, on very complex transactions or on internal control mechanism.
- (c) Using the blockchain makes it possible to prove integrity of electronic files easily. One approach is to generate a hash string of the file. That hash string represents the digital fingerprint of that file. Next, that fingerprint is immutably time stamped by writing it into the blockchain via a transaction. At any subsequent point in time, one can prove the integrity of that file by again generating the fingerprint and comparing it with the fingerprint stored in the blockchain. In case the fingerprints are identical, the document remained unaltered since first writing the hash to the blockchain.
- (d) Finally, blockchain technology allows for smart contracts, that is, computer programs that may execute under certain conditions. Think of an invoice paying for itself after checking that delivered goods have been received according to specifications and sufficient funds are available on the company's bank account.
- (e) The blockchain technology has the potential to shapeshift the nature of today's accounting. It may constitute a way to vastly automate accounting processes in compliance with regulatory requirements. A flow of new applications will likely follow that are built on top of each other, leading the way for new, unprecedented services.
- (f) With the use of blockchain technology in an organisation, manual procedure of recording and verification is reduced. Blockchain technology is the future of accounting, because instead of keeping separate records based on transaction receipts, companies can write their transactions directly into a joint register, creating an interlocking system of enduring accounting records.
- (g) The most effective method to reduce frauds and errors in recording and verification is by implementing the blockchain technology in the organisation. Since all entries are distributed and cryptographically sealed, falsification or destruction of such entries in order to hide activity is rendered practically impossible.
- (h) Blockchain finally allows traceable audit trails, automates the auditing processes and authentication of transactions.

19.3.6 Conclusion

Blockchain is currently one of the most widely debated technologies, because of its indestructible and incorruptible features. Blockchain accounting offers to record data in a way which can be simultaneously accessible by auditors and regulators. This could potentially reduce the need for accountants to record transactions in separate locations with almost no way to consolidate and validate same.

Blockchain accounting is capable of providing a more transparent and secured accounting framework to track transactions and assets. Hence, traditional accounting is at the verge of a disruption which will redefine the role and need for accountants in an industry. Instead of being record keepers, accountants will become interpreters of financial statements and direct facilitators in decision making.

19.4 Virtual accounting principles and practice

Section overview

- Explain the meaning of virtual accounting
- List some of the services offered by virtual accounting service providers
- Describe the practice of virtual accounting- its benefits and challenges

19.4.1 Introduction

In this competitive world, to ease the stress of managing the accounts of a business and still achieve strategic goals, a businessman needs to decide whether to hire an in-house accountant or to take help of a virtual accountant.

19.4.2 Virtual accounting

Virtual accounting is a flexible system in which a qualified professional provides accounting services remotely, rather than physically working at the client's office. Virtual accounting offers all of the same benefits of hiring an accountant for a business, but because the accountant telecommutes and is a contractor, the cost is often less.

Virtual accounting offers an opportunity for qualified accountants to offer their services remotely. It is an efficient, flexible, and cost-effective accounting option that allows businesses to focus on achieving their goals by concentrating on their core competences.

19.4.3 Services offered by virtual accountants

Services offered in practice include:

- (a) Bookkeeping;
- (b) Payable and receivable accounts;
- (c) Banks, credit and loan accounts reconciliation;
- (d) Payroll processing;
- (e) Tax preparation;
- (f) Financial statements preparation;
- (g) Management reporting;
- (h) Financial analysis; and
- (i) Any other tasks which can be handled by an in-house accountant.

19.3.4 Benefits of virtual accounting

- (a) **Flexibility:** Virtual accounting services are great options for both small and large companies who have an accounting department, but need extra assistance. No matter the industry - real estate, hospitality, manufacturing, healthcare, retail, technology, telecoms, wholesale foods, among others, virtual accounting professionals can easily integrate into the existing department and provide assistance, as long as they are needed. This offers a unique blended solution for those businesses which need extra help, but cannot afford to hire additional accounting staff.
- (b) **Efficiency:** Accounting tasks like tax and payroll services can be efficiently and cheaply achieved without hiring a full-time accountant or consultant.
- (c) **Cost saving:** Virtual accounting helps cut costs by ensuring that small businesses only pay for needed and essential accounting work, especially when they cannot afford a full-time employee. It helps in cutting the costs in terms of unutilised time salary, benefits, utilities, supplies and other overheads for an in-house staff member.
- (d) **Professional expertise:** Virtual accountants work effectively in improving their skills, qualifications, and services so that the accounting work is handled by a skilled, experienced, knowledgeable and reliable professional. A person or a company providing virtual accounting services has great expertise in handling the accounting needs of businesses from varied industries.
- (e) **Convenience:** A virtual accounting department works at a client's pace and need. When a client has a question, they get back to you quickly because they understand the value of timely information.
- (f) **Multiple avenues of communication:** Most of the communication with virtual accountants will take place via email. When necessary, they will answer quick questions via instant messenger, and, when the situation warrants, a phone call can always take place. Thus, removing the constraints of physical meeting and delays in reporting.
- (g) **Virtual accounting services are delivered on the client's timeline**
Reports needed on daily, weekly or monthly basis can be provided using virtual accounting services. With the aid of a service level agreement (SLA), this contract binds the virtual accounting professional providing the services and stipulates the terms of operation with the business.
- (h) **Cloud computing:** In addition to receiving financial statements via email on a pre-set schedule, businesses have access to their financial documents at any time, from any device with secure internet access. The financial data is stored securely in data centres, which are protected from fire, flood and other damage. All data on the servers are encrypted for protection, and could be backed up frequently.
- (i) Virtual accounting adds value to the business even beyond the accounting services provided.

19.3.5 Challenges of virtual accounting

The impact of the coronavirus pandemic has changed the business landscape significantly. Many firms which did not embrace the idea of working from home or remote locations, have realised the benefits of having a virtual workforce. But virtual accounting can also create challenges, such as:

- (a) Difficulty in communicating with and managing remote employees;
- (b) Cost implications for setting up necessary technology for the implementation of virtual accounting;
- (c) Establishing and enforcing processes and policies for a virtual working environment may prove challenging for small or medium-sized businesses;
- (d) Other challenges include, lack of motivation; how to deal with distractions often from children, noisy neighbours; and cohabitating with family, all day, every day; and
- (e) Data security: Every business owner is concerned about data security. Every business wants its financial data to be secure. It is not easy to trust anyone with such financial information. It becomes a major point of concern when considering the use of virtual accounting professionals, who will handle the business accounts remotely.

19.4 Fraud opportunities from working remotely

Section overview

- Explain the meaning of remote working.
- Identify some vulnerabilities in a remote working environment.
- Describe fraud opportunities that arise in a remote working environment.
- Identify some measures to curb fraud in a remote working environment.

19.4.1 Introduction

Remote working has increased since the advent of the pandemic. Consequently, organisations need to put controls in place to protect against the risk of fraud. Remote working provides companies with the opportunity to save money by spending less on fixed overheads. The successful implementation of remote working during the pandemic makes it likely that it will continue to feature, at least in part, in the operations of most companies. In as much as, there are many benefits of remote work, it brings along ongoing threats to businesses in the form of monetary and data losses originating from cyber attacks, internal fraud, control weaknesses, and workflow inefficiencies.

19.4.2 Vulnerabilities in a remote workplace

Remote workers often access corporate accounts on unprotected public Wi-Fi, conduct business on personal computers rather than an employer-issued PC, and transfer files between work and personal devices. Without an IT professional, to regularly update software with security patches designed to stay one step ahead of cyber criminals, employees are exposed to cyber attacks.

Once employees are working in a different environment, such as in a living room or bedroom, they may feel more comfortable and less professional, which can lead to an opportunity for cyber thieves.

Hackers prey on emotional vulnerabilities, too. By clicking ignorantly on links over the internet, they unknowingly give criminals access to their personal data and their employers', exposing valuable corporate information like usernames and passwords, as well as other corporate information. These breaches can have dire financial consequences for individuals and organisations, with the potential to erode customers' trust and loyalty.

19.4.3 Opportunities for fraud in a remote environment

- (a) **Lack of supervision of employees:** Inadequate supervision of employees creates access and opportunity to commit certain types of fraud that are more difficult in a physical office environment. Examples include: data theft, time theft, payroll fraud, workers' compensation fraud, among others.
- (b) **Cyber security risks:** Employees with weak home network security which if not addressed, could create fraud risks for an organisation. As opposed to the office environment, where IT managers can effectively control the security of the company's networks, employees' home networks may use weaker protocols and default passwords. This allows cyber thieves easier access to the network's traffic.
- (c) **Unsupervised and unlimited access:** Unsupervised access to systems and information in a remote environment creates opportunities for employees to easily steal company or customer data and use them for personal gain. Unlimited employees' access to systems and information, more than they need to perform their job functions and also creates fraud opportunities. Breaches of customer data or proprietary secrets could lead to legal issues and lost funds at best; lost customers and reputation damage at worst.
- (d) **Exposure of data security:** Many remote workers take advantage of their newfound flexibility to work in public places with free Wi-Fi. A compromised public Wi-Fi connection can leave a company susceptible to data breach. One successful phishing attempt could reveal a company's confidential and proprietary information and ruin the company's reputation. Thus, increasing the company's risks to cyber fraud.
- (e) **Limited evaluation of fraud risk potentials in virtual environments:** Ignoring potentially costly vulnerabilities of the data or network security control system in a virtual environment, may lead to fraud. The limited evaluation of fraud risk potentials and preparedness to prevent their occurrence endangers an organisation.
- (f) **Inadequate monitoring:** In a physical environment, adequate monitoring of a company's books and records for signs of fraud can be immediately investigated so as to establish new priorities and policies. Whereas, in a remote work environment, this may not be the case.

19.4.4 Fraud prevention measures

Employees do not exist in a vacuum; they have roommates, family members, and visitors who can pose a risk to sensitive data. The fraud triangle suggests that fraudulent behaviour is more likely to occur at the intersection of pressure, opportunity, and rationalisation. Remote work provides the perceived opportunity, while financial hardship can add to the pressure; the rationalisation can easily follow. Some measures to reduce the incidence of fraud in a remote working environment include:

- (a) Provision of company-issued devices and home office equipment to reduce data theft and ensure safe work environments;
- (b) Allow for flexible work schedules to reduce motive and opportunity for time theft;

- (c) Modernise company's best practices in-line with the changing work environment and educate employees on working more safely from public spaces;
- (d) Use time tracking software to monitor productivity. The company may install productivity monitoring software to ensure that employees are fully engaged and productive while working from home;
- (e) Install advanced anti-virus facilities and firewalls to enhance the security in the home environment;
- (f) Implement right restrictions of sensitive financial and non financial corporate information;
- (g) Install properly configured and secure routers for workers at home;
- (h) Issue company-owned devices to employees and secure the devices with device management solution. Enforce the activation of the "find my device" feature on all devices;
- (i) Implement a company-wide screen timeout of 1 minute of inactivity;
- (j) Develop an effective information system use policy that clearly communicates to employees company's expectations regarding their use of company resources, emails and data;
- (k) Employees should be educated on the inherent risks whenever company data flows through a home network. Employees hold more of company's security in their hands than ever before, so the need for following security best practices and controls is vital;
- (l) Train employees on best practices for accessing your company's virtual private network (VPN) for hosting virtual meetings. Staff are on the frontline in the fight against cybercrimes; therefore knowledge and awareness of what fraud looks like, how it could affect the business, and their roles and responsibilities in preventing them;
- (m) Authorisation & authentication: Levels of authorisation can continue to operate remotely, which can leverage email audit trails and electronic signatures as proof of authorisation at the appropriate management levels;
- (n) Increase awareness of social engineering scams: The concern is that the opportunities for fraud are not necessarily happening by exploiting existing authority levels and segregations of duties. The most commonly used route still appears to be social engineering and cybercrime. Combined with a greater reliance on the telephone and electronic interactions, staff who cannot just turn to a colleague and talk through an issue with them, could find themselves inadvertently persuaded to allow a transaction to take place that turns out to be fraudulent; and
- (o) Make sure employees stay connected: Employees need to feel that they are still connected to the firm, and that the contributions they make on a day-to-day basis are valued. Regular firm-wide communications and updates will help to reduce the extent to which employees feel vulnerable about working from a remote location, thus helping to achieve higher rates of co-operation.

19.5 Chapter review

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

- (a) Explain the meaning of digitisation and its impact on businesses;
- (b) Describe the key differences between digitisation and digitalisation;
- (c) Describe data structures and their uses;
- (d) Explain the importance of block chain technology in accounting;
- (e) Explain the purpose of virtual accounting and its impact on the accounting profession;
- (f) Explain some of the fraud opportunities in a remote environment; and
- (g) Describe some of the measures to prevent fraud and other cyber crimes in a remote environment.

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