NATIONAL OPEN UNIVERSITY OF NINGERIA

SCHOOL OF MANAGEMENT SCIENCE

COURSE CODE: ACC 812

COURSE TITLE: INTRODUCTION TO ACCOUNTING

COURSE DEVELOPMENT

ACC 812

INTRODUCTION TO ACCOUNTING

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UNIT 1: ACCOUNTING CONCEPTS

CONTENTS

1.0 INTRODUCTION

An appreciation of the conceptual and theoretical foundations of financial accounting is fundamental to the preparation, understanding and interpretation of financial statements. The conceptual and theoretical foundations can be described as a set of rules, principles, postulates, conventions and methods. This unit explains the nature of the underlying concepts of accounting. Some of the concepts are referred to specifically in the International Accounting Standard Committee's (IASC's) *Framework for the Preparation and Presentation of Financial Statements* (the *Framework*) (IASC, 1989 quoted in Thomas and Ward, 2012).

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Define accounting concept;
- Explain the key accounting concepts;
- Describe the other accounting concept.

3.0 MAIN CONTENT

3.1 Key Accounting Concepts

Accounting concepts can be defined as broad basic assumptions that underlie the periodic financial statements of business enterprises. Two concepts have been specifically in the Framework and they are the going concern and the accruals concepts.

3.1.1 Going Concern Concept

The going concern concept is the assumption that an entity will continue in operational existence for the foreseeable future. Any user when looking at an entity's financial statements has the right to assume that the company is not going to liquidate or curtail materially the scale of its operations. Users should be able to look at the financial implications of prior activity as captured in the financial statements and use this as an indication of future activity.

The implication of the going concern assumption is that assets are valued at their historical cost (or fair value), not their scrap value. If there is reason to believe that the entity will not be able to continue in business, then the going concern principle no longer holds and the assets should be valued on a cessation basis; that is, at their net realizable value. For example a N10,000 machine, which can easily generate output for the next 10 years, would be recognized in the statement of financial position at cost price less depreciation, if the company is a going concern. However, if the company decides to go into voluntary liquidation, then this machine is not going to produce revenue for the next 10 years, hence should be written down to the value expected to be received on its sale (its net realizable value). This may be zero.

Self Assessment Exercise
Explain the nature of the going concern concept and its implications for the preparation of financial statements.

3.1.2 Accruals Concept

According to the *Framework* and IAS 1, to meet their objectives, financial statements should be prepared on the accruals basis of accounting.

The accruals concept is concerned with allocating expenses and income to the periods to which they relate (when the expenses were used by the entity, or when the income was earned, as distinctly different to when cash is paid out for expenses and when cash is received from a sale).
The *Framework* states that the transactions should be 'recorded in the accounting records and reported in the financial statements in the periods to which they relate'. In most instances this refers to the accounting period in which the goods or services physically pass from the seller to the buyer.

The accruals concept also assumes that costs should be recognized when they occur, and not when money is paid: that is, goods and services are deemed to have been purchased on the date they are received and services consumed, for which no invoice has been received at the end of an accounting year (e.g. electricity, gas, telephone), are treated as a cost for that year. The amount due is treated as a liability. These are referred to as accrual expenses. In contrast, services paid for in advance (e.g. rent, insurance, road tax, local government taxes) that have not been received at the end of an accounting year are treated as a cost of the following accounting year, and thus carried forward as an asset at the end of the current year. These are referred to as prepaid expenses or prepayments.

Self Assessment Exercise
Explain the accrual concept and its implications for the preparation of financial statements.

3.2 Other Concepts

The fundamental concepts (going concern and accruals) are discussed above. There are a number of other concepts that are implicit in the preparation of financial statements and are so engrained in the process of accounting. To be comprehensive, a short explanation of each is given in this section.

3.2.1 Matching Concept

The matching concept/principle refers to the assumption that in the measurement of profit, costs should be set against the revenue that they generate at the time when they arise. A classic example of the application of the matching principle is inventory. Where goods are bought in one accounting year but sold in the next, their cost is carried forward as inventory at the end of the year and set against the proceeds of sale in the accounting year in which it occurs.

3.2.2 Entity Concept

The entity concept, otherwise known as the accounting entity or the business entity concept. In simple terms this concept allows the user to look at a reporting entity's financial statements and to know that these represent the performance and financial position of the business unit and do not include any assets, liabilities, income or expenditure that are not related to the business. Therefore, when a sole trader uses the business cheque book to buy a car for personal use, this car will not form part of the business's assets; it will be treated as the owner withdrawing equity capital. This is called a 'drawing'.

3.2.3 Materiality Concept

The materiality concept affects every transaction and every set of financial statements. This concept affects two main areas: presentation and application of accounting standards. In respect of the first, this concept assumes that only material items should be disclosed in financial statements. This is important for achieving the objective of financial statements as attention being afforded to immaterial items can mislead the user. The user should be able to look at a set of financial statements and focus on the important figures, not see a mass of information, much of which is of no use for economic decision-making. For example, it is irrelevant to disclose a yearly spend on stationery of N100 and a yearly spend on coffee of N75, if the company has a turnover of N10 million and total expenditure of N8 million. The immaterial items need to be grouped together, or grouped into categories that are material. For example, the stationery and coffee could be combined into administration expenses that might have a total of N2.5 million.

3.2.4 Time Period Concept

Another concept, the time period concept, otherwise known as the time interval concept, refers to the practice of dividing the life of an entity into discrete periods for the purpose of preparing financial statements. The norm, as required by company law, is one year. Therefore, a user has the right to assume that the figures shown in a set of financial statements refer to a one-year period. When the period is different to one year, the financial statements need to make it clear that this is the case. Indeed, company law limits the ability of companies to change their accounting year-end date. Entities can of course elect to report for different time periods; however, to comply with law and the tax authorities they will also need to prepare financial statements every 12 months.

3.2.5 Historical Cost Concept/Fair Value

The historical cost concept allows a user to assume that all the transactions in an entity's financial statements reflect the actual cost price billed, or revenue charged, for items. In addition, it allows the reader to see the history of the management team's investment decision- making from the statement of financial position. This concept is becoming less relevant now as it is widely believed that historical cost information does not support financial statements in their aim of producing information that is useful for economic decision-making. In particular the impact of inflation means that many of items recorded at historic cost, do not reflect current value. Measuring items at fair value is deemed to provide more relevant information. Fair value is defined by the International Accounting Standards Board (IASB) as the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in arm's length transaction.

3.2.6 Money Measurement Concept

The money measurement concept allows the user to assume that the performance and financial position of a reporting entity will be expressed in monetary amounts (usually in the currency of the country where the business is registered).

3.2.7 Duality Concept

The duality concept, otherwise known as the dual aspect concept or double entry, assumes that every transaction has two aspects. Every transaction affects two accounts in a set of financial statements in such a manner as to keep the accounting equation in balance (i.e. assets will always equal liabilities plus owners' capital).

3.2.8 Prudence Concept

The prudence concept, as the name implies, assumes that the financial statements have been prepared on a prudent basis. This allows the user to have confidence that no profits are included that are not earned and, if not yet received, are reasonably certain to be received. The user can also be confident that expenses are complete and are not understated, that assets are not overstated and liabilities are complete and are not understated. At one time this concept was deemed to be fundamental to the objective of financial statements (i.e. to provide relevant information to a wide range of users for economic decision-making). However, it was abused by some companies. When companies did well they tended to overstate expenses (by creating provisions for expenditure) and understate revenue. Then, in years when performance was not strong, the companies reversed the adjustments – reducing the provisions and the expenses in the year and increasing revenue. The result was that users could not quite work out how the company really performed. For this reason prudence was downgraded and provisions and manipulations that were based on the prudence concept are no longer allowed.

These transactions did not follow the spirit of this concept. They manipulated it for earnings management purposes. Earning management is where the preparers of financial statements use accounting adjustments to alter the reported performance of the reporting entity. They usually try to smooth profits, that is, to show steady profits. The concept still is applicable; however, it cannot be used as a defence for earnings management or earnings manipulation.

3.2.9 Substance Over Form Concept

This concept assumes that when accounting for transactions the preparer should look at the economic substance of a transaction, not its legal form. This was a reactive concept/standard that was introduced to try to stop the accounting practices that had emerged of creating complicated legal transactions which, because of their legal form, allowed transactions to be omitted from the financial statements. In particular, debts/ liabilities were arranged in such a manner as to enable them to be left off the statement of financial position. This would make the company look stronger, healthier and in general masked the real debt commitment that the entity had, from the users. This is no longer allowed. Regardless of the legal contract underlying a transaction, the preparer of the financial statements has to determine whether the transaction creates an asset or a liability as defined by the *Framework*. If the transaction does, then the preparer has to account for it as such.

3.2.10 Consistency Concept

The consistency concept allows the user to look at a set of financial statements over a number of years for an entity and to assume that the same methods, policies and estimation techniques have been used from year to year. This allows the user to compare the performance of the entity over time. Financial information should allow users to determine trends in the performance of an entity over time. If accounting policies, techniques and methods used were allowed to vary from year to year, this would make comparisons meaningless. Similarly, users should be able to look at the financial statements of several entities within the same industry and make informed comparisons in the performance and financial standing of each entity; relative to each other. If consistent accounting policies and practices are not adopted, this process would be very difficult. Consistency is one of the qualities that financial information should have, as detailed in the *Framework*.

3.2.11 Separate Determination Concept

This concept allows the user to look at the assets, liabilities, income and expenditure and to know that the reported figure is the total value for each of these elements. The entity should have a separate record of every asset held. The asset category in the financial statement should not be just a big bath that includes a whole host of untraceable past transactions. This concept also does not allow a company to net one element against another. This is important as netting can mislead users.

For example, if a company were able to net its debt against some assets so that less debt is shown in the statement of financial position, then the user would be unable to make a proper assessment of the entity's ability to pay back the debt as the user would assume the repayments required to clear it were less than they actually were.

4.0 CONCLUSION

The IASB's conceptual/theoretical *Framework* of accounting may be described as essentially being a set of accounting principles. These are said to comprise the objective of financial statements, the underlying assumptions of accounting (the concepts), the qualitative characteristics of financial information, the elements of financial statements, recognition in financial statements, measurement in financial statements and concepts of capital maintenance.

5.0 SUMMARY

In this unit, we have explained the nature of the going concern concept, the accruals concept, the matching concept, the entity concept, the materiality concept, the time period concept, the cost concept, the money measurement concept, the prudence concept, the duality concept, the substance over form concept, the consistency concept and the separate determination concept, including their implications for the preparation of financial statements;

6.0 TUTOR-MARKED ASSIGNMENT

In a paragraph each, explain the materiality, time period, historical cost, money measurement, duality, prudence, substance over form, consistency and the separate determination concept.

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 2: THE ACCOUNTING EQUATION AND ITS COMPONENTS

CONTENTS

1.0 INTRODUCTION

In this unit we shall be considering the components of the accounting equation and how each component is affected when a transaction takes place.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Explain the meaning of the key terms and concepts in the accounting equation.
- Explain the relevance of the accounting entity concept in financial accounting.
- Explain the nature of assets, liabilities and capital.
- Distinguish between revenue expenditure and capital expenditure, including their effects on the statement of financial position.

3.0 MAIN CONTENT 3.1 The Accounting Entity

The entity concept was introduced in the previous unit. Accounting for a reporting entity focuses on setting up a means of recording all accounting information in relation to that entity, as distinct from information that does not relate to the entity. The reporting entity may be, for example, a particular company, club or business partnership. We are used to hearing that a financial report relates to a specific organization, but now the organization is called an 'entity'. The use of the word 'entity' emphasizes the properties of being separate and discrete. Greater precision is demanded by accounting in deciding what is, and is not, part of the entity. Boundaries are created to separate out the accounting entity. Realizing that these boundaries are necessary, even though they may be artificial, is the key to the entity concept. It becomes possible to accept that a business may be separate from its sole proprietor.

Example: A trainee accountant is starting to prepare the financial statements for a sole proprietor who has a retail shop as his business. The following items appear in the list of cheques written by the businessman. The trainee accountant has been asked to state whether or not the items of expenditure below should be included in the financial statements of the retail shop.

1. Cheque paying the shop's rates.
2. Cheque paying the sole proprietor's house rates.
3. Cheque paying for a new cash till.
4. Cheque paying for a new washing machine for the proprietor's wife's birthday.
5. Cheque for stationery (90 per cent is for the shop, 10 per cent is for his kids).
6. Cheque purchasing overalls for himself for cleaning the shop.
7. Cheque paying for a new outfit, which he can wear to work.

Required:
Complete a table detailing whether the items should enter the accounting system of the reporting entity or not.

		Yes	**No**
1.	Shop rates √		
2.	House rates √		
3.	Till √		
4.	Watching machine √		
5.			Stationery √ (90%) √
(100%)			
6.	Overalls √		
7. New outfit			√

In sum, an accounting entity can be a legal entity, part of a legal entity, a combination of several legal entities, part of another accounting entity, or a combination of accounting entities.

The accounting/reporting entity concept is also sometimes referred to as the 'business entity' or simply the 'entity concept'.

3.2 The Statement of Financial Position as an Accounting Equation

An accounting entity may also be viewed as a set of assets and liabilities. Perhaps the most familiar form this takes is the *statement of financial position* . As an equation this would appear as follows:

Proprietor's *ownership interest* in the business = Net resources of the business
The ownership interest or claims are called owner's *equity* or owner's *capital*. The net resources are analysed into assets and liabilities.

3.2.1 An *asset* can be defined as a tangible or intangible resource that is owned or controlled by an accounting entity, and which is expected to generate future economic benefits. Examples of assets include land and buildings, motor vehicles, plant and machinery, tools, office furniture, fixtures and fittings, office equipment, goods for resale (known as inventory), amounts owed to the accounting entity by its customers (i.e. trade receivables), money in a bank account, and cash in hand.

The use of the word 'net' to describe the resources possessed by the business recognizes that there are some amounts set against or to be deducted from the assets. There are two major types of such deduction*: liabilities and provisions*.

3.2.2 ***A liability*** can be defined as a legal obligation to transfer assets or provide services to another entity that arises from some past transaction or event. *Liabilities* represent claims by outsiders (compared to the owners, whose claims are equity or capital) and may include such items as loans made to the business and amounts owed for goods supplied (i.e. trade payables).

3.2.3 Provisions are amounts provided to allow for liabilities that are anticipated but not yet quantified precisely, or for reductions in asset values. Examples are bad debts and depreciation.

Given that liabilities can be regarded as being negative in relation to assets, the accounting equation can now be stated in the form:

Assets - Liabilities = Owners' capital

Or alternatively:

Assets = Owners' capital + Liabilities

This equation is based on what is sometimes referred to as the 'duality' or 'dual aspect concept'. This concept purports that every transaction has two aspects: one represented by an asset and the other a liability, or two changes in either the assets or the liabilities. For example, the purchase of an asset on credit will increase the assets and the liabilities by the same amount. The purchase of a vehicle for cash will increase the value of the vehicle asset but decrease the amount of the cash asset. These two aspects of each transaction are also reflected in the duality of double-entry bookkeeping.

The accounting equation is a fundamental equation and is a valuable basis from which to begin understanding the whole process of accounting. It sets out the financial position of the owners at any point in time, although in practice a complete and detailed statement of financial position may only be produced periodically, such as monthly or yearly. For now we will examine accounting simply in terms of statements of financial position. Let us trace how this approach reflects the setting-up of a plumbing business (see Example 1).

ILLUSTRATION

KOLAWOLE decided to start his business by opening a bank account for business transactions and depositing N200,000 into it on 1 July 20X2: This transaction involves a flow of value from KOLAWOLE to his business and will affect two parts of the accounting equation: owner's capital and assets. Owner's capital will increase by N200,000 as the business is now 'indebted to KOLAWOLE for the N200,000 that he provided-to the business and cash at the business bank will have increased by N200,000. There are several ways of presenting this. In practice companies usually adopt a vertical approach, placing capital vertically below net assets in the form:

KOLAWOLE (Plumber)
Statement of financial position as at 1 July 20X2

	N
Assets	
Cash at bank	200,000
Equity	200,000
Owner's capital	

However, a side-by-side or horizontal presentation may illustrate more clearly the accounting equation format.

KOLAWOLE (Plumber)
Statement of financial position as at 1 July 20X2

Assets	**N**	**Equity**	**N**
Cash at bank	200,000	Owner's capital	200,000

Following on from the example, if on 2 July 20X2 KOLAWOLE draws out N80,000cash and spends it all on purchasing tools, then cash at bank will be decreased by N80,000 and a new asset, tools, is introduced on the statement of financial position with a balance of N80,000.

KOLAWOLE (Plumber)
Statement of financial position as at 2 July 20X2

Assets	**N**	**Equity and liabilities**	**N**
Tools	80,000	Owner's capital	200,000
Cash at bank	120,000		200,000
200,000			

In this case one asset is increased by exactly the same amount as another is decreased (N80,000), so that the accounting equation, assets equals capital plus liabilities, continues to balance.

Following on from the example, on 3 July KOLAWOLE buys a range of plumbing accessories for N30,000 from the local storekeeper, but arranges to pay in the next few days. The arrangement is described as 'on credit: The credit transaction with the storekeeper becomes a trade payable since he is now owes a debt of N30,000. There is no problem in maintaining the balance of the equation when including the effects of this transaction in the business statement of financial position, since the new liability of N30,000 owed to the store exactly complements the N30,000 increase in assets represented by the inventory of accessories:

KOLAWOLE (Plumber)
Statement of financial position as at 3 July 20X2

Assets	**N**	**Equity and liabilities**	**N**	
Tools	80,000	Owner's capital		200,000
Inventory	30,000	**Liabilities**		
Cash at bank	120,000	Trade payable	30,000	230,000
230,000				

As mentioned, the horizontal approach adopted to portray the outcome of the last three transactions reflects the accounting equation (assets = liabilities + equity). However, in practice this is rarely utilized; therefore, the vertical approach is used throughout the remainder of this course material.

KOLAWOLE (Plumber)
Statement of financial position as at 4 July 20X2

	N
Assets	
Tools	80,000
Inventory	30,000
Cash at bank	90,000
	200,000
Equity and liabilities	**£**
Owner's capital	200,000
	200,000

3.3 The Accounting Period and Profit Reporting

The accounting period concept (sometimes called periodicity concept) is a means of dividing up the life of an accounting entity into discrete periods for the purpose of reporting performance for a period of time (in a statement of profit and loss) and showing its financial position at a point in time (in a statement of financial position). The period of time is usually one year and is often referred to as the accounting year, financial year or reporting period. Each accounting year of an entity's life normally ends on the anniversary of its formation, and therefore does not necessarily coincide with the calendar year. It could thus end on any day of the calendar year, but for convenience the accounting year is nearly always taken to be the end of a calendar month, and sometimes adjusted to the end of the calendar year or to the end of a particular month (e.g. for tax reasons). Some companies report on their financial position half-yearly or even quarterly. Thus, the accounting period can be less than one year.

3.4 Revenue Expenditure versus Capital Expenditure

The word 'capital' is associated with items that appear in the statement of financial position (e.g. owners' capital), whereas the word 'revenue' encapsulates items that appear in the statement of profit and loss (comprehensive income). Expenditure of the type that is to be matched against the period's revenue and is used up in the period is called revenue expenditure. Revenue expenditure will have no value at the end of the period to which it relates. Revenue expenditure is distinguished from capital expenditure - that which represents amounts which it is appropriate to carry forward as part of the next year's opening statement of financial position. Capital expenditure is carried forward because it will be used over a number of periods and contributes to several periods' revenues.

ILLUSTRATION

A trainee accountant who has been given the task of listing items of expenditure as being either capital or revenue expenditure approaches you for advice. She specifically wants to know whether the following expenditures (which relate to a builder's yard) should be classed as capital or revenue items:

1. rates charge for the year;
2. a new delivery van;
3. rent for the building;
4. sand that is not yet sold;
5. stationery;
6. telephone bills for the year;
7. a new telephone;
8. a new fence surrounding the yard (this is expected to reduce theft);
9. wages;
10. electricity bills;
11. timber in the yard that is not yet sold.

Required:

Complete a table detailing whether the items are capital or revenue in nature.

Solution

	Capital	**Revenue**
1. Rates		√
2. Delivery van (motor vehicle)	√	
3. Rent		√
4. Sand (inventory)	√	
5. Stationery		√
6. Telephone bill		√
7. New telephone (office equipment)	√	
8. Fence (fixtures and fittings)	√	
9. Wages		√
10. Electricity		√
11. Timber (inventory)	√	

Capital expenditure typically includes the cost of purchasing a non-current asset (including the costs of getting the non-current asset operational at the begining) and the cost of improvements to a non- current asset that lead to increased revenue, or sustained revenue. Expenditure on tools, which represent the long-term equipment of the business, is capital expenditure and is carried forward from statement of financial position to statement of financial position. Rental expenditure on a building used during the year is revenue expenditure - what it provides is used up in the period. The purchase of the building, however, would be capital expenditure, as it is entirely appropriate to represent ownership being carried forward from period to period.

SELF ASSESSMENT EXERCISE

A trainee accountant who has been given the task of analysing items of expenditure in respect of the motor vehicles of the business in the year approaches you for advice. She specifically wants to know whether the following expenditures should be classed as capital or revenue items:

- repair of a lorry (the lorry is already included in the opening statement of financial position):
- purchase of a new truck;
- motor tax on the truck and lorry;
- cost of removing seats in the truck to create more room for transporting goods for the business;
- new tyres for the lorry;
- advertising painted on the side of both the lorry and the truck.

Required:

Complete a table detailing whether the items are capital or revenue in nature.

4.0 CONCLUSION

The accounting equation : Asset = Owner's equity + Liability is an explanation of the principle of double entry.

5.0 SUMMARY

In this unit we have discussed the accounting entity, the statement of financial position as an accounting equation, the accounting period and profit reporting, the difference between revenue expenditure and capital expenditure

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the relevance of the entity concept in accounting.
2. Define and distinguish between the following:
    a. assets and liabilities;
    b. capital and revenue expenditure.
3. State the accounting equation and explain its components.

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 3 BASIC DOCUMENTATION AND PRIME BOOKS

CONTENTS

1.0 INTRODUCTION

No two businesses are exactly the same and the same can be said of the accounting systems used by firms. Most firms have their own particular ways of doing things. Some use manual record-keeping, others use off- the-shelf accounting software packages such as Sage, while others create their own accounting systems. However, there is a certain degree of similarity in keeping accounting records that is prevalent among the great majority of firms. This unit focuses on providing background information on the typical documentation and books of account that are used by most firms.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Distinguish between cash transactions and credit transactions.
- Describe the nature of trade discount and cash discount.
- Give examples of source documents
- Explain the purpose of books of prime entry.
- List the books of prime entry and state what each is used to record.

3.0 MAIN CONTENT

3.1 Basic Documentation for Cash and Credit Transactions

In accounting, a cash transaction is one in which goods or services are paid for in cash or by cheque when they are received or delivered. A credit transaction is one where payment is made or received some time after delivery . This should not be confused with hire purchase or credit card transactions. Credit transactions are extremely common in many industries.

Credit transactions often involve trade discount.

3.1.1 Trade discount : This is a discount given by one trader to another. It is usually expressed as a percentage reduction of the recommended retail price of the goods, and is deducted in arriving at the amount the buyer is charged for the goods.

A large number of businesses also allow their customers cash discounts.

3.1.2 Cash discount : This is a reduction in the amount that the customer has to pay, provided payment is made within a given period stipulated by the seller at the time of sale (e.g. 5 per cent if paid within one week).

A cash transaction is recorded in the books of account from the receipt received if paid in cash, or from the cheque book stub if paid by cheque.

SELF-ASSESSMENT EXERCISE

Explain the difference between a cash transaction and a credit transaction.

3.2 Source documents

This is where original transaction information is to be found. Examples of source documents include the invoice, debit note, credit note, cheque and receipt.

3.2.1 The Invoice

The purpose of the invoice, which is sent by the seller, is primarily to inform the buyer how much is owed for the goods supplied. It is not demand for payment.

The information shown on an invoice typically consists of the following items:

- the name and address of the seller;
- the name and address of the buyer;
- the invoice and delivery note number of the seller (usually the same);
- the date of the invoice;
- the address to which the goods were delivered;
- the buyer's order number;
- the quantity of goods supplied;
- details/description of the goods supplied;

The buyer checks the invoice against the order and the delivery note (or more usually with a goods received note prepared by the receiving department). If correct, the invoice is then entered in the buyer's books. Similarly, a copy of the invoice would have been entered in the seller's books.

3.2.2 The debit note

A debit note is sent by the seller if the buyer has been undercharged on the invoice. It has basically the same layout and information as the invoice except that instead of details of the goods, it shows details of the undercharge. It is recorded in the books of the seller and buyer in the same way as an invoice.

3.2.3 The credit note

A credit note may be sent by the seller for a number of reasons. These include:

- The buyer has returned goods because they were not ordered, or they were the wrong type, quantity or quality, or are defective.
- The seller has overcharged the buyer on the invoice. This may be due to an error in the unit price or calculations.

A credit note has basically the same layout and information as an invoice, except that instead of the details of the goods, it will show the reason why it has been issued.

A credit note will be recorded in the books of the seller and buyer in a similar way as the invoice, except that the entries are the reverse. This document is called a credit note because it informs the buyer that the account in the books of the seller is being credited. Conversely, a debit note informs the buyer that the account in the seller's books is being debited.

3.2.4 The Cheque

This is the most common form of payment in business because of its convenience and safety. Most cheques are crossed and therefore have to be paid into a bank account. This makes it possible to trace the cheque if it is stolen and fraudulently passed on to someone else. A crossed cheque may be paid into anyone's bank account if the payee endorses (i.e. signs) the back of the cheque. However, if the words 'account payee only' are written between the crossings it must be paid into the account of the person named on the cheque.

The information that must be shown on a cheque consists of the following items:

- the date; the signature of the drawer (i.e.
- payer);
- the name of the drawee (i.e. the bank at which the drawer has the account);
- the name of the payee (i.e. who is to receive the money);
- the words 'Pay ..'. or 'Order the sum of ..;
- the amount of money in figures and in words.

The bank account number of the drawer, and the cheque and bank number are also shown on pre-printed cheques. Since there is only one copy of a cheque, it is essential to write on the cheque stub to whom the cheque was paid (i.e. the payee), the amount and what the payment was for. Without this information the books of account cannot be prepared..

3.2.5 The receipt

The law requires the seller to give the buyer a receipt for goods or services that have been paid for in cash. However, there is no legal requirement to do so in the case of payments by cheque. A receipt must contain the following information:

- the name of the payer; the signature of the
- recipient; the amount of money in figures and
- in words; the date.
-

A receipt is only recorded in the books of account when it relates to cash receipts and payments.

SELF-ASSESSMENT EXERCISE

Give examples of source documents

3.3 Prime books

The main book of account in which all transactions are recorded is called the ledger (otherwise known as the general ledger, or the nominal ledger). However, before a transaction is recorded in the ledger, it must first be entered in a book of prime entry. These books are designed to show more detail relating to each transaction than appears in the ledger. They also facilitate making entries in the ledger, in that transactions of the same type can be posted periodically in total rather than one at a time. A business may make use of up to nine books of prime entry, which consist of the following:

3.3.1 The sales day book : records the sale on credit of goods bought specifically for resale. It is written up from copies of sales invoices and debit notes retained by the seller. The amount entered in the sales day book is after deducting trade discount (but before deducting cash discount).

3.3.2 The purchases day book : in which is recorded the purchase on credit of goods for resale. It is written up from the invoices and debit notes received from suppliers. The amount entered in the purchases day book is after deducting trade discount (but before deducting cash discount).

3.3.3 The sales returns day book : in which is recorded the goods sold on credit that are returned by customers. It is written up from copies of credit notes retained by the seller.

3.3.4 The purchases returns day book : in which is recorded the goods purchased on credit that are returned to suppliers. It is written up from the credit notes received from suppliers.

3.3.5 The petty cash book : in which is recorded cash received and cash paid. This is written up from receipts or petty cash vouchers where employees are reimbursed expenses.

3.3.6 The cash book : in which are recorded cheques received (and cash paid into the bank) and payments made by cheque (and cash withdrawn from the bank). This is written up from the bank paying-in book stub and cheque book stubs.

3.3.7 The Journal : in which are recorded any transactions that are not included in any of the other books of prime entry. At one time all entries passed through the journal, but now it is primarily used to record the purchase and sale of non-current assets on credit, the correction of errors, opening entries in a new set of books and any remaining transfers. Non-current assets are items not bought specifically for resale, such as land and buildings, machinery or vehicles. The journal is written up from copies of invoices and adjustments requested by the accountant.

Source documents Books of prime entry

Commonly used books of account and related source documents
Source: Thomas and Ward (2012)

4.0 CONCLUSION

In accounting a distinction is made between cash and credit transactions. A cash transaction is one where goods or services are paid for in cash or by cheque when they are received or delivered. A credit transaction is one where payment is made or received some time after delivery. Credit transactions often involve trade discounts and cash discounts.
receipts and payments are entered in a book of prime entry known as the 'petty cash book' Cheque receipts and payments are entered in the 'cash book:

Credit transactions involve a number of different documents, but those which are recorded in the books of account comprise invoices, debit notes and credit notes. These arise in connection with both purchases and sales, and are entered in a set of books of prime entry commonly known as 'day books'.

5.0 SUMMARY

In this unit we have discussed the accounting cycle making reference to the source documents, books of prime entry and the journal

6.0 TUTOR MARKED EXERCISE

1. You have just received a debit note for N10,000.
    a. What is a debit note?
    b. How should the N10,000 be accounted for?
2. List the four books of prime entry that are used to record inventory movements.
3. What do you have to do to a cheque to make it safe when sending it to a supplier using the postal system?

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accountin*g. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 4 PRIME BOOKS, GENERAL LEDGERS AND THE JOURNAL

CONTENTS

1.0 INTRODUCTION

Before a transaction is recorded in the general ledger, it must first be entered in a book of prime entry. These are intended to facilitate the posting of the general ledger, in that transactions of the same type are entered in the same book of prime entry, which is periodically posted to the general ledger in total (rather than one transaction at a time). These initial entries in the prime books do not form part of the double-entry bookkeeping.

There are several books of prime entry. This unit examines only those that are used to record credit transactions. These consist of: (1) the sales day book; (2) the purchases day book; (3) the sales returns day book; (4) the purchases returns day book; and (5) the journal. These prime books have been defined in unit 3. So, we shall be considering some illustrations.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Describe the transactions and documents that are recorded in each of the prime books and the journal.
- Enter credit transactions in the appropriate day books or journal and post these to the relevant ledger accounts.

ILLUSTRATION 1

Big Sparkle is an electrical goods wholesaler. The transactions during June 20X3, which are all on credit, were as follows:

1 **June** Bought on credit from Lightings Ltd various bulbs with a retail price of N1,000,000 and received 20 per cent trade discount

4 **June** Sold goods on credit to Electric Reserves Ltd for N500,000 and allowed them 10 per cent trade discount on this amount

8 **June** Sent Electric Reserves Ltd a credit note for goods returned that had a retail value

of N300,000

10 June Sold goods on credit to Swiggle Ltd for N600,000 after deducting 40 per cent trade discount

12 June Purchased goods with a retail value of N1,000,000 from Swatch Ltd who allowed 30 percent trade discount.

15June Purchases on credit from Cables Ltd goods costing N550,000.

16 June Sent Swiggles Ltd a credit note' for goods returned that had a retail value of N100,000.

18 June Swatch Ltd sent us a credit note for N300,000·in respect of goods returned

19 June Received a credit note for goods returned to Lightings Ltd that had a retail value of N250,000

25 June Sold goods to Gross Retails Ltd on credit for N250,000

27 June Sent Gross Retails Ltd a credit note for N50,000 to rectify an overcharge on their invoice

28 June Sold goods on credit to Electric Reserves Ltd at a price of N569,000.

29 June Purchased on credit a motor van from Baba Ltd that cost N800,000.

30 June Sold on credit to Lagos Trading Co. some fixtures and fittings no longer required in the shop for 350,000. (Prior. to this the business owned fixtures costing N1,000,000.)

Required

Make the necessary entries in the books of prime entry and general ledger.

Solution

Before starting to undertake double entry, the first step is to summarize the transactions in the day books. The first part of this solution deals with the transactions that do not impact on the journal.

3.1 Prime Books

Sales day book

Date	Name of credit customer	Our invoice number	Folio	Amount
20X3				**N'000**
4 June	Electric Reserves	100446	F34	450
10 June	Swiggle Ltd	100447	F8	600
25 June	Gross Retails Ltd	100448	F45	250
28 June	Electric Reserves	100449	F15	560
				1,860

Sales returns day book

Date	Name of credit customer	Our credit note number	Folio	Amount

20X3				N'000
8 June	Electric Reserves	CRN06	F34	270
16 June	Swiggle Ltd	CRN07	F8	60
27 June	Gross Retails	CRN08	F45	50
				380

Purchases day book

Date	Name of credit customer	Our ref no for supplier's invoice	Folio	Amount
20X3				**N'000**
1 June	Lightings Ltd	Inv460	T23	800
12 June	Swatch Ltd	1000672	T5	700
15 June	Cables Ltd	S0056932	T10	550
				2,550

Purchase returns sales book

Date	Name of credit suppliers	Our ref no for supplier's credit note	Folio	Amount
20X3				**N'000**
18 June		C00569	T5	300
19 June	Lightings Ltd	SC452	T23	200
Swatch Ltd				500

3.2 Ledgers

The next step is to take the day books and to use them to enter the information into the main double-entry bookkeeping system (the general ledger, sales ledger and purchase ledger). These ledger accounts are shown in T account format.

The first two day books to be closed off and posted are those involving customers (sales day book and the sales return day book). Note the normal double-entry rules in respect of recording the flow of value are being applied.

General ledger entries

Sales account

20X3	Details	N'000	20X3	Details	N'000
			30 June	Total per sales day book	1,860

Sales returns account

20X3	Details	N'000	20X3	Details	N'000
30 June	Total per sales returns day book	380			

Sales ledger entries

Electric Reserves Ltd

20X3	Details	N'000	20X3	Details	N'000
4 June	Sales	450	8 June	Returns	270
28 June	Sales	560			

Swiggle Ltd

20X3	Details	N'000	20X3	Details	N'000
10 June	Sales	600	16 June	Returns	60

Gross Retails Ltd

20X3	Details	N'000	20X3	Details	N'000
25 June	Sales	250	27 June	Returns	50

Next, the two day books involving suppliers (purchases day book and the purchases return day book) are closed and posted.

General ledger entries

Purchase account

20X3	Details	N'000	20X3	Details	N'000
30June	Total purchases day book	2,050			

Purchase returns account

20X3	Details	N'000	20X3	Details	N'000
			30 June	Total per purchases returns day book	500

Purchase ledger entries

20X3	Details	N'000	20X3	Details	N'000
19 June	Returns	**200**	1 June	Purchases	800

Light Ltd

20X3	Details	N'000	20X3	Details	N'000
18 June	Returns	**300**	12 June	Purchases	700

Purchase account

20X3	Details	N'000	20X3	Details	N'000
			15 June	Purchases	550

3.3 The Journal

The entries required to post the motor van on credit and the sale of fixtures and fittings are first recorded in the journal before they enter the general ledger bookkeeping system as follows:

Date	Details (account in which the ledger entry is to be made)	Folio	Debit Amount N’000	Credit amount N’000
20X3				800
29 June	Motor vehicles	Dr	800	
To Baba Ltd		Cr		
	Being purchase on credit of motor van reg no LAG 123			
29 June	Lagos Trading Co	Dr	350	350
	To fixtures and fittings	Cr		
	Being sale on credit of shop fittings.			

Second, the journal is taken and its entries are posted to the individual ledger accounts in the general ledger as follows:

General ledger entries

Motor vehicles account

20X3	**Details**	**N’000**	**20X3**	**Details**	**N’000**
29 June	Baba Ltd	800			

Baba Ltd account (sundry payable)

20X3	**Details**	**N’000**	**20X3**	**Details**	**N’000**
			29 June	Motor vehicles	800

Fixtures and fittings account

20X3	**Details**	**N’000**	**20X3**	**Details**	**N’000**
1 June	Balance b/d	1,000	30 June	Lagos Trading Co	350 30
			June	Balance c/d	650 1,000
		1,000			
1 July	Balance b/d	650			

Lagos Trading Co account (sundry receivable)

20X3	**Details**	**N’000**	**20X3**	**Details**	**N’000**
30 June	Fixtures and fittings	350			

Notes

1. The fixtures and fittings that were sold must obviously have already been owned by the business. Their cost is therefore included in the balance brought down on the debit side of the fixtures and fittings account along with the cost of other fixtures and fittings owned at that date.
2. The Lagos Trading Co. is referred to as a sundry receivable and Baba Ltd as a sundry payable.

SELF ASSESSMENT EXERCISE

Where possible, approach a local business or a family member who works in the administration function of a business and ask them about the books of account of the business. Ask them to explain the transactions that they record in each type of book. Different names to those used in this chapter may exist, however, they will typically perform the same function.

4.0 CONCLUSION

Before a transaction is recorded in the ledger, it must first be entered in a book of prime entry. These are intended to facilitate the posting of the general ledger, in that transactions of the same type are entered in the same book of prime entry, the totals of which are periodically posted to the general ledger rather than one transaction at a time.

Credit transactions not relating to goods for resale (or services), such as the purchase and sale of non- current assets, are recorded in another book of prime entry known as the 'journal. This is also used to record transactions that are not appropriate to any other book of prime entry, and various accounting adjustments that are not the subject of a transaction such as the correction of errors. The format of the journal includes a details column and two money columns labelled 'debit' and 'credit: The narrative in the details column and amounts in the money columns indicate the entries that will be made in the ledger in respect of a given transaction or item.

5.0 SUMMARY

In this unit we have considered how credit transactions pass through the prime books before postings are made to the ledgers using the double entry bookkeeping rules. We also considered the use of the journals for transactions that do not involve the use of prime books

6.0 TUTOR MARKED ASSIGNMENT

1. B. Jaja is in business as a builders' merchant. The following credit transactions took place during April 20X3:

1 Apr Bought goods on credit from Bebe Ltd for N725,000
2 Apr Sold goods on credit to Oasis Ltd for N410,000
4 Apr Bought goods costing N315,000 from Slate Ltd on credit
7 Apr Sold goods on credit to Pulp Ltd for N870,000
11 Apr Bought goods costing N250,000 from Sage Ltd on credit
15 Apr Sold goods to Lemon Ltd for N630,000 on credit
17 Apr Bought goods on credit from Bebe Ltd for N290,000
19 Apr Received a credit note for N120,000 from Bebe Ltd
22 Apr Sent Oasis Ltd a credit note for N220,000
24 Apr Slate Ltd sent us a credit note for N75,000 in respect of goods returned 27
Apr Sent Pulp Ltd a credit note for N360,000

28 Apr Bought a delivery truck on credit from Coscharis motors for N5,000,000.

Required:

You are required to make the necessary entries in the books of prime entry and the general ledger.

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 5 DOUBLE ENTRY AND THE GENERAL LEDGER

CONTENTS

1.0 INTRODUCTION

As mentioned earlier, financial accounting is all about providing useful information in the financial statements to users to enable them to make economic decisions. It is all about communicating information. Recording transactions in the books of an entity is not accounting, it is bookkeeping. Accountants usually come in after the bookkeeper has finished and use the information supplied by the bookkeeper to prepare financial statements. However, to be able to account properly, accountants need to understand bookkeeping. Double-entry bookkeeping is a systematic method of recording an enterprise's transactions in a book called the general ledger, or
simply the 'ledger'

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Explain the principles of double-entry bookkeeping, including the purpose of having different ledger accounts.
- Describe the format and contents of the general ledger and ledger accounts. Distinguish
- between asset and expense accounts, and between capital, liability and income accounts.
- Enter cash (including cheque) transactions and credit transactions in the ledger.

3.0 MAIN CONTENT 3.1 The

Principles of Double-Entry

Each page of the ledger is split into two halves: the left half is called the debit side and the right half is called the credit side. The ledger is divided into sections called accounts. In practice, each of these accounts is on a separate page. There is usually an 'account' for every class of expenditure, income, asset, and liability. Separate accounts are created to also record transactions in and out of the business by its owner. For example, there are typically separate accounts for wages expenses, for stationery, for heat and light, for motor vehicles, loans, drawings, capital introduced by the owner, and so on. There could be 1,000 accounts, depending on the detail required by management. Each of these accounts' can be traced to the financial statements. More detail is provided in the ledger than is provided in the statement of profit and loss and in the statement of financial position, as too-much detail would reduce the understandability of the information being presented. So, the expenses, income, assets and liabilities are usually combined in company financial statements to provide meaningful information

Double-entry bookkeeping is an application of the dual aspect concept. Under this concept each transaction affects two accounts (hence the name 'double-entry') and records a flow of value between the accounts. In accounting, a language has developed to indicate the direction of the flow, to debit an account means to have value flow into that account, whereas to credit an account means to have value flow out of that account. Convention has it that a debit always means an adjustment to the left-hand side of the ledger account, whereas a credit means an adjustment to the right-handside of the ledger account. Some people find it easer to think of debits as being a '+' and a credit as being a '-'.

The money value of each transaction is entered once on each side of the general ledger in different accounts. The actual process of placing the bookkeeping entry in each account is called 'posting the transaction' or simply 'posting: For example, if we take one transaction such as the sale of goods for cash of N10,000 on 6 January, this would be recorded (posted) as follows:

3.1.1 Ledger

		Debit				**redit**	
Date	**etails**	**Folio**	**mount**	**ate**	**etails**	**olio**	**Amount**
			ash account (page 1)				
6 Jan	ales	p.2	10,000				

		Debit				**redit**	
Date	**etails**	**Folio**	**mount**	**ate**	**etails**	**olio**	**Amount**
			Sales account (page 2)				
				Jan	Cash	p.1	10,000

The cash account on page 1 is debited with N10,000 and the sales account on page 2 is credited with N10,000.

3.1.2 T-accounts

Many academics and textbooks create a simplified version of a ledger account called a 'T' account to teach bookkeeping to students. A 'T' account leaves out some of the detail that is given in ledger accounts, such as the reference to the folio page (the pages in a ledger are typically called folios) and contains less lines. A typical 'T' account looks like the following:

	DEBIT	Amount name		**CREDIT**	
Date	**Details**	**N**	**Date**	**Details**	**N**

The date column is the date of the transaction, the details column outlines the other account being posted to (so that the transaction can be traced) and the N column records the amount that is being posted Just like the ledger, flows of value to the account will be debited to the left-hand side, and flows of value from the account are recorded on the right-hand side (credited). A separate T account is opened for every type of expense, asset, liability, income and transaction with the owner (capital introduced and separately, drawings).

Three steps are required for every double-entry transaction:

1. Determine the two accounts to be adjusted.
2. Consider the flow of value (which account does it go to? which account does it leave?).
3. Identify the money value that is transferring.

The transaction noted previously was the sale of goods for cash of N10,000 on 6 January.

1. The two accounts affected are the sales account and the cash account.
2. Cash comes in (debit); therefore, the value must leave the sales account (credit).
3. The value transferring is N10,000.

In accounting language this translates as:

Debit: Cash account N10,000
Credit: Sales account N10,000
and is shown in the two T accounts as follows:

	Cash account							**Sales account**			
Date	**Details**	**N**	**Date**	**Details**	**N**	**Date**	**Details**	**N**	**Date**	**Details**	**N**
6 Jan	Sales	10,000							6 Jan	Cash	10,000

The same occurs with cheques received and paid, except that they are entered in an account called the bank account instead of the cash account.

3.2 Ledger entries for cash transactions

When someone starts a business they usually put money into the business. This is debited to the cash or bank account (depending on whether it is cash or a cheque) and credited to a capital introduced account. Money introduced at a later date by the proprietor as additional capital is treated in the same way. Any money withdrawn by the proprietor is credited in the cash or bank account (depending on whether it is cash or a cheque) and debited to a drawings account. These accounts are never netted against each other.

Sometimes businesses also borrow money. The amount received is debited to the cash or bank account (depending on whether it is cash or a cheque) and credited to an account in the name of the lender, who is referred to as a loan creditor.

Illustration: Complete the following table showing which accounts are to be debited and which are to be credited in the spaces provided:

	Debit	Credit
a) Bought office computer for cash		
b) Bought lorry for cash		
c. A loan of N20,000 is received by cheque from Ige		
d. Paid stationery by cheque		
e. Paid rates by cash		
f. Owner wrote a cheque to himself		
g. Owner put cash into the business		
h. Owner buys a washing machine for his home and pay by cheque		

Solution

	Debit	Credit
a). Bought office computer for cash	Office computer a/c	ash a/c
b). Bought lorry for cash	Motor vehicles a/c	ash a/c
c). A loan of N20,000 is received by cheque from Ige	Bank a/c	arls a/c (Loan creditor)
d). Paid stationery by cheque	Stationery a/c	ank a/c
e). Paid rates by cash	Rate a/c	ash a/c
f). Owner wrote a cheque to himself	Drawings a/c	ank a/c
g). Owner put cash into the business	Cash a/c	apital introduced a/c
h). Owner buys a washing machine for his home and pay by cheque	Drawings a/c	ank a/c

Double entry is now taken a step further by introducing monetary values and T account entries. The entries for various cash transactions are illustrated below

Preety Treety started business on 1 January 20X3 as a grocer with capital (in cash) of N10,000. She also borrowed N5000 in cash from Lagos Bank Ltd. Her transactions during January, which are all in cash, were as follows:

1 Jan	Paid one month's rent for the shop: N1,000
2 Jan	Bought fixtures and fittings for the shop: N3,000
8 Jan	Purchased goods for resale: N4,000

9 Jan Paid N250 carriage inwards
10 Jan Bought stationery for N500
15 Jan Paid N2,000 in wages for shop assistant
20 Jan Cash taken by Preety Treety for her private use: N1,500
31 Jan Cash takings for month: N6,000

You are required to write up the accounts in the general ledger.

Cash account

20X3	**Details**	**N**	**20x3**	**Details**	**N**
1 Jan	Capital	10,000	1 Jan	Rent	1000
1 Jan	Loan-Lagos Bank Ltd	5,000	2 Jan	Fixtures And Fittings	3000
31 Jan	Sales revenue	6,000	8 Jan	Purchases	4000
			9 Jan	Carriage inwards	250 10
			Jan	Stationery	500 15 Jan
			Wages		2000 20 Jan
			Drawings	1500	

Capital introduced account

20X3	**Details**	**N**	**20X3**	**Details**	**N**
			1 Jan	Cash	10,000

Loan-Lagos Bank account

20X3	**Details**	**N**	**20X3**	**Details**	**N**
			1 Jan	Cash	5000

Rent account

20X3 **Details** **N**

1 Jan Cash 1000 20X3 Details N 1 Jan Cash

Fixtures and fittings account

20X3 **Details** **N**

2 Jan Cash 3000 20X3 Details N 1 Jan Cash

Purchases account

20X3 **Details** **N**

8 Jan Cash 4000 20X3 Details N 1 Jan Cash

Carriage inwards account

20X3 **Details** **N**

9 Jan Cash 250 20X3 Details N Stationery

account

20X3	**Details**	**N**	**20X3**	**Details**	**N**
10 Jan	Cash	500			

Wages account

20X3	Details	N	20X3	Details	N
15 Jan	Cash	2000			

Drawings account

20X3	Details	N	20X3	Details	N
20 Jan	Cash	1500			

Sales revenue account

20X3	Details	N	20X3	Details	N
			31 Jan	Cash	6000

Note:

1. The narrative in the details column of an account specifies the name of the-account that contains the other entry for each transaction.
2. Carriage inwards refers to haulage costs relating to goods that this business has purchased and is responsible for transporting from the sellers' premises.

SELF ASSESSMENT EXERCISES

Prepare a cash account for your cash transactions over the forthcoming week or month. Make the necessary double-entry in the other ledger accounts.

3.3 Ledger entries for credit transactions

The entries in the ledger for credit transactions are more complicated than those for cash transactions. This is because a credit transaction involves at least two (and sometimes three) events, each of which is recorded in double-entry form. In this section, credit bookkeeping is explained using the most common types of credit transactions - the purchase and sale of inventory. Movements in inventory are not recorded in an inventory account because the value moving out of the account (sale) is different from the value moving into the account (the purchase). Putting the two transactions in one account would be an example of netting (off-set), which is not allowed under law. Users are interested in knowing sales figures; it is one of the growth indicators. They are also interested in knowing the value of items that were sold. Therefore, they want to see purchases. The difference between the sales value and the purchase value of the item(s) sold is the gross profit on the item(s) and this information is disclosed separately in the statement of profit and loss (covered later). In addition to sales and purchases, there are two other types of inventory movement that have to be recorded separately: purchase returns and sales returns. The level of sales returns gives an indication of the quality of the entity's products and the level of purchase returns provides information on the entity's purchasing policy. Therefore, inventory movements are recorded in four separate accounts. This is illustrated below.

Movements inwards	Postings	Movement outwards	Postings
Purchases	Debit	Sales	Credit
Sales returns (returns inwards)	Debit	Purchase returns (returns outwards)	Credit

Postings to the purchases and sales returns ledger accounts will always be on the debit side and these accounts will always have a debit balance, and postings to the sales and purchase returns ledger accounts will always be on the credit side and these accounts will always have a credit balance. A walked-through example of the double-entry posting to the appropriate T accounts is now provided. At this stage it is assumed that the sales ledger and the purchase ledger are not kept separate from the general ledger, so each credit customer and credit supplier have their own account in the general ledger.

3.3.1 Credit sales

The first event consists of the purchase or sale of goods on credit as evidenced by an invoice. The invoice is recorded in the ledger as follows:

1 Feb Sold goods on credit to AB Ltd for N5000

The first step is to identify the two accounts affected: The sales account and AB Ltd account.
The next step is to identify the flow of value: The goods represent the value and the goods physically go to AB Ltd (so the value leaves the sales account (credit) and flows to AB Ltd's account (debit)).
The next step is to identify the monetary value flowing between the accounts: In this case it is N5000.

Sales account						**AB Ltd account**					
20X3	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**£**
			1 Feb	AB Ltd	5000	31 Jan	Cash	5000			

The amount outstanding on credit from a credit customer is referred to as a trade receivable. In the above example, the balance owing from AB Ltd is a trade receivable of the business whose books are being prepared. Trade receivables are commonly called 'debtors'. The term 'debtor' arises from the existence of an account in the seller's books that contains more on the debit side than on the credit side.

Credit purchases

2 Feb Purchased goods on credit from CD Ltd for N2,500.

The first step is to identify the two accounts affected: The purchases account and CD Ltd account.
The next step is to identify the flow of value: The goods represent the value and they physically come from CD Ltd (so the value flows to the purchases account (debit) and from CD Ltd account (credit)).
The next step is to identify the monetary value flowing between the accounts: In this case it is N2,500.

CD Ltd account						**Purchases account**					
20X3	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**
			2 Feb	Purchases	2,500	2 Feb	CD Ltd	2,500			

The amount owing to a business or person from whom goods are purchased on credit is referred to as trade payable. In the above example, the balance owing to CD Ltd is a trade payable of the business whose books are being prepared. In the UK, trade payables are commonly called 'creditors'. The term 'creditor' arises from the existence of an account in the purchaser's books which contains more on the credit side than on the debit side. IASs do not use the term 'creditor'.

3.3.2 Sales returns

A second event that may occur when goods are bought and sold on credit is the return of goods. This can arise for example when some of the goods delivered were not ordered, or are defective. When goods are returned the seller sends the buyer a credit note. This is recorded in the ledger as follows:

3 Feb AB Ltd returned goods invoiced for N1,000.

The first step is to identify the two accounts affected *:* The returns inward account and AB Ltd account.
The next step is to identify the flow of value*:* The goods represent the value and they come from AB Ltd (so the value flows to the returns inward account (debit) and comes from AB Ltd's account (credit)).
The next step is to identify the monetary value flowing between the accounts . In this case it is N1,000.

Return inward account						**AB Ltd account**					
20X3	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**
3 Feb	AB Ltd	1,000				1 Feb	Sales	5,000	3 Feb inward	Returns	1,000

3.3.3 Purchase returns

Similarly, goods received may be defective, or not fit for purpose. These will be returned to the supplier. They are not treated as a reduction in purchases, but are recorded in a separate account, the returns outward account.
Then on 4 Feb The entity returned goods to CD Ltd invoiced for N500
The first step is to identify the two accounts affected: The returns outward account and CD Ltd account.
The next step is to identify the flow of value. The goods represent the value and they go to CD Ltd (so the value flows to CD Ltd's account (debit) and comes from the returns outward account (credit)).
The next step is to identify the monetary value flowing between the accounts: In this case it is N500.

CD Ltd account						**Returns outwards account**					
20X3	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**	**20X3**	**Details**	**N**
3 Feb Outward	Returns	500	2 Feb	Purchases	2500				4 Feb	CD Ltd	500

The balance on the customer's (AB Ltd) and supplier's (CD Ltd) accounts thus show the amounts of money owed at any point in time.

3.3.4 Receiving funds from credit customers

The third event that occurs when goods are bought and sold on credit is the transfer of money in settlement of the debt. The entries on settlement of a trade receivable account by a credit customer, is recorded in the ledger as follows:

5 Feb Received from AB Ltd cash of N4000

The first step is to identify the two accounts affected: The cash account and AB Ltd account.
The next step is to identify the flow of value: Money is the value and it flows to the cash account (debit) and flows from AB Ltd's account (credit).
The next step is to identify the monetary value flowing between the accounts: In this case it is N4000.

Cash account

20X3	Details	N	20X3	Details	N
5 Feb	AB Ltd	1000			

AB Ltd account

20X3	Details	N	20X3	Details	N
1 Feb	Sales	5000	3 Feb	Returns inward	1000
			5 Feb	Cash	4000

3.3.5 Paying credit suppliers

The entries on settlement of a trade payable account by the business, is recorded in the ledger as follows:

6 Feb Paid CD Ltd N2000 in cash

The first step is to identify the two accounts affected: The cash account and CD Ltd account.
The next step is to identify the flow of value: Money is the value and it flows from the cash account (credit) and flows to CD Ltd's account (debit).
The next step is to identify the monetary value flowing between the accounts: In this case it is N2000.

CD Ltd account

20X3	Details	N	20X3	Details	N
4 Feb	Returns outward	500	2 Feb	Purchases	2500
6 Feb	Cash	2000			

Returns outwards account

20X3	Details	N	20X3	Details	N
5 Feb	AB Ltd	4000	4 Feb	CD Ltd	500

An illustration of both credit and cheque transactions is shown in Example 10.3. The three steps are not shown in each instance. This is something that is done subconsciously and is not recorded.

ILLUSTRATION

Eagle Ltd commenced business on 1 July 20X2 as a wholesale greengrocer with a capital in the bank of N2,000,000. His transactions during July were as follows:

1 **July** Bought a second-hand van by cheque for N800,000
3 **July** Paid insurance on the van by cheque for N150,000
7 **July** Purchased goods costing N250,000 on credit from A. Bamidele

11 July Sold goods on credit to B. Ghandi amounting to N450,000
14 July Paid carriage outwards by cheque amounting to N20,000
16 July Returned goods to A. Bamidele of N50,000
18 July Repairs to van paid by cheque: N30,000
20 July B. Ghandi returned goods of N75,000
23 July Sent A. Bamidele a cheque for N140,000
26 July Received a cheque from B. Ghandi for N240,000
31 July Paid telephone bill by cheque: N65,000
31 July Paid electric bill by cheque: N45,000

You are required to write up the accounts in the general ledger.

Bank account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
1 July	Capital	2,000	1 July	Van	800
26 July	B. Ghandi	240	3 July	Motor expenses	150
			14 July	Carriage outward	20
			18 July	Motor expenses	30
			23 July	A. Bamidele	140
			31 July	Telephone and postage	65
			31 July	Light and heat	45

Capital account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
			1 July	Bank	2,000

Van account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
1 July	Bank	800			

Motor expenses account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
3 July	Bank	150			
18 July	Bank	30			

Purchases account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
7 July	A. Bamidele	250			

A. Bamidele account (trade payable)

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
16 July	Returns	50	7 July	Purchases	250
23 July	Bank	140			

Sales account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**

			11 July	B. Ghandi	450

B. Ghandi account (trade receivable)

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
11 July	Sales	450	20 July	Returns	75 26
			July	Bank	240

Purchase returns (outwards) account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
			16 July	A. Bamidele	50

Sales returns (inwards) account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
20 July	B. Ghandi	75			

Carriage outwards account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
14 July	Bank	20			

Telephone and postage account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
31 July	Bank	65			

Light and heat account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
31 July	Bank	45			

3.4 Adjustments for Drawings and Capital introduced

Drawings may take a number of forms in addition to cash. For example, it is common for the owner to take goods out of the business for his or her personal consumption. This requires an adjustment that may be done by either of two entries:

1. debit drawings and credit purchases with the cost of the goods to the business; or
2. debit drawings and credit sales where the goods are deemed to be taken at some other value such as the normal selling price.

3.5 Ledger Account Balances

Each account can be totaled to give a balance that represents all the transactions affecting that account in the period. This balance can then be transferred to the statement of profit and loss or the statement of financial position. The main purposes of the ledger accounting system are to provide a means of ascertaining the total amount of each type of income and expenditure, the total value of the assets owned by the business (e.g. cash), and how much is owed to and by the business. For example, the cash account shows how much money the business has at any time. When the total amount of money on the debit side of an account is greater than that on the credit side, the account is said to have a debit balance. When the reverse is the case, the account is said to have a credit balance. An account that contains a debit balance represents either an asset (such as cash) or an expense or loss. An account with a credit balance represents capital, a liability, income (such as sales) or a gain

4.0 CONCLUSION

The capital account can be regarded as the owner's investment in the entity. From the entity's perspective the capital account is the liability of the entity to the owner. Hence the capital account usually has a credit balance. Having knowledge of what the owner withdraws and introduces to the business is deemed to be of relevance for users. Hence, the movements in the owner's capital account are recorded in three accounts - drawings, capital introduced and the statement of profit and loss.

The statement of profit and loss is an account that takes the balances of all the revenue type accounts (income and expense accounts), summarizes them and presents them in a manner that is deemed to be of use to users and then transfers the balance (profit or loss) to the owner's capital account.

5.0 SUMMARY

In this unit we have treated the principles of double-entry, ledger entries for cash and credit transactions, adjustments for drawings and capital introduction and ledger account balances.

6.0 TUTOR MARKED ASSIGNMENT

Complete the following table showing which ledger account is to be debited and which is to be credited:

Debit **Credit**

a. Stationery purchased an credit from Goke
b. Rates paid by direct debit
Telephone bill paid by cash
c.
Stationery returned to Goke
d.
e. Insurance paid by direct debit
f.
Cash sales
g. Cheques received for sales
Cash wages
h.
Wages paid by Boyle
i.

2.

Complete the following tables which ledger accounts are to be debited and which are to be credited:

Debit **Credit**

a). Goods sold on credits
b). Goods bought on credit
c). Good bought for a cash
d). Goods bought by cheque

e). Goods sold for cash

f). Goods sold on credit to Eloka

g). Goods bought on credit from Muna

3. Halima commenced business as a butcher on 1 October 20X4 introducing cash of N500,000 from her personal bank account to the newly opened business bank account. Her transaction during October 20X4, which were all in cash, are as follows:

1 Oct Rent of shop: N200,000
2 Oct Purchases of goods: N970,000
4 Oct Bought fixtures and fittings: N1,250,000
6 Oct Borrowed N3,500,000 from Sylvester
9 Oct Purchased delivery van: N2,650,000
12 Oct Sold goods for N1,810,000
15 Oct Paid wages of N150,000
18 Oct Purchases: N630,000
19 Oct Drawings: N350,000
21 Oct Petrol for van: N25,000 22
Oct Printing costs: N65,000
24 Oct Sales: N1,320,000
25 Oct Repairs to van: N45,000
27 Oct Wages: N250,000
28 Oct Purchased stationery costing N35,000
30 Oct Rates on shop: N400,000
31 Oct Drawings: N175,000

You are required to record the above transactions in the ledger (use T accounts).

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accountin*g. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 6 THE BALANCING OF ACCOUNTS AND THE TRIAL BALANCE

CONTENTS

1.0 INTRODUCTION

At the end of every accounting period it is necessary to balance each account in the ledger. This has to be done at least annually, and more likely monthly.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Balance and close ledger accounts (T accounts).
- Describe the nature and purposes of a trial balance.
- Prepare a trial balance from the ledger or a list of ledger account balances (T accounts).

3.0 MAIN CONTENT

3.1 The Balancing of Accounts

The procedure for balancing an account is as follows:

1. Leave one blank line under the last entry in the ledger account and draw parallel lines on the top and bottom of the next line in the amounts column on each side. When this happens it marks the end of the period. All the transactions before the totaling lines represent the period that has just ended and the area after the totaling lines represents the new period.
2. Add up each side of the ledger account (the debit and credit sides) and calculate the difference using a separate piece of paper.
3. If the amount of the debit side exceeds that on the credit side, enter the difference on the credit side immediately after the last entry on that side (in step one you left a blank line for this purpose). This is the closing balance on the account. Similarly where the amount on the credit side exceeds that on the debit side, the difference should be entered on the debit side immediately after the last entry on that side. The result is that with the entered closing balance, both sides will total (balance) exactly.

4. Enter the total of each side of the ledger account between the parallel lines. These two figures should now be the same.

5. There are three descriptions used to close off accounts. These descriptions identify where the closing balance will end up in the new period.

a. When the ledger account is a statement of financial position account (an asset, capital or liability account, for example the motor vehicles account, bank account, loan account, etc.), the closing balance within the period (before the parallel lines) should be described as the 'balance carried down' (Bal. c/d). Enter the same figure on the opposite side below the parallel lines. This should be described as the 'balance brought down' (Bal. b/d).

b. When the account is a statement of profit and loss account (income or expense accounts for example sales, wages, purchases, heat and light, etc.) the closing balance transfers to the statement of profit and loss account and should be described as such (shortened sometimes to P/L a/c). This is a T account that is set up to determine the profit or loss made in the period. These ledger accounts will typically not have opening balances in the next period as the balance from the previous period has been transferred somewhere else (the statement of profit and loss account).

c. Finally, any account that represents a movement in owners' capital (drawings, capital introduced and the statement of profit and loss account) will be balanced off to the owners' capital account. Therefore, the description showing the destination of the closing balance on these accounts will be 'owners' 'capital: The owners' capital account is a statement of financial position account. As all movements take place in the latter-mentioned accounts, this account will only have the opening balance. When all the movement accounts are closed and the balances transferred to this account, it will be closed and the balance carried down to the next period. This is the last account to be closed off.

This is illustrated below using the ledger accounts from the answer to Eagle Ltd in Unit 4. It is the period end (31 July) and the ledger accounts are being closed for the purposes of preparing the financial statements. This illustration will take you step by step through the stages of closing off an entity's books. An example of the three different types of account and the different way of closing them off is highlighted by shading.

3.1.1 Closing a statement of financial position account - the bank account

Step one - identify the type of account it is (Bank is a statement of position account. It is the least predictable account as the bank can either be a current asset or a current liability, if in overdraft).

Step two -leave a gap below the longest column of figures (shaded in grey below) and put total lines on both the credit and debit sides of the account. Leave room below the total lines for the opening balance. In practice, in a ledger there would be enough room after the total rows for several periods' transactions after July.

Bank Account

20x2 Details N’000 20X2 Details N’000
1 July Capital 2,000 26 1 July Vehicle 800
July B. Ghandi 240 3 July Motor expenses 150 14
July Carriage outwards 20 18 July
Motor expenses 30 23 July A.
Bamidele 140 31 July
Telephone and postage 65 31 July
Light and heat 45

Step three - add up each side of the ledger account and calculate the difference using a separate piece of paper. In this instance the debit side totals N2,240 and the credit side totals N1,250. As the debit side has a larger balance, this will be the expected sign of the opening balance in the next period. This account will be regarded as having a debit balance (debits > credits). The larger of the sides will be the amount that goes in the totals' column (N2,240), as follows.

Bank account

20x2 Details N’000 20X2 Details N’000
1 July Capital 2,000 26 1 July Vehicle 800
July B. Ghandi 240 3 July Motor expenses 150 14
July Carriage outwards 20 18 July
Motor expenses 30 23 July A.
Bamidele 140 31 July
Telephone and postage 65 31 July
Light and heat 45

2,240
2,240

Step four - work out the dosing balance and put it in the correct side. In this instance, the closing balance is £990 (£2,240 - £1,250) and the balance will have to go on the credit side of the account, otherwise the numbers on the credit side will not add up to £2,240. This is shown as follows:

Bank account

20x2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
1 July	Capital	2,000 26	1 July	Vehicle	800
July	B. Ghandi	240	3 July	Motor expenses	150 14
			July	Carriage outwards	20 18 July
			Motor expenses	30	23 July A.
			Bamidele	140 31 July	
			Telephone and postage	65 31 July	
			Light and heat	45	
		2,240			
					2,240

Step five - complete the double entry (otherwise the books will not balance). If you make an entry into an account, you must carry the value to another account, or in this case to the next period of the same account. At this stage the correct date and description need to be entered beside the closing balance. As a statement of position account, this period will be closed off and the balance carried into the next period (which starts on 1 August).

Bank account

20x2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
1 July	Capital	2,000 26	1 July	Vehicle	800
July	B. Ghandi	240	3 July	Motor expenses	150 14
			July	Carriage outwards	20 18 July
			Motor expenses	30	23 July A.
			Bamidele	140 31 July	
			Telephone and postage	65 31 July	
			Light and heat	45	
		2,240	990		
1 Aug	**Balance b/d**	990			2,240

Closing a movement in capital account - the capital introduced account

This account is a movement in capital account and the balance on it will be transferred to the capital account at the period end (as this is a new business, the capital account will have to be opened).

Capital introduction account

20X2	Details	**N'000**	20X2	Details	**N'000**
			1 July	Bank	2,000
31 July	Capital a/c	2,000			
2,000					2,000

The double-entry to close the capital introduced account is provided in journal form to assist student understanding. This is not required to be produced in exams and is not reproduced in the examples from now on. Instead (just in the case of this example), the relevant entries are shaded to highlight the debit-credit relationship.

Debit:	Capital introduced account (to close)	N2,000,000
Credit:	Capital account	N2,000,000

The capital introduced account is now closed and has no opening balance in the new period. This makes sense as users will want to see what the owner has introduced in each period. This information would be difficult to obtain if all the items affecting owners were just pooled into the capital account.

Capital account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
			31 July	Capital introduced a/c	2,000

The capital account is not closed yet, it is the last ledger account to close as the statement of profit and loss account is closed off to this account.

The next account to close is the motor vehicles account.

Motor vehicle account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
1 July	Bank	800			
			31 July	**Balance c/d**	800
		800			800
1 Aug	Balance b/d	800			

As an asset, the motor vehicles account is a statement of financial position account; therefore, the closing- balance is carried into the next period.

Closing a revenue type account - the motor expenses account

As a revenue expense, this account will balance into the statement of profit and loss ledger account and will have no opening balance in the next period. The statement of profit and loss ledger account for this period has to be opened to receive this expense.

Motor expenses account

20X2	Details	N’000	20X2	Details	N’000
3 July	Bank	150			
18July	Bank	30			
		180	31 July	**Statement of P&L a/c**	180
					180

The motor expenses account is described as having a debit balance as the debit side is greatest and the balance is carried into the debit side of the statement of profit and loss ledger account. The statement of profit and loss ledger account is not closed at this time. It is the second last ledger account to be closed.

Statement of *profit and* loss *account*

20X2	Details	N’000	20X2	Details	N’000
31 July	Motor expenses	180			

The next account to be closed is the purchases account. As a revenue expense, this is a statement of profit and loss account, hence will be closed off in the same manner as the motor vehicles account.

Purchases account

20X2	Details	N’000	20X2	Details	N’000
7 July	A. Bamidele	250	31 July	**Statement of P&L a/c**	250
		250			250

Statement of *profit and* loss *account*

20X2	Details	N’000	20X2	Details	N’000
31 July	Motor expenses	180			
31 July	Purchases	250			

The next account to be closed is A. Bamidele's trade payable account. As a liability, this account is a statement of financial position account; hence the balance will be carried into the next period.

A. Bamidele account (trade payable)

20X2	Details	N’000	20X2	Details	N’000
16 July	Returns	50	7 July	Purchases	250
23 July	Bank	140			
31 July	**Balance c/d**	60			
		250			250
			1 Aug	**Balance b/d**	60

The sales revenue account is a revenue account, as such it will be closed off to the statement of profit and loss ledger account.

Sales revenue account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
			1July	B. Ghandi	450
31 July	**Statement of P&l *a/c***	450			
		450			450

Statement of *profit and* loss account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
	Motor 31 July		31 180	Sales revenue	450
31 July	Purchases	250			

B.Ghandi's account is a trade receivable. Trade receivables are current assets also refered to as debtors, which are of statements of financial position ledger accounts; therefore, the closing balance will be carried forward into the next period.

B. Ghandi account (trade receivable)

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
11 July	Sales revenue	450	20 July	Returns	750 26
			July	Bank	240 31 July
		____		Balance c/d	135 450
		450			
1 Aug	**Balance b/d**	135			

The purchase returns account is a revenue account; as such the balance is transferred to the statement of profit and loss ledger account.

Purchase returns (return outwards) account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
31 July	**Statement of P&L a/c**	50	16July	A. Bamidele	50 ___
					50
		50			

Statement of profit and loss account

20X2	**Details**	**N’000**	**20X2**	**Details**	**N’000**
31 July	Motor expenses	180 31	31 July	Sales revenue	450 31
July	Purchases	250	July	Purchase returns	50

Likewise, the sales returns account is a revenue account; as such the balance is transferred to the statement of profit and loss ledger account.

Sales returns (return inwards) account

20X2	Details	N'000	20X2	Details	N'000
20 July	B. Ghandi	75	31 July	**Statement of P&L a/c**	75
		75			75

Statement of profit and loss account

20X2	Details	N'000	20X2	Details	N'000
14 July	Motor expenses	180	31 July	Sales revenue	450
31 July	Purchases	250	31 July	Purchases returns	50
31 July	Sales returns	75			

Carriage outwards, telephone and postage and heat and light are revenue expenses; therefore, the balances will be transferred to the statement of profit and loss ledger account.

Carriage outwards account

20X2	Details	N'000	20X2	Details	N'000
14 July	Bank	20	31 July	**Statement of P&L a/c**	20
		20			20

Telephone and postage account

20X2	Details	N'000	20X2	Details	N'000
31 July	Bank	65	31 July	Statement of P&L a/c	65
		65			65

Heat and Lighting account

20X2	Details	N'000	20X2	Details	N'000
31 July	Bank	45	31 July	**Statement of P&L a/c**	45
		45			45

At this stage all the ledger accounts (except the capital account) have been closed; therefore, the statement of profit and loss ledger account can be closed. The balance represents the period's profit or loss. If the sum of the debit side (expenses) is greater than the sum of the credit entries then the entity has made a loss in the period; if the credit side (income) is greater, then the entity has made a profit in the period. Either way the balance is transferred to the owners' capital account. No balance will appear in the next period. Like the bank, the balance on this account can either be a debit or a credit, so it is good practice to add up each side and determine the largest before proceeding with the closure. In this instance the debit side is larger at N635,000 whereas the credit side adds to N500,000. Therefore the balance is a loss.

Statement of profit and loss account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
31 July	Motor expenses	180	31 July	Sales revenue	450
31 July	Purchases	250	31 July	Purchases returns	50
31 July	Sales returns	75			
31 July	Carriage outward	20			
31 July	Telephone and postage	65			
31 July	Heat and light	45			
			31 July	**capital a/c**	135
		635			635

At this stage the capital ledger account (a statement of financial position account) can be closed with the balance carried forward into the next period to reflect the owner's investment in the business on that date. This becomes the opening capital balance in the new period.

Capital account

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
			31 July	Capital introduced a/c	2,000
31 July	Loss from P/L a/c	135			
31 July	**Balance c/d**	1,865			
		2,000	31 July	**Balance b/d**	1,865

The ledger accounts are now fully closed for the period.

3.2 The Purposes and Preparation of a Trial Balance

The trial balance is neither part of the general ledger nor is it a book of prime entry (although it is often prepared on paper with the same ruling as the journal). It is a list of the balances in the general ledger at the end of an accounting period. Since every transaction recorded in the ledger consists of both a debit and a credit entry, the total of the balances on each side should be the same. This is checked by entering on the trial balance the balance of each account in the ledger, and adding up each side

3.2.1 The Purpose of a Trial Balance

The purpose of the trial balance may be summarized as follows:

1. To ascertain whether the total of the ledger accounts with debit balances equals to the total of the ledger accounts with credit balances. If so, this proves that the same money value of each transaction has been entered on both sides of the general ledger. It also proves the arithmetic accuracy of the ledger account. However, a trial balance can agree but there may still be errors in the ledger. For example, an amount may have been entered on the correct side but in the wrong account, or a transaction could have been completely omitted.

2. The trial balance is also used for the preparation of final financial statements that show the profit or loss for the period and assets and liabilities at the end of that period. In practice this is done in the form of an extended trial balance.

All the ledger accounts end up in two reports in the financial statements: the statement of profit and loss and the statement of financial position. It should be noted that the trail balance does not form part of the double-entry process; shown in detail above. The trial balance is just a memorandum that is used to check that the ledger accounts balance and assist in preparing the financial statements for disclosure purposes. As mentioned before, it is expected that expenses, returns inward and assets will have debit balances and income, returns outward, capital, and liabilities will have credit balances.

Below is an illustration of a trial balance prepared from the entries of Eagle Ltd.

Eagle Ltd
Trial balance as at 31 July 20X2

Name of account	**Debit**	**Credit**
	N'000	**N'000**
Bank	900	
Capital introduced		2,000
Motor vehicles	800	
Motor expense	180	
Purchase	250	
A.Brown (trade payable)		60 Sales
revenue		450
B.Green (trade receivable)	135	
Purchases returns		50
Sales returns	75	
Carriage outwards	20	
Telephone and postage	65	
Heat and light	45	
	2,560	2,560

Note: the capital account and the statement of profit and loss account are not listed as these accounts only include the closing balances of other ledger accounts. To include them in the trial balance would be to account for all their component accounts twice.

3.2.2 Correcting Errors In a Trial Balance

The following procedure can be adopted when a trial balance fails to agree. This procedures will minimize effort and time spent looking for the errors.

1. Recast the trial balance.
2. Check that no ledger account has been omitted from the trial balance. This sometimes happens with the cash and bank balances as they are usually in separate books.
3. Check that each amount entered in the trial balance is on the correct side. This is quick to do once you become familiar with the nature of different ledger accounts.
4. Check to see that the amounts entered in the trial balance are the same as those shown in the ledger accounts.
5. If the error has still not been found, it will then be necessary to check all the entries in the general ledger.
6. If the difference between the totals of the trial balance is divisible by nine, then it is likely that a ledger account balance or a transaction has been transposed incorrectly - for example, if the heat and light account had been recorded as N54,000 instead of N45,000 or the account B. Ghandi had been recorded at N315,000 instead of N135,000. In these instances careful consideration should be given to looking for this type of error.

It is also worth noting that often in examinations no marks are given for correct trial balance totals. The student will therefore only lose marks for the error that caused it to disagree. Thus, do not spend more than a few minutes trying to make a trial balance agree.

4.0 CONCLUSION

At the end of each accounting period every account in the ledger must be balanced. The balance is the difference between the monetary amounts on the sides of an account. There are three ways to close off ledger accounts depending on the nature of the account. If the ledger account is a movement in the owners' capital account, then it is balanced off to the capital account (a statement of financial position account). If the account is revenue ledger account, (income or expense), the balance is transferred to the statement of profit and loss ledger account. Finally, if the ledger account is an asset, liability or capital account, then the balance carries forward into the new period. The closing balance is entered in the ledger account as a balance carried down at the end of the period, and as a balance brought down at the start of the following period.

The balances on all the ledger accounts are used to prepare a trial balance. A trial balance is a list of the balances in a general ledger at a specific time, divided between those with debit balances and those with credit balances. Since every transaction is recorded in the general ledger on both the debit and credit sides, the total of the ledger accounts with debits should equal the total of the ledger accounts with credit balances. The main purpose of the trial balance is to ascertain whether this is the case, and thus to check the accuracy of the ledger. Another function of the trial balance is to facilitate the preparation of final financial statements.

5.0 SUMMARY

In this unit we have treated how to balance and close ledgers, taking the balances to the capital account, profit and loss account and the statement of financial position. We have also described the nature and purposes of a trial balance and how to prepare a trial balance from a list of ledger account balances.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the main purposes of a trial balance.

A further illustration of the preparation of a trial balance is given in Example 11.2. The data in the question would not be presented in this manner in practice, but the question is a useful way of testing your knowledge of which ledger accounts contain debit balances and which contain credit balances.

The following is a list of the balances appearing in the general ledger of T. Wall at 30 September 20X2:

	£		£
Capital	32,890	Trade payables	4,620
Drawings	5,200	Land and buildings	26,000
Loan from M. Head	10,000	Plant and machinery	13,500
Cash	510	Listed investments	4,800
Ban k overdraft	1,720	Interest paid	1,200
Sales	45,600	Interest received	450
Purchase	29,300	Rent received	630
Returns inwards	3,800	Salaries	3,720
Returns outwards	2,700	Repairs to buildings	810
Carriage inwards	960	Plant hire charges	360
Carriage outwards	820	Bank charges	240
Trade receivables	7,390		

You are required to prepare a trial balance.

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accountin*g. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting* . Edinburgh Gate: Pearson Education Limited.

UNIT 7 THE CASH BOOK

CONTENTS

1.0 INTRODUCTION

Cash is a very important medium of conducting transaction. And there are two basic forms in which cash is used- in physical form, termed ‘cash-in-hand’ and as deposit, that is ‘cash at bank’. Because of the liquid nature of cash there is the need to develop a sound recording and control system.

2.0 OBJECTIVES

After an in-depth study of this unit, you should be able to:

- Define cash book
- Prepare a two-column and three-column cash book
- Explain the term ‘suspense account’.

3.0 MAIN CONTENT

3.1 Cash Book

This is a book or record in which bank/cash transactions are recorded. These include receipts (from customers) and payments (to suppliers) as well as bank charges, interest received, etc. A cash book is a type of day book, recording transactions where the balance will be included in the trial balance. The cash book is regularly reconciled with the bank statement as an internal control check. Cash transactions not made through the bank are generally recorded in a petty-cash book. The purpose of the cashbook is to decongest the ledger by taking the bank account and cash account out of the ledger and combining them in one subsidiary book called the cashbook.

3.2 Types of Cashbook:

(i) Main cash book and

(ii) Petty cash book

The main cashbook is divided into Two-column cash book and Three-column cash book.

3.2.1. Two-Column Cash Book

This cash book has two columns, one each for bank and cash transactions. The two columns on the debit side (cash and bank columns) record the receipt of money while the two columns on the credit side record payment of money.

Typical Format of a Two-column cash book

2. Column Cash Book

Date	Particulars	Cash	Bank	Date	Particulars	Cash	Bank
		N	N			N	N
1/1/x4	Bal. b/d	x	X	1/1/x4	Transport expenses	X	x
2/1/x4	Bank (contra)	X		2/1/x4	Cash (Contra)		x

3/1/x4	Sales	x		6/1/x4	Wages	X	
5/1/x4	Ahmed		X	11/1/x4	Rent	X	
6/1/x4	Sales	x		12/1/x4	Transport Expenses	X	
22/1/x4	Cash (contra)		X	22/1/x4	Bank (contra)	x	
25/1/x4	Biola	x		25/1/x4	Equipment		x
				26/1/x4	Stationery	x	
				28/1/x4	Salaries and Wages	X	
				29/1/x4	Bal. c/d	x	x
		x	x			x	x
1/2/x4	Bal. b/d	x	x				

Contra Entry: This is an entry that is used to describe the movement of cash between the office and the bank. This entry affects both sides of the cash book i.e the credit and the debit sides.

3.2.2 3- Column Cash Book

This cash book has a third column on either side in addition to the two columns for cash and bank. The third column is for cash discounts. The discount column on the left-hand side is for discounts allowed (an expense) while the discount column on the right-hand side is for discount received (an income).

Discount is divided into two: Trade discount or cash discount.

3.2.2.1 Trade Discount

Trade discount is the amount allowed off normal selling price at the time goods are being sold to encourage the customer to buy the goods or to buy in larger quantity than he would have done ordinarily.

3.2.2.2 Cash Discount

Cash discount is the amount allowed off the amount owed by a debtor to encourage the debtor to settle his debt within a stipulated period. It should be noted that trade discount is not normally recorded in the double-entry system except that its calculation would be indicated on the sales invoice. But cash discounts are recorded in the Double-entry system and it is an expense to the person granting but an income to the one receiving it.

Typical format of a 3-column cash book

3. Column Cash Book

Date	Particulars	Disc.	Cash	Bank	Date	Particulars	Disc.	Cash	Bank
		N	N	N			N	N	N
1/1/x4	Bal. b/d		x	X	1/1/x4	Transport expenses		x	x
2/1/x4	Bank (contra)				2/1/x4	Cash (Contra)		x	x
3/1/x4	Sales	x			6/1/x4	Wages			
6/1/x4	Sales	x			7/1/x4	Johnson	X		x
22/1/x4	Cash (contra)		x		8/1/x4	Electricity		x	
25/1/x4	Biola				9/1/x4	Okechukwu & Co	X		x
				X	12/1/x4	Transport Expenses			
					22/1/x4	Bank (contra)			
					25/1/x4	Equipment		x	x
					26/1/x4	Stationery			
					28/1/x4	Salaries and Wages			
					29/1/x4	Bal. c/d			
		x	x	x			x	x	x
1/2/x4		bal. c/d	x	X					

Illustration

Using the following transactions, prepare a 2-column cash book and a 3-column cash book and balance the cash book at the end of the month.

March 2 Cash sales, N 136,000

March 3 Received cheque from Amadin & Co N 285,000

March 5 Purchased goods for cash, N120,000

March 6 Cash sales, N184,000

March 7 Paid to E. Nelson N 65000, discount received N 300

March 9 Paid cash into bank, N 100,000

March 11 Paid E. Faith cheque N156,000, received N 4000 discount March 12 Received from A. Osarobo , cash N 98000 discount allowed N 2,000 March 13 Received from E. Oluwaseun , N 97,000, discount allowed N3,000 March 15 Sold goods and received cheque, N330,000

March 16 Withdrew cash from bank, N 108,000

March 17 Purchased goods for cash, N 88,000

March 19 Received cheque from B. Olumide N237,000

March 21 Sold goods for cash N 119,000

March 22 Paid cash into bank N300,000

March 25 Paid Aminu , cheque N86,000, received discount N2000

March 26 Paid cheque to Chinedu Obina, N216,000

March 26 Purchased goods and paid cheque, N186,000

March 27 Cheque received from B. Olumide was dishonoured by bankers

March 28 Paid vehicle insurance by cheque N46,000

2-Column Cash Book

Date	Particulars	Cash	Bank	Date	Particulars	Cash	Bank
		N	N			N	N
March 2	Sales	136,000		March 5	Purchases	120,000	
3	Amadin and Co	285000		7	E. Nelson	65,000	
6	Sales	184,000		9	Bank	100,000	
9	Cash (Contra)		100,000	11	E. Faith		156,000
12	A. Osarobo	98,000		16	Cash		108,000
13	E. Oluwaseun	97,000		17	Purchases	88,000	
15	Sales		330,000	22	Bank	300,000	
16	Bank (Contra)	108,000		25	Bank		86,000
19	B.Olumide		237,000	26	Chinedu O.		216,000
21	Sales	119,000		26	Purchases		186,000
22	Cash		300,000	27	B.Olumide		237,000
				28	Vehicle Insurance		46,000
						69,000	217,000
		742,000	1,252,000			742,000	1,252,000
April 1	Bal. b/d	69,000	217,000				

3. Column Cash Book

Date	Particulars	Discount N	Cash N	Bank N	Date	Particulars	Discoun t N	Cash N	Bank N
March 2	Sales		136,000		Mar. 5	Purchases		120,000	
3	Amadin and Co 5,000 285000 7					E. Nelson	3,000	65,000	
6	Sales 184,000				9	Bank		100,000	
9	Cash (Contra) 100,000 11					E. Faith	4,000		156,000
12	A.Osarobo	2,000	98,000		16	Cash			108,000
13	E.Oluwaseun	3,000	97,000		17	Purchases		88,000	
15	Sales			330,000 22		Bank		300,000	
16	Bank (Contra)		108,000		25	Bank	2,000		86,000
19	B.Olumide			237,000 26		Chinedu Obinna			216,000
21	Sales		119,000		26	Purchases			186,000
22	Cash			300,000 27 28		B.Olumide			237,000
						Vehicle Insurance			46,000
						Bal c/d		69,000	217,000
		10,000	742,000	1,252,000			9,000	742,000	1,252,000
April 1	Bal. b/d		69,000	217,000					

SELF ASSESSMENT EXERCISE

1. What is a cash book?

4.0 CONCLUSION

The cash book is an indispensable book of entry because cash - at hand and bank- is necessary in the running of the day-to-day activities in an organization. Good records of monies going in and out of the organization should be closely monitored.

5.0 SUMMARY

In this unit, we discussed the importance of cash transactions. We also differentiated between a trade discount and a cash discount.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between a trade discount and a cash discount

2. Explain the term 'Contra Entry".

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Aguolu, O. (2010). *Financial Accounting. A Practical Approach* . Institute for Development Studies, Enugu, Nigeria

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UNIT 8 THE PETTY CASH BOOK

CONTENTS

1.0 INTRODUCTION

The petty cash book is used to record the receipt and payment of small amounts of cash. Any large amounts of cash received and cash takings are usually paid into the bank and thus recorded in the cash book. The petty cash book is written up from receipts and petty cash vouchers (where employees are reimbursed expenses).

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Explain the relationship between a petty cash book and the cash account in the general ledger, including the implications of the petty cash book being a book of prime entry as well as being a part of the double-entry system.
- Describe the format of a columnar petty cash book.
- Explain the function of the analysis columns in a columnar petty cash book.
- Describe the petty cash imprest system and its advantages.
- Enter transactions in a columnar petty cash book using the imprest system, and post these to the appropriate ledger accounts.

3.0 MAIN CONTENT

3.1 The Columnar Petty Cash Book

It is usual for a (columnar) petty cash book to have analysis columns on the credit side. Each column relates to a particular type of expenditure, such as postage, stationery or travelling expenses. These are intended to facilitate the posting of entries to the general ledger. Every item of expenditure is entered in both the credit column and an appropriate analysis column. At the end of each calendar week or month the total of each analysis column is debited to the relevant ledger account in the general ledger. Thus, instead of posting each transaction to the general ledger separately, expenditure of the same type is collected together in each analysis column and the total for the period posted to the relevant ledger account.

3.2 The Imprest System

Many firms also operate their petty cash on an imprest system. At the beginning of each period (week or month) the petty cashier has a fixed amount of cash referred to as a float. At the end of each period (or the start of the next) the petty cashier is reimbursed the exact amount spent during the period, thus making the float up to its original amount. The reimbursement usually takes the form of a cheque drawn for cash. The amount of the petty cash float is determined by reference to the normal level of petty cash expenditure in each period.

The advantages of the imprest system are as follows:

1. It facilitates control of the total petty cash expenditure in each period as the petty cashier cannot spend more than the amount of the float, except by applying to the management for an increase.

2. It deters theft of cash by the petty' cashier since a large cash balance cannot be accumulated by drawing cash from the bank at irregular intervals.

3. The entries in the petty cash book are kept up to date because the cash expenditure is not reimbursed until the petty cash book is written up and the total amount of expenditure for the period is known.

4. It discourages the practice of loans from petty cash since these would have to be accounted for at the end of the period, and in addition may result in insufficient cash to meet the necessary expenditure.

ILLUSTRATION

A.Santos uses a columnar petty cash book to record his cash payments. He also operates an imprest system with a float of N150,000. During August 20X2 the cash transactions were as follows:

1 Aug Postage stamps: N5,000
2 Aug Cleaning materials: N13,000
4 Aug Recorded delivery: N2,000
5 Aug Gratuity to delivery man: N4,000
7 Aug Tea, milk, etc.: N1,000
9 Aug Rail fare: N11,000
10 Aug Paper clips and pens: N6,000
13 Aug Window cleaner: N10,000
18 Aug Travelling expenses: N7,000
21 Aug Envelopes: N3,000
22 Aug Postage stamps: N9,000
24 Aug Stationery: N14,000
27 Aug Taxi fare: N12,000
28 Aug Office cleaning: N8,000
31 Aug Received reimbursements to make float up to N150,000

You are required to make the necessary entries in the petty cash book using appropriate analysis columns, and show the relevant general ledger account entries.

The petty cash book

Debit Amount N'000	**Date**	**Details**	**Amount** N'000	**Credit** Telephone and postage N'000	**Cleaning** N'000	**Printing and Stationery** N'000	**Traveling expenses** N'000	**Miscellaneous expenses** N'000
	20X2							
	1 Aug	Stamps	5	5				
	2 Aug	Materials	13		13			
	4 Aug	Recorded Delivery	2	2				
	5 Aug	Gratuity	4					4
	7 Aug	Tea and milk	1					1
	9 Aug	Rail fare	11				11	
b/d 150	10 Aug	Clips and pen	6			6		
105	13 Aug	Windows	10		10			
255	18 Aug	Travelling	7				7	
b/d 150	21 Aug	Envelopes	3			3		
	22 Aug	Stamps	9	9				
	24 Aug	Stationery	14			14		
	27 Aug	Taxi	12				12	
	28 Aug	Office	8		8			
	31 Aug	Reimbursement	105	16	31	23	30	5
	31 Aug	Balance c/d	150					
			255					

Alternatively, the cash reimbursement is made at the beginning of the next period, in which case the entries are as follows (highlighted by shading):

Debit Amount N'000	**Date**	**Details**	**Amount** N'000	**Credit** Telephone and postage N'000	**Cleaning** N'000	**Printing and Stationery** N'000	**Traveling expenses** N'000	**Miscellaneous expenses** N'000
150	31 Aug	Totals	105	16	31	23	30	5
b/d 45	31 Aug	Balance c/d	45					
105			150					
150	1 Sept	Reimbursement						

Ledger entries

Telephone and postage

20X2	**Details**	**N'000**
31 Aug	Total per PCB	16

Cleaning

20X2	**Details**	**N'000**
31 Aug	Total per PCB	31

Printing and stationery

20X2	**Details**	**N'000**
31 Aug	Total per PCB	23

Travelling expenses

20X2	**Details**	**N'000**
31 Aug	Total per PCB	30

Miscellaneous expenses

20X2	**Details**	**N'000**
31 Aug	Total per PCB	5

Cash book (bank account)

20X2	**Details**	**N'000**	**20X2**	**Details**	**N'000**
31 Aug	Total per PCB	xxxx	31 Aug	Total per PCB	105

Self Assessment exercise

1. Describe the purpose and format of a columnar petty cash book.
   a.
   b. Explain how you would determine the appropriate number of analysis columns.
2. Describe how a petty cash imprest system operates.
   a.
   b. Explain how such a system facilitates control.

4.0 CONCLUSION

When designing a columnar petty cash book it is necessary first to decide on the appropriate number of analysis columns. This is done by identifying the number of different types of expenditure for which there is more than one transaction. In Example 1 there are four different types, namely postage, cleaning, stationery and travelling expenses. These four, plus a column for miscellaneous expenses, give five columns. The headings for each of these columns should be the same as the name of the general ledger account to which the total of the column will be posted.

5.0 SUMMARY

In this unit we have been able to treat the petty cash book. We noticed that the petty cash book is both a book of prime entry and a part of the double-entry system in the ledger, and thus has the same format as a ledger account. It is used to record cash receipts and payments, and is written up from copies of the receipts and petty cash vouchers. The petty cash book replaces the cash ledger account in the general ledger, and thus entries in this book need only to be posted to the opposite side of the relevant ledger accounts.

6.0 TUTOR MARKED ASSIGNMENT

C.Harrow has a petty cash book that is used to record his cash receipts and payments. This also incorporates an imprest system that has a float of N400,000. During February 20X4 the following cash transactions took place:

1 Feb Purchases: N31,000
3 Feb Wages: N28,000
6 Feb Petrol for delivery van: N9,000
8 Feb Bus fares: N3,000
11 Feb Pens and pencils: N8,000
12 Feb Payments for casual labour: N25,000
14 Feb Repairs to delivery van: N17,000
16 Feb Copying paper: N15,000
19 Feb Goods for resale: N22,000
20 Feb Train fares: N12,000
21 Feb Repairs to premises: N35,000
22 Feb Postage stamps: N6,000
23 Feb Drawings: N20,000
24 Feb Taxi fares: N7,000 25
Feb Envelopes: N4,000 26
Feb Purchases: N18,000
27 Feb Wages: N30,000
28 Feb Petrol for deliver van: N14,000
On 28 February 20X4 the cash float was restored to N400,000.

Record the above in the petty cash book using appropriate analysis columns and make the necessary entries in the ledger.

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 9 THE FINAL FINANCIAL STATEMENTS OF SOLE TRADERS

CONTENTS

1.0 INTRODUCTION

Financial statements consist of a statement of comprehensive income (or statement of profit and loss) and a statement of financial position. These are prepared after the trial balance has been completed. Some businesses also produce financial statements yearly, quarterly or even monthly. This chapter focuses on the preparation of financial statements for sole traders.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Explain the purpose and structure of statements of profit and loss. Explain the purpose and
- structure of statements of financial position. Describe the nature of administrative
- expenses, selling and distribution expenses, non- current assets, current assets, current liabilities, non-current liabilities and capital. Explain the relevance of inventory and the
- cost of sales in the determination of gross profit. Prepare a simple statement of profit and loss and statement of financial position from a trial
- balance using either an account/horizontal format or a vertical format.

3.0 MAIN CONTENT 3.1 The Purpose and structure of statement of profit and loss

The purpose of a statement of profit and loss is to enable users of financial statements, such as the owner, to evaluate the financial performance of a business for a given accounting year. It may be used to determine the amount of taxation on the profit.

The basic format of the statement of profit and loss is shown below.

Statement of profit and loss for the year 201X

	N	N
Revenue		x
Less: Cost of sales		(x)
Gross profit		x
Less: **other costs and expenses**		
Selling and distribution cost	x	
Administrative expenses	x	
Interest payable on loans	x	
		(x)
Profit/(Loss) for the period		x

An example of the layout of a statement of profit and loss for a sole trader

In the financial statements of sole traders and partnerships, the actual composition of each of the above groupings of costs would be shown in detail. Selling and distribution costs include advertising expenditure, the wages of delivery-van drivers, motor expenses including petrol and repairs, and so on. Administrative expenses usually comprise the salaries of office staff, rent and rates, light and heat, printing and stationery, telephone and postage, and so on.

3.1.1 Gross Profit: Inventory and the Cost of Sales

The first stage in the determination of the profit for the year involves calculating gross profit. It is usually carried out in the statement of profit and loss. However, this part of the statement of profit and loss is sometimes presented as a separate account referred to as the 'trading account'. The gross profit for a given period is computed by subtracting the cost of goods sold/cost of sales from sales revenue.

Example

S.Musa, whose accounting year ends on 30 April, buys and sells one type of product. On 1 May 20X3 there were 50 units in inventory that had cost N100,000 each. During the subsequent accounting year he purchased a further 500 units at a cost of N100,000 each and sold 450 units at a price of N150,000 each. There were 100 units that cost N100,000 each that had not been sold at 30 April 20X4. You are required to compute the gross profit for the year.

S.Mann

Trading account for year ending 30 April 20X4

Units		**N,000**	**N,000**
450	Sales Revenue		67,500
	Less: Cost of Goods Sold:		
50	Inventory of Goods At May 1 20X3	5,000	
500	Add: Goods Purchased During The Year	50,000	
550	Cost of goods available for sale	55,000	
100	Less: Inventory of goods at 30 April 20X4	10,000	
450	Cost of sales		45,000
	Gross profit for the year		22,500

Note: The number of units is not usually shown in a trading account. They have been included in the above to demonstrate that the cost of sales relates to the number of units that were sold.

3.1.2 The Trading Account

The trading account is an account in the general ledger and is thus a part of the double-entry system. It is used to ascertain the gross profit and is prepared by transferring the balances on the sales revenue, purchases and returns ledger accounts to the trading ledger account. In addition, certain entries are required in respect of inventory. These are as follows:

1. Inventory at the start of the period:
   Debit: Trading account

   Credit: Inventory account
2. Inventory at the end of the period:

   Debit:
   Inventory account

   Credit:
   Trading account

Note that the inventory at the start of the period will be the inventory at the end of the previous period. This is a statement of financial position account.

Prior to the preparation of the trading account the ledger will appear as follows:

Sales revenue

0X4	**Details**	**N'000**	**0X4**	**Details**	**N'000**
		0	Apr	Balance b/d	67,500 Purchases

20X4	**Details**	**N'000**
30 Apr	Balance b/d	50,000

Inventory

20X3	**Details**	**N'000**
30 Apr	Balance b/d	5,000

The trading income account will then be prepared as follows:

Sales revenue

20X4	Details	N'000	20X4	Details	N'000
30 Apr	Trading account	67,000	30 Apr	Balance b/d	67,000

Purchases

20X4	Details	N'000	20X4	Details	N'000
30 Apr	Balance b/d	50,000	30 Apr	Trading account	50,000

Inventory

20X4	Details	N'000	20X4	Details	N'000
1 May	Balance b/d	5,000	30 Apr	Trading account	5,000
20X4					
30 Apr	Trading account	10,000			

S.Musa

Trading income account for year ending 30 April 20X4

	N'000		**N'000**
Inventory at 1 May 20X3	5,000	Sales revenue	65,500
Purchases	50,000	Inventory at 30 April 20X4	10,000
Gross profit c/d	22,500		
	75,000		77,500
		Gross profit b/d	22,500

Notes

1. The gross profit is the difference between the two sides of the trading account and must be brought down to the opposite side of the account.
2. No date columns are shown in the trading account since the date appears as part of the heading of the account.
3. When the trading account is prepared in account form the inventory at the end of the year may be shown as' either a credit entry or deducted on the debit side as shown below. This has the advantage of showing the cost of sales.

S.Musa

Trading account for the year ended 30 April 20X4

	N'000			**N'000**
Opening inventory	5,000		Sales Revenue	67,500
Add: Purchases	50,000	55,000		
Less: Closing inventory		10,000		
Cost of sales		45,000		
Gross profit c/d		22,500		
		67,500		67,500
			Gross profit b/d	22,500

4. The trading income account is a ledger account in the general ledger and thus part of the double-entry system. However, when it is prepared for submission to the management, it is often presented vertically as shown at the start of Example 1. .
5. No entries other than those shown above (and the correction of errors) should be made in an inventory account. It is not a continuous record of the Value of inventory. ,
6. The inventory shown in a trial balance will always be that at the end of the previous year (and thus the opening inventory of the year to which the trial balance relates).

3.1.3 The statement of profit and loss

The statement of profit and loss is taken from a ledger account in the general ledger (called the profit and loss account) and thus is a part of the double-entry system. It is used to ascertain the profit (or loss) for the period and is prepared in the same way as the trading account. That is, the balances on the Income and expense ledger accounts in the general ledger are transferred to the profit and loss account by means of double entry.

3.2 The purpose and structure of a statement of financial position

The statement of financial position is a list of the assets, liabilities and capital of a business at the end of a given accounting period. It therefore provides information about the resources and debts of the reporting entity. The statement of financial position enables users of financial statements to evaluate the entity's financial position, in particular whether the business is likely to pay its debts or not. The statement of financial position is like a photograph of the financial state of affairs of a business at a specific time.

Statements of financial position contain five groups of items, as follows.

Non-current assets

These are items not specifically bought for resale but to be used in the production or distribution of those goods normally sold by the business. They are utilized to generate economic inflows to the entity. Non-current assets are durable goods that usually last for several years, and are normally kept by a business for more than one accounting year. Examples of non-current assets include land and buildings, plant and machinery, motor vehicles, office equipment, furniture, fixtures and fittings. These are tangible assets. The different types are recorded in separate ledger accounts with the balances on each account being disclosed in the statement of financial position.

In company financial statements tangible non-current assets are collectively referred to as 'property, plant and equipment' - only one combined figure would be disclosed in a company's statement of financial position.

Current assets

These are items that are normally kept by a business for less than one accounting year. Indeed the composition of each type of current asset is usually continually changing. Examples include, inventories, trade receivables, short-term investments, money in a bank account and cash.

Equity capital
This refers to the amount of money invested in the business by the owner(s). This can take the form of cash introduced or profits not withdrawn.

Non-current liabilities
These are debts owed by a business that are not due until after one year (often much longer) from the date of the statement of financial position. Examples include loans and mortgages.

Current liabilities
These are debts owed by a business that are payable within one year (often considerably less) from the date of the statement of financial position. Examples include trade payables and bank overdrafts.

ABC
Statement of financial position as at…
Non-current assets
+
Current assets
=
Total assets

Equity capital
+
Non-current liabilities
+
Current liabilities
=
Total equity and liabilities

An example of the key areas covered in a statement of financial position for a sole trader

Prepare a statement of financial position listing your assets and liabilities, or those of your family. Use an appropriate method of classifying the assets and liabilities and show the relevant totals and subtotals.

3.3 Preparing Financial Statements from the Trial Balance

It is important to appreciate that the general ledger entries described above to close the income and expenditure ledger accounts also have to be done, although students are not normally expected to show them in their answer to examination questions.

The following is the trial balance of A. Dauda at 31 March 20X3

	Debit N'000	Credit N'000
Capital		42,140
Drawings	13,600	
Loan from S. Rikha		10,000
Bank	5,800	
Cash	460	
Sales revenue		88,400
Purchases	46,300	
Sales returns	5,700	
Purchases returns		3,100
Inventory at 1 Apr 20X2	8,500	
Carriage inwards	2,400	
Carriage outwards	1,600	
Trade receivables	15,300	
Trade payables		7,200
Motor vehicles	23,100	
Fixtures and fitting	12,400	
Wages and salaries	6,800	
Rent	4,100	
Light and heat	3,200	
Telephone and postage	1,700	
Discount allowed	830	
Discount received		950
	151,790	151,790

The inventory at 31 March 20X3 was valued at N9,800,000. The loan from S. Rikha is repayable on 1 January 20X5.

Required

Prepare the statement of profit and loss and statement of financial position (horizontal format) for A. Dauda from the trial balance provided.

Solution

Ledger entries

Sales revenue a/c

Trading a/c	88,400	Balance b/d	88,400

Sale returns a/c

Balance b/d	5,700	Trading a/c	5,700

Purchases a/c

Balance b/d	46,300	Trading a/c	46,300

Purchases returns a/c

Balance a/c	3,100	Trading b/d	3,100

Inventories a/c

Balance b/d	8,500		
Trading a/c	9,800	Trading a/c	8,500

Carriage inwards a/c

Balance b/d	2,400	Trading a/c	2,400

Carriage outwards a/c

Balance b/d	1,600	Profit and loss a/c	1,600

Wages and salaries a/c

Balance b/d	6,800	Profit and loss a/c	6,800

Rent a/c

Balance b/d	4,100	Profit and loss a/c	4,100

Light and heat a/c

Balance b/d	3,200	Profit and loss a/c	3,200

Telephone and postage a/c

Balance b/d	1,700	Profit and loss a/c	1,700

Discount allowed a/c

Balance b/d	830	Profit and loss a/c	830

Discount received a/c

Profit and loss a/c	950	Balance b/d	950

Drawings a/c

Balance b/d	13,600	Capital a/c	13,600

All other accounts contain only the balances shown in the trial balance.

A.Dauda

Trading and profit and loss account for the year ended 31 March 20X3

	N'000	**N'000**		**N'000**
Inventory at 1 Apr 20X2		8,500	Sales revenue	88,400
Purchases	46,300		*Less:* returns	5,700
Less: Returns	3,100	45,600		82,700
	43,200	54,100		
Add: Carriage inwards	*2,400*	9,800		
		44,300		
Less: Inventory at 31 Mar 20X3		***38,400***		
Cost of sales		82,700		
Gross profit c/d to P/L a/c				82,700
Carriage outwards		1,600	***Gross profit b/d from***	***38,400***
Wages and salaries		6,800	Discount received 4,100	950
Rent		3,200		
Light and heat		1,700		
Telephone and postage				
Discount allowed		830		
Profit for the period c/d				39,350
		21,120		***21,120***
		39,350		
Capital a/c (Profit transferred)		21,120		42,140
			Profit for the year b/d	21,120
		Capital		63,260
Drawings		13,600	Balance b/d	49,660
Balance b/d		49,660	Profit and loss *a/c*	
		63,260		
			Balance b/d	

A. Dauda
Statement of financial position as at 31 March 20X3

redit	**N'000**	**ebit**	**N'000**	**N'000**
QUITY AND LIABILITIES		**SSETS**		
quity capital		**on-current assets**		
alance at 1 Apr 20X2,	42,140	otor vehicles		23,100
dd: Profit for year	21,120	ixtures and fittings		12,400
	63,260			35,500
ess: *Drawings*	13,600	**urrent assets**		
alance at 31 Mar 20X3	49,660	nventories	9,800 rade receivables	
on-current liabilities		15,300 ank	5,800 ash	
oan from S. Rikha	10,000	460 31,360		
urrent liabilities				66,860
rade payables	7,200			
66,860				

When the statement of profit and loss and statement of financial position are presented to the owner(s) and other stakeholders of a business, it is common to use a vertical format. This is illustrated next using the data above. This format is adapted from the suggested formats for statements of profit and loss under IAS 1 - *Presentation of Financial Statements* as it is deemed to provide the most useful information to the users; this method is utilized in this material from now on.

A.Dauda
Statement of profit and loss for the year ending 31 March 20X3

	N	**N**	**N**
Sale Revenue			88,400
Less: Returns			5,700 82,700
Less: Cost Of Sales:		8,500	
Inventory At 1 Apr 20x2	46,300		
Add: Purchases	3,100		
Less: Returns		43,300 2,400	
Add: Carriage Inwards		54,100 9,800	
Less: Inventory At 31 Mar 20X3			44,300
Gross profit			**38,400**
Add: Discount received			950 39,350
Less: Expenditure:			
Carriage outwards		1,600 Wages	
and salaries		6,800 Rent	
4,100 Light and heat		3,200	

Telephone and postage 1,700 Discount allowed
830 18,230
Profit for the year **21,120**

A.Dauda
Statement of financial position as at 31 March 20X3

ASSETS **N**
Non-current assets
Motor vehicles 23,100 Fixtures
and fittings 14,400 35,500
Current assets
Inventories 9,800 Trade
receivables 15,300 Bank
5,800 Cash 460
31,360
Total assets 66,860

OWNER'S EQUITY AND LIABILITIES
Owner's capital
Balance at 1 Apr 20X2 42,140 Add:
Profit for year 21,120 63,260
Less: Drawings 13,600 Balance
at 31 Mar 20X3 46,660
Non-current liabilities
Loan from S. Rikha 10,000
Current liabilities
Trade payables 7,200
Total liabilities 17,200
Total equity and liabilities 66,860

5.0 SUMMARY

Final financial statements comprise a statement of profit and loss and a statement of financial position. These are prepared at the end of the accounting year after the trial balance has been completed. The statement of profit and loss enables users to evaluate the performance of the enterprise. The statement of financial position is a list of the assets and liabilities (and capital) of a business at the end of a given accounting year. It enables users to evaluate the financial position of the enterprise, including whether it is likely to be able to pay its debts. In the statement of financial position, assets are classified as either non-current or current, and liabilities as either current or non-current.

6.0 TUTOR MARKED ASSIGNMENT

1. a. Explain the purposes of a statement of profit and loss and a statement of financial position.
   b. Describe the structure of each.

2. A company has 100 units in inventory at the start of the year valued at N1,000,000. During the year it purchases a further 500 units for N5,000,000 and sells 400 units for N8,000,000.

Required

a. What is the quantity and value of the closing inventories?
b. What is the gross profit for the year?
c. Prepare the trading account for the year.

7.0 REFERENCES/FURTHER READINGS

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

Wood, F. and Sangster, A. (2008). *Business Accounting*. Edinburgh Gate: Pearson Education Limited.

UNIT 10 DEPRECIATION AND NON-CURRENT ASSETS

CONTENTS

1.0 INTRODUCTION

This unit treats the depreciation of non-current assets also known as fixed assets. Depreciation is the gradual fall in the value of a non-current asset arising from wear and tear; passage of time and obsolescence.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Describe the nature, recognition and valuation of non -current assets including intangible non-current assets such as goodwill and development expenditure.
- Discuss the nature of depreciation.
- Describe the straight-line, reducing balance and sum of the years' digits methods of depreciating assets including the resulting pattern of charges to the statement of profit and loss over an asset's useful life, and the circumstances in which each might be the most appropriate.
- Compute the amount of depreciation using the methods in the point above, and show the relevant entries in the journal, general ledger, statement of profit and loss and statement of financial position.
- Compute the depreciation on an asset in the years of acquisition and disposal, and the profit or loss on disposal; and show the relevant entries in the journal, general ledger, statement of profit and loss and statement of financial position.

3.0 MAIN CONTENT 3.1 The Nature and Types of

Non-Current Assets

An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise' (the Framework) (IASC, 1989).

The ability to generate future economic benefits is arguably the most important criterion in determining whether expenditure is to be classified as an asset, or not. Assets are categorized as being either current or non- current into cash or near cash in the near future -usually in a period of less than one year. Current assets include assets whose useful economic lives do not exceed one year before they are transformed into other kinds of assets. Current assets include inventories, trade receivables, short-term financial assets (investments), bank and cash.

Non-current assets are items not specifically bought for resale but to be used in the production or distribution of those goods normally sold by the business. They are durable goods that usually last for several years, and are normally kept by a business for more than one accounting year. However, expenditure on such items is only regarded as a non-current asset if it is of a material amount.

The Accounting Standards Committee (ASC) defines a non-current asset as an asset that:

a. is held by an enterprise for use in the production or supply of goods and services, for rental to others, or for administrative purposes and may include items held for the maintenance or repair of such assets;
b. has been acquired or constructed with the intention of being used on a continuing basis; and
c. is not intended for sale in the ordinary course of a business.

Money spent on non-current assets is referred to as capital expenditure. All other costs and expenses are referred to as revenue expenditure. The latter are entered in the statement of profit and loss for the year in which the costs are incurred.

Non-current assets are classified as either tangible or intangible.

Tangible assets are assets that have physical substance. Examples are motor vehicle, inventory, etc.

Intangible assets are defined as identifiable non-monetary assets without physical substance: Examples include goodwill, patents, trademarks, copyrights, fishing licences, milk quota, franchises, customer or supplier relationships, mortgage servicing rights, customer loyalty, market share, brand name and development expenditure such as expenditure creating computer software.

Goodwill usually arises in the statement of financial position because at some time in the past the business has taken over, or been formed from, another business.

3.2 The Recognition and Valuation of Non-Current Assets

The term 'valuation' refers to the amount at which assets are shown in the statement of financial position. IAS 16 allows non-current tangible assets to be valued using two approaches: historical cost and the alternative treatment, revalued amount.

Historical cost

In historical cost accounting, non-current assets are valued at their historical cost less the aggregate/accumulated depreciation from the date of acquisition to the date of the statement of financial position. The resulting figure is known as the written-down value (WDV), net book value (NBV) or net carrying amount. Depreciation is discussed below.

Revalued amount

The Companies Act 2006 and IAS 16 allow companies to revalue their tangible non-current assets and show them in the statement of financial position at fair value rather than historical cost. This is known as the alternative treatment.

- The carrying value for an asset accounted for under historical cost is its net book value.
- The carrying amount for a revalued asset is its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.

The current value of a tangible non- current asset to the business is the lower of replacement cost and recoverable amount. The recoverable amount is the higher of fair value and value in use.

3.3 The Nature of Depreciation

The purchase of a non-current asset occurs in one year but the revenue generated from its use normally arises over a number of years. This is referred to as its useful (economic) life. In IAS 16 the useful life of an asset is defined as 'the period over which an asset is expected to be available for use by an entity; or the number of production or similar units expected to be obtained from the asset by an entity'.

If the cost of non-current assets were treated as an expense in the statement of profit and loss in the year of purchase, this would probably result in an excessive loss in that year, and excessive profits in the years in which the revenue arose. This gives a misleading view of the profits and losses of each year and distorts comparisons over time. Thus, the cost of a non-current asset is not treated as an expense in the year of purchase but rather carried forward and written off to the statement of profit and loss over the useful economic life of the asset in the form of depreciation. The part of the cost of an asset that is 'used up' or 'consumed' in each year of the asset's useful economic life must be set against the revenue that this generates (in conjunction with other factors of production). That part of the cost of a non-current asset, which is 'used up' or 'consumed' during an accounting period, is referred to as 'depreciation; Thus, depreciation may be defined as the allocation of the cost of a non-current asset over the accounting periods that comprise its useful economic life to the business according to some criterion regarding

IAS 16 defines depreciation as 'the systematic allocation of the depreciable amount of an asset over its useful life' where the depreciable amount is 'the cost of the asset, or other amount attributed to that asset, less its residual value:

The allocation tries to measure the reduction in the economic benefits available from the tangible non-current asset or to capture the economic benefits that have been consumed during the period. Consumption is generally considered to include the wearing-out, using-up or other reduction in the useful economic life of a tangible non -current asset. The reduction can be caused by wear and tear as a result of use, the passing of time or obsolescence through either changes in technology or demand for the goods and services produced by the asset.

Obsolescence through technological change refers to the situation where a new model of the asset, is significantly more efficient or performs additional functions, comes on to the market. Obsolescence through demand changes occurs when there is a substantial reduction in demand for the firms product because of, for example, technological advances in competitors' products. Both of causes of obsolescence usually result in a sudden, relatively large decrease in value of the asset, particularly where it cannot be used for any other purpose.

3.4 Methods of Depreciation

A number of different methods have been developed for measuring depreciation, each of which will give a different annual charge to the statement of profit and loss. There is no one method of depreciation that is superior to all others in all circumstances. The most appropriate method will depend on the type of asset and the extent to which it is used in each period.

Whichever method is used to calculate depreciation, at least three pieces of data relating to the asset in question are needed:

1. the historical cost of the asset;
2. the length of the asset's expected useful economic life to the business;
3. The estimated residual value of the asset at the end of its useful economic life. The useful life of an asset refers to the period that the business regards as being the most economical length of time to keep the particular asset. This will depend on a number of factors, such as the pattern of repair costs. The useful life of an asset may well be considerably shorter than its total life. Residual value refers to the estimated proceeds of sale at the end of the asset's useful life to the business. This is usually considerably more than its scrap value. It should be noted that both the useful life and the residual value have to be estimated when the asset is purchased.

As mentioned earlier, the difference between the historical cost of a tangible non -current asset and its residual value is referred to in IAS 16 as the 'depreciable amount'. According to IAS 16, the depreciable amount of a tangible non-current asset should be allocated to reflect the pattern in which the economic benefits are expected to be consumed by the entity. The two most common methods of depreciation are the straight-line/fixed installment method and reducing balance method. Another method more common in the USA is the sum of the years' digits method (sum of digits). These are described below.

The straight-line/fixed installment method

Under this method the annual amount of depreciation that will be charged to the statement of profit and loss, referred to as the depreciation expense, is computed as follows:

$$\text{Depreciation} = \frac{\text{Cost} - \text{Estimated Residual value}}{\text{Estimated useful life in years}}$$

Alternatively the annual rate of depreciation can be expressed as a percentage. The annual amount of depreciation is then calculated by applying this percentage to the cost of the asset.

$$\text{Depreciation} = \text{Rate of depreciation} \times \text{Cost of asset}$$

This method gives the same charge for depreciation in each year of the asset's useful life. It is therefore most appropriate for assets that are depleted as a result of the passage of time (e.g. buildings, leases, pipelines, storage tanks, patents and trademarks). The method may also be suitable where the utilization of an asset is the same in each year.

The main advantages of the straight-line method are that it is easy to understand and the computations are simple. The main disadvantage is that it may not give an accurate measure of the reduction in the useful life of an asset.

The diminishing/reducing balance method

Under this method it is necessary first to compute the annual rate of depreciation as a percentage, as follows:

$$\text{Rate of depreciation} = 100 - \left(\sqrt[ul]{\frac{\text{Residual value}}{\text{Cost}}} \times 100\right)$$

where ul refers to the estimated useful life.

The annual amount of depreciation that will be charged to the statement of profit and loss is then computed as:

$$\text{Depreciation} = \text{Rate of depreciation} \times \text{WDV of asset (at start of year)}$$

The WDV of the asset refers to its cost less the aggregate depreciation of the asset since the date of acquisition. This method gives a decreasing annual charge for depreciation over the useful life of the asset. It is therefore most appropriate for non -current assets that deteriorate primarily as a result of usage where this is greater in the earlier years of their life (e.g. plant and machinery, motor vehicles, furniture and fittings, office equipment).

The main criticisms of this method relate to its complexity, and there is an arbitrary assumption about the rate of decline built into the formula.

The sum of the years' digits method

Under this method the annual amount of depreciation that will be expensed in the statement of profit and loss is computed by multiplying the depreciable amount by a fraction. The denominator in this fraction is the same each year, and is the sum of a decreasing arithmetic progression, the first number of which is the useful life of the asset and the last is one. For example, where an asset has a useful life of three years, the denominator is calculated as follows (3 + 2 + 1 = 6), with the numerator in the fraction being the number of years of the asset's remaining useful life at the start of the accounting year in question (e.g. 3 years, 2 years, 1 year). Therefore, in year one the depreciable amount will be multiplied by in year two the depreciable amount will be multiplied by and so on.

This method gives a decreasing annual charge for depreciation over the useful life of the asset that is similar to, but not the same amount as, the reducing balance method. The arguments for and against the sum of the years' digits method are thus the same as those relating to the reducing balance method except that the former is simpler. Moreover, the difference in the annual depreciation expense highlights the arbitrary nature of the different assumptions about the rates of decline that are built into the two methods.

3.5 Accounting for Depreciation

The accounting entries in respect of the annual charge for depreciation are made after the trial balance been extracted when the statement of profit and loss is being prepared. These consist of the following:

Debit: Depreciation expense account

Credit: Provision for depreciation account

The depreciation expense account is transferred to the profit and loss account thus:

Debit: Profit and loss account

Credit: Depreciation expense account

The effect is to accumulate the provision while making a charge in the statement of profit and loss each year.

ILLUSTRATION

D.McDonald has an accounting year ending on 31 December. On 1 January 20X3 he purchased a machine for N1,000, which has an expected useful life of three years and an estimated residual value of N343.

Required

a. Calculate the amount of depreciation in each year of the asset's useful life using: (i) the straight-line method; (ii) the reducing balance method; and (iii) the sum of the years' digits method.

b. Show the journal and ledger entries relating to the purchase and the provision for depreciation in each year (using the amounts calculated from the straight-line method).

c. Show the relevant entries on the statement of financial position for 20X4 (using the amounts calculated from the straight-line method).

solution

a. The calculation of depreciation

i. The straight-line method:

Annual depreciation = NI000-N343 = N219 per annum 3

ii. The reducing balance method:

Depreciation rate = 100 − $\left(\sqrt[3]{\frac{343}{1000}} \times 100\right) = 100 - (0.7 \times 100) = 30$ per cent

The annual amount of depreciation is calc ... s
the aggregate depreciation of previous ye ...

For 20X3: 30% of N1,000 = N300
For 20X4: 30% of (N1,000 – 300) = N210
For 20X5: 30% of [N1,000 – (N300 + N210)] = N147

iii. The sum of the years' digits method:

Depreciable amount = N1,000 - N343 = N657
Sum of the years' digits = 3 + 2 + 1 = 6

Annual depreciation:

For 20X3: x N657 = N329

For 20X4: x N657 = N219 For

20X5: x N657 = N109

b. The *ledger entries (straight line only)*

The journal

20X3

31 Dec	epreciation expense	Dr	219	
	o provision for depreciation	Cr		219
	eing the charge for depreciation on plant for 20X3			
31 Dec	tatement of profit and loss	Dr	219	
	o depreciation expense	Cr		219
	eing the entry to close the depreciation expense			

ccount at the year end

Plant and machinery

20X3	**Details**	**N**
1 Jan	Bank	1,000

Depreciation expense account

20X3	**Details**	**N**	**20X3**	**Details**	**N**
31 Dec	Provision for depreciation A/C	219	31 Dec	P/L A/C (depreciation charge)	219
20X4			**20X4**		
31 Dec	Provision for depreciation A/C	219	31 Dec	P/L A/C (depreciation charge)	219
20X5			**20X5**		
31 Dec	Provision for depreciation A/C	219	31 Dec	P/L A/C (depreciation charge)	219

Provision for depreciation on plant and machinery

20X3	**Details**	**N**	**20X3**	**Details**	**N**
31 Dec	Balance c/d	219	31 Dec	depreciation expense a/c	219
20X4			**20X4**		
			1 Jan	Balance b/d	219 31
31 Dec	Balance c/d	438 438	Dec	depreciation expense a/c	219 438
20X5			**20X5**		
			1 Jan	Balance b/d	438 31
31 Dec	Balance c/d	657	Dec	depreciation expense a/c	219
		657			657
			20X6		
			1 Jan	Balance b/d	657

The entries for 20X4 and 20X5 would be exactly the same.

c. The statement of financial position at 31 December 20X4 would appear as follows:

Non-current assets	**N**
Plant and machinery at cost	1,000
Less: Provision for depreciation	438
written down value (WDV)	562

Alternatively, where there are several types of non-current asset, it is easier to present the non-current assets in columnar form as follows:

Non-current assets

		Cost	Provision depreciation	WDV
N	N	N Plant and machinery		1,000
			438	562

3.6 Profits and Losses on the Disposal of Non-Current Assets

Almost without exception, when an asset is sold at the end of (or during) its useful life the proceeds of sale differ from the estimated residual value (or written -down book value (WDV) if sold during its useful life). Where the proceeds are less than the WDV, this is referred to as a loss on sale. Where the proceeds are greater than the WDV, this is referred to as a profit on sale. Suppose the asset was sold on 31 December 20X5 for N400. The WDV is the difference between the cost of the asset and the aggregate depreciation up to the date of disposal; that is, N1,000 - N657 = N343. The profit (or loss) on sale is the difference between the proceeds of sale and the WDV of the asset. There is thus a profit on sale of N400 - N343 = N57.

When a non-current asset is sold the cost of the asset is transferred from the non-current asset account to an asset disposals account. This is sometimes referred to as an 'asset realization account: The aggregate depreciation on the asset that has been sold, the proceeds of sale, and the cost of the asset are all entered in the disposals account. The balance on this account is either a profit or a loss on sale. This will be transferred to the profit and loss account.

This is illustrated with the continuation of the illustration and the additional data above in.

The Journal

20X5

31 Dec Provision for depreciation Dr 657 To: asset disposals account Cr 657 Being the aggregate depreciation at the date of sale
of the asset removed from the ledger account.

31 Dec Asset disposals account Dr 1,000 To: Plant and machinery Cr 1,000 Being the cost of asset at the date of sale removed
From the ledger account.

31 Dec Plant and machinery Dr 57 To: profit and loss account Cr 57 Being the profit on sale of plant and machinery to
P/L A/C

The Ledger Entries

Plant and machinery

20X3	Details	N	20X5	Details	N
	Bank – purchase	1,000	31 Dec	Asset disposals a/	
		1,000			1,000

Provision for depreciation

20X5	Details	N	20X5	Details	N
31 Dec	Asset disposals a/c	657	31 Dec	Balance b/d	657

Asset disposals account (Plant and machinery)

20X5	Details	N	20X5	Details	N
			31 Dec	Bank – proceeds of scale	400 31
31 Dec	Plant and machinery	1,000 31	Dec	Provision for depreciation	657 31
			Dec	Profit and loss a/c (any loss on sales)	
Dec	Profit and loss a/c				1,057
	(profit on sale)	57			
		1,057			

Profit and loss account

	N		N
Loss on sale of non-current assets	–	Profit sale of plant and machinery	57

4.0 CONCLUSION

A non-current asset is an asset that is held by an enterprise for use in the production or supply of goods and services, has been acquired with the intention of being used on a continuing basis, and is not intended for sale in the ordinary course of business.

All non-current assets except for land and investment properties must be depreciated in the final financial statements. Depreciation is 'the systematic allocation of the depreciable amount of an asset over its useful life' where the depreciable amount is 'the cost of the asset, or other amount attributed to that asset less its residual value'.

There is a range of acceptable depreciation methods. Management should select the method regarded as most appropriate to the type of asset and its use in the business so as to allocate depreciation as' fairly as possible to the periods expected to benefit from the asset's use. The depreciation method adopted should reflect the consumption, wearing-out, using-up or other reduction in the useful economic life of a non- current asset whether arising from use, effluxion of time or obsolescence. The two most common methods are the straight-line/fixed instalment method and diminishing/reducing balance method. The former gives the same charge for depreciation in each year of the asset's useful life. The latter results in a decreasing-annual charge over the useful life of the asset.

5.0 SUMMARY

In this unit, we have discussed the nature and types of non-current assets, the recognition and valuation of non-current assets, the nature of depreciation, methods of depreciation, accounting for depreciation and profits and losses on the disposal of non-current assets.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the nature of non -current assets.
2. a.Explain the difference between capital expenditure and revenue expenditure.
   b. What criteria would you use to decide whether expenditure should be classified as relating to a non-current asset?
3. Briefly explain the circumstances in which each of the following would be regarded as a non- current asset: (a) tools; (b) investments; and (c) advertising expenditure.
4. You bought a lorry for N5,000,000.
   Its useful life is estimated at four years.

The residual value is expected to be N1,000,000 after the four years. Required

Calculate the depreciation charge for each of the four years using the straight line, reducing balance and the sum of digits methods.

8.0 REFERENCES/FURTHER READINGS

Igben, R.O. (2014) *Financial Accounting Made Simple*. Mushin: ROI Publishers

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

UNIT 11 BAD DEBTS AND PROVISIONS FOR BAD DEBTS

CONTENTS

1.0 INTRODUCTION

In this unit, we shall be discussing about bad debts and provision for bad debts. Bad debts are debts which has become irrecoverable because of inability of the debtor to pay, disappearance of the debtor and debt of the debtor.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Explain the nature of bad debts, provisions and provisions for doubtful debts.
- Distinguish between specific and general provisions for doubtful debts.
- Show the entries for bad debts and provisions for doubtful debts in the journal, general ledger, statement of profit and loss and statement of financial position.

3.0 MAIN CONTENT

3.1 The Nature and Ledger Entries for Bad Debts

When goods are sold on credit, it sometimes transpires that the customer is unwilling or unable to pay the amount owed. This is referred to as a bad or irrecoverable debt. The decision to treat a debt as bad is a matter of judgement. A debt may be regarded as irrecoverable for a number of reasons, such as being unable to trace the credit customer, it not being worthwhile financially to take the credit customer to court, or the credit customer being bankrupt. However, if a credit customer is bankrupt, this does not necessarily mean that the whole of the debt is irrecoverable. When a person is bankrupt, his or her possessions are seized and sold in order to pay the creditors. Such payments are often made in instalments known as 'dividends'. Frequently, the dividends do not consist of the repayment of the whole of the debt. Thus, when the 'final dividend' is received, the remainder of the debt is irrecoverable.

When a debt is regarded as irrecoverable the entries in the ledger are as follows:

Debit: Bad debts ledger account

Credit: Trade receivables ledger account (the individual credit customer's account would also be amended in the sales ledger)

Occasionally, debts previously written off as bad are subsequently paid. When this happens, the ledger entries are the reverse of the above, and the trade receivables ledger account is credited with the money received in the normal way.

Debit: Trade receivables ledger account (the individual credit customer's account would be amended in the sales ledger)

Credit: Bad debts ledger account

At the end of the accounting year the balance on the bad debts account is transferred to the statement of profit and loss.

3.2 The Nature and Ledger Entries for Provisions for Bad Debts

A provision is the setting-aside of income to meet a known or highly probable future liability or loss, the amount and/or timing of which cannot be ascertained exactly, and is thus an estimate. An example would be a provision for damages payable resulting from a legal action where the verdict had gone against the business but the amount of the damages had not been fixed by the court at the end of the accounting year, If the damages had been fixed, these would be treated not as a provision but as a liability, Another example of a provision is depreciation.

It should be noted that when accountants talk of setting aside income, what they mean is that 'funds' are being retained in the business but not put into a separate bank account. The funds are automatically retained in the business by designating part of the income as a provision, since this reduces the profit that is available for withdrawal by the owner(s) of the business.

The need for a provision for bad/doubtful debts essentially arises because goods sold and recognized as sales revenue in one accounting year may not become known to be a bad debt until the following accounting year. Thus, the profit of the year in which the goods are sold would be overstated by the amount of the bad debt. In order to adjust for this, a provision in respect of probable bad debts is created in the year of sale (matching concept).

A provision for bad debts may consist of either a specific provision or a general provision, or both. A specific provision involves ascertaining which particular credit customers at the year end are unlikely to pay their debts. A general provision is an estimate of the total amount of bad debts computed using a percentage (based on previous years' figures) of the trade receivables at the end of the current year. Where both specific and general provisions are made, the two amounts are added together and the total is entered in the general ledger.

The accounting entries in respect of a provision for bad debts are made after the trial balance has been extracted when the statement of profit and loss is being prepared. It is important to appreciate that any balance on a provision for bad debts account shown in a trial balance must therefore relate to the balance at the end of the previous year. A charge (or credit) is made to the statement of profit and loss in each year that consists of an amount necessary to increase (or decrease) the provision at the end of the previous year to the amount required at the end of the current year.

An increase in a provision always consists of:

Debit: Profit and loss account (increase in provision for bad debts)

Credit: Provision for bad debts account

A decrease in a provision is entered:

Debit: Provision for bad debts account

Credit: Profit and loss account (decrease in provision for bad debts)

The balance on the provision for bad debts account at the end of the year is deducted from trade receivables in the statement of financial position to give the net amount that is expected to be received from credit customers - that is, their net realizable value. The principle is similar to that applied in the case of a provision for depreciation where the accumulated depreciation at the end of the year, as shown by the balance on the provision for depreciation account, is deducted from the cost of the non-current asset in the statement of financial position. All other provisions such as for legal costs, damages or fines are shown in the statement of financial position as a current liability or non-current liability, depending on whether they are payable within one year or more from the date of the statement of financial position. The treatment of bad debts and provisions for bad debts is illustrated below.

ILLUSTRATION

A.Jones has an accounting year ending on 30 November. At 30 November 20X2 his ledger contained the following accounts:

	N
Trade receivables	20,000
Provision for bad debts	1,000

The trade receivables at 30 November 20X3 were N18,900. This includes an amount of N300 owed by F. Simons that was thought to be irrecoverable. It also includes amounts of N240 owed by C. Steven, N150 owed by M. Evans and N210 owed by A. Mitchell, all of which are regarded as doubtful debts.

You have been instructed to make a provision for bad debts at 30 November 20X3. This should include a specific provision for debts regarded as doubtful and a general provision of 5 per cent of trade receivables.

Show the ledger entries in respect of the above and the relevant statement of financial position extract.

Provision for bad debts at 30 November 20X3	**N**	
Specific provision- C. Steven	240	
M.Evans	150	
A.Mitchell	210	600
General provision - 5% x (N18,900-N300-N600)	900	1,500

The ledger

(Note: Assume the individual customer accounts are maintained in the general ledger; A. Jones does not keep a sales ledger.)

F.Simons (trade receivable)

20X3	**Details**	**N**	**20X3**	**Details**	**N**
30 Nov	Balance b/d	300	30 Nov	Bad debts	300

Bad Debts

20X3	**Details**	**N**	**20X3**	**Details**	**N**
30 Nov	F. Simons	300	30 Nov	Profit and loss a/c	300

Provision for Bad Debts

20X3	**Details**	**N**	**20X2**	**Details**	**N**
30 Nov	Balance c/d	1,500	1 Dec	Balance b/d	1,000
			20X1		
			30 Nov	Profit and loss a/c	500
		1,500			1,500
			20X3		
			1 Dec	Balance b/d	1,500

Profit and loss account

20X3	**Details**	**N**
30 Nov	Bad debts	300 30
Nov	Provision for bad debts	500

Statement of financial position (extract)

Current assets	**N**
Trade receivables (N18,900-N300)	18,600
Less: Provision for bad debts	1,500
	17,100

There is another method of accounting for bad debts .and provisions for bad debts that essentially involves combining these two accounts. This is shown below.

(Provision for) *bad debts*

20X3	Details	N	20X2	Details	N
0 Nov	F Simons	300	1 Dec	Balance b/d	1,000
0 Nov	Balance c/d	1,500	20X3		
		___	30 Nov	Profit and loss a/c	800
		1,800			1,800
			20X3	Details	
			1 Dec	Balance b/d	1,500

Profit and loss account

20X3	**Details**	**N**
30	Bad debts	800

The combined charge to the statement of profit and loss for the year in respect of bad debts and the vision for bad debts is the difference between the two sides of the (provision for) bad debts account after inserting the amount of the provision at 30 November 20X3 as a balance carried down. The charge the statement of profit and loss under both methods is always the same in total.

Example

During the year ended 30 November 20X4 C. Steven was declared bankrupt and a first dividend of N140 was received from the trustee. M. Evans was also declared bankrupt and a first and final dividend of N30 was received from the trustee. A. Mitchell paid his debt in full.
A further debt of N350 owed by R. Jackson that is included in trade receivables at 30 November 20X3 proved to be bad. The trade receivables at 30 November 20X4 were N24,570. This figure is after recording all money received but does not take into account bad debts. You have been instructed to make a provision for bad debts at 30 November 20X4. This should include a specific provision for doubtful debts and a general provision of 5 per cent of trade receivables.

Show the ledger entries in respect of the above and the relevant statement of financial position extract.

Provision for bad debts at 30 November 20X4

	N	
Specific provision – C. Steven (N240-N140)	100	
General provision – 5%x(N24,570-N120-N350-N100)		1,200
		1,300

The ledger

C.Steven (trade receivable)

20X3	**Details**	**N**	**20X4**	**Details**	**N**
1 Dec	Balance b/d	240	30 Nov	Bank	140 30
			Nov	Balance c/d	100 240
		240			
20X4					
1Dec	Balance b/d	100			

M.Evans (trade receivable)

20X3	**Details**	**N**	**20X4**	**Details**	**N**
1 Dec	Balance b/d	150	30 Nov	Bank	30 30
			Nov	Bad debts	120 150
		150			

R.Jackson (trade receivable)

20X3	**Details**	**N**	**20X4**	**Details**	**N**
1 Dec	Balance b/d	350	30 Nov	Bad debts	350

Bad debts

20X4	**Details**	**N**	**20X4**	**Details**	**N**
30 Nov	M. Evans	120 30	30 Nov	Profit and loss a/c	470
Nov	R. Jackson	350 470			
					470

Provision for bad debts

20X4	**Details**	**N**	**20X3**	**Details**	**N**
30 Nov	Profit and loss a/c	200 30	1 Dec	Balance b/d	1,500
Nov	Balance c/d	1,300 1,500			
					1,500
			20x4		
			1 Dec	Balance b/d	1,300

Profit and loss account

20X4	**Details**	**N**			
30 Nov	Bad debts	470	20X4	Details	N 30 Nov Provision

Statement of financial position

Current assets		**N**
Trade receivable (N24,570-N120-N350)		24,100 Less:
Provision for bad debts	1, 300	22,800

Alternative method

(Provision for) bad debts

20X4	**Details**	**N**	**20X3**	**Details**	**N**
30 Nov	M. Evans	120	1 Dec	Balance b/d	1,500
30 Nov	R. Jackson	350	**20X4**		
30 Nov	Balance c/d	1,300	30 Nov	Profit and loss a/c	270
		1,770			1,770
			20X4		
			1 Dec	Balance b/d	1,300

The main method shown above (that has separate bad debt and provision for bad debts accounts) is the most common in practice. However, this tends to obscure the logic behind provisions for bad debts, because it is accounts for the provision separately from the bad debts. The 'alternative method' shown above allows the logic to be demonstrated as follows. The bad debts for the year (N120 + N350 = N470) are set against the provision at the end of the previous year (N1,500). Any under-or overprovision (N1,500 – N470 = overprovision of N1,030) is written back to the comprehensive income account. The amount of the provision required at the end of the current year (N1,300) is then created in full by debiting the comprehensive income account with this amount. This can be illustrated as follows.

(Provision for) bad debts

20x4	**Details**	**N**	**20x3**	**Details**	**N**
30 Nov	M. Evans	120	1 Dec	Balance b/d	1,500
30 Nov	R. Jackson	350	**20X4**		
30 Nov	Profit and loss a/c overprovision	1,030	30 Nov	Profit and loss a/c	1,300
30 Nov	Balance c/d	1,300			
		2,800			2,800
			20X4		
			1 Dec	Balance b/d	1,300

4.0 CONCLUSION

A debt is treated as irrecoverable if a credit customer is unwilling or unable to pay, and the enterprise decides it is uneconomical to pursue the matter further. The ledger entry for irrecoverable debts is to credit the credit customers' trade receivable personal account and debit a bad debts account. The balance on the bad debts account is transferred to the statement of profit and loss account at the end of the accounting year.

A provision is the setting-aside of income to meet a known or highly probable future liability or loss, the amount and/or timing of which cannot be ascertained exactly, and is thus an estimate. The most common examples are provisions for depreciation and doubtful/bad debts.

A provision for bad debts may consist of a specific provision and/or a general provision.

5.0 SUMMARY

In this unit we have treated the definition of bad debts, the nature of bad debts and ledger entries for bad debts. We also treated the nature and ledger entries for the provision for bad debts

6.0 TUTOR MARKED ASSIGNMENT

1. What do you understand by the term 'bad debts'? In what circumstances might a debt be treated as irrecoverable?
2. Explain the nature of a provision, including how this differs from a liability.
3. A business has an accounting year ending on 31 July. It sells goods on credit and on 31 July 20X3 had trade receivables of N15,680,000. This includes debts of N410,000 due from A. Wall and N270,000 from B. Wood, both of which were regarded as irrecoverable. The business has decided to create a provision for bad debts at 31 July 20X3 of 4 per cent of trade receivables. Previously there was no provision for bad debts. You are required to show the ledger entries in respect of the above bad debts and provision for bad debts.
4. Briefly discuss the similarities between provisions for bad debts and depreciation.

7.0 REFERENCES/FURTHER READING

Igben, R.O. (2014) *Financial Accounting Made Simple*. Mushin: ROI Publishers

Thomas, A. and Ward, A.M. (2012). *Introduction to Financial Accounting*. Berkshire: McGraw-Hill Education.

UNIT 12 ACCRUALS AND PREPAYMENTS

CONTENT

1.0 INTRODUCTION

This unit treats the definition and accounting entries of accruals and prepayments. Accruals are expenses due but which are not yet paid as at the financial position date. They are expenses not yet paid for a period ending at the trial balance date. Prepayments can also be referred to as incomes received in advance. They are incomes received in respect of a period after the trial balance date.

2.0 OBJECTIVES

After reading this chapter you should be able to do the following:

- Explain the conceptual foundation of accruals and prepayments, including the nature of the resulting charge to the statement of comprehensive income (statement of profit and loss).
- Describe the nature of accruals and prepayments and how the amounts can be ascertained in practice.
- Show the entries for accruals and prepayments in the journal, general ledger, statement of profit and loss and statement of financial position.
- Prepare simple final financial statements from a trial balance making the required adjustments for accruals and prepayments.

3.0 MAIN CONTENT

3.1 The Nature of and Ledger Entries for Accrued Expenses

The accruals concept dictates that costs are recognized as they are incurred, not when money is paid. That is, goods and services are deemed to have been purchased on the date they are received. This gives rise to accrued expenses/accruals. Accruals are 'payables' in respect of services received that have not been paid for at the end of the accounting year. Accrued expenses can obviously only occur where services are paid for in arrears, such as electricity or gas.

An accrual may comprise either or both of the following:

i. Invoices received (for expenses) that have not been paid at the end of the accounting year.

ii. The value of services received for which an invoice has not been rendered at the end of the accounting year.

Although accrued expenses are essentially payables, rather than have a separate accruals' account it is usual to enter accruals in the relevant expense account. This consists of debiting the amount owing at the end of the year to the expense account as a balance carried down and crediting the same account as a balance brought down in the next period. Thus, the amount that will be transferred to the income account consists of the amount paid during the year plus the accrual at the end of the year (less the accrual at the start of the year). This will reflect the total value of the services that have been received during the current accounting year. The balance brought down is entered on the statement of financial position as a current liability. A pro forma ledger account showing typical entries is now provided below. This can be used to check that entries have been correctly posted.

Light and heat

20X2	**Details**	**N**	**20X2**	**Details**	**N**
	Bank	xx	1 Jan	Opening accruals b/d	x
31 Dec	Closing accrual c/d	x xx	31	Dec Profit and loss a/c	xx
					xx
			20X3		
			1 Jan	Opening accruals b/d	x

The shaded entry is the entry that is derived when the account is closed. This is the charge for the year. The opening accrual on the 1 January 20X3 is the payable that will be disclosed under current liabilities in the statement of financial position. The journal to record (post) the year end accrual shown Figure 18.1 is as follows:

Debit: Light and heat account current period (this will end up in the current year profit and loss charge)

Credit: Light and heat account new period (opening accrual in the next period - this balance will form part of the profit and loss charge in the next period)

The mechanics of calculating the yearly charge is illustrated in below.

Example

Spring has an accounting year ending on 31 December. The following amounts have been paid for electricity:

Date paid	**Quarter ended**	**N'000**
29 Mar 20X2	28 Feb 20X2	96

7 July 20X2	31 May 20X2	68
2 Oct 20X2	31 Aug 20X2	73
5 Jan 20X3	30 Nov 20X2	82
3 Apr 20X3	28 Feb 20X3	105

You are required to show the entries in the light and heat account for the year ended 31 December 20X2 and the relevant statement of financial position extract.

Workings

Accrual at 1 Jan 20X2 = ⅓x N96,000 = N32,000

Accrual at 31 Dec 20X2 = N82,000 + (⅓ x £105) = N117,000

Light and heat

20X2	**Details**	N'000	**20X2**	**Details**	N'000
29 Mar	Bank	96	1 Jan	Accrual b/d	32 31
7 July	Bank	68	Dec	Profit and loss a/c	322
2 Oct	Bank	73 31			
Dec	Accrual c/d	117 354			
					354
			20X3		
			1 Jan	Accrual b/d	117

Statement of financial position as at 31 December 20X2 (extract)

	N'000
Current liabilities	
Accrued expenses	117

Note: The amount transferred to the statement of profit and loss is the difference between the two sides of the light and heat account after entering the accrual at the end of the year.

3.2 The Nature of and Ledger Entries for Prepaid Expenses

The accruals concept also gives rise to prepaid expenses/prepayments. Prepayments are 'receivables' in respect of services that have been paid for but not yet due at the end of the accounting year. Prepayments can obviously only occur where services are paid for in advance, such as rent, local government taxes, road tax and insurance. The amount of the prepayment is ascertained by determining on a time basis how much of the last payment made during the accounting year relates to the services that will be received in the following accounting year.

Although prepaid expenses are essentially receivables, rather than have a separate prepayment account, it is usual to enter the prepayment in the relevant expense account. This consists of crediting the amount of the prepayment to the expense account as a balance *carried down* and debiting the same account as a balance *brought down.* Thus, the amount that will be transferred to the profit and loss account consists of the amount paid during the year minus the prepayment at the end of the year (plus the prepayment at the start of the year). This will reflect the total value of the services that have been received during the current accounting year. The balance brought down is entered on the statement of financial position as a current asset. A pro forma

ledger account showing the relevant entries is provided below. This can be used to check entries.

Rent

20X2		N	**20X31**	**Details**	**N**
1July	Opening Prepayment b/d	x	30 June	Prepayment a/c	
1 Sep	Bank	xx xx	30 June	Closing prepayment c/d	x xx
20X3					
1 July	opening prepayment b/d	x			

The shaded entry is the entry that is derived when the account is closed. This is the charge for the year. The opening prepayment on the 1 July 20X3 is the receivable that will be disclosed under current assets in the statement of financial position. The mechanics of calculating the yearly charge is illustrated below.

ILLUSTRATION

M.Waters has an accounting year ending on 30 June. The following amounts have been paid as rent:

Date paid	**Quarter ended**	**N**
2 Jun 20X2	31 Aug 20X2	600
1 Sep 20X2	30 Nov 20X2	600
3 Dec 20X2	28 Feb 20X3	660
5 Mar 20X3	31 May 20X3	660
4 Jun 20X3	31 Aug 20X3	720

You are required to show the entries in the rent account for the year ended 30 June 20X3 and the relevant statement of financial position extract.

Workings

Prepaid at 1 July 20X2 = N600 = N400

Prepaid at 30 June 20X3 = N720 = N480

Rent

20X2	Details	N'000	20X3	Details	N'000
1 Jul	Prepayment b/d	400	30 Jun	Profit and loss a/c	2,560
1 Sep	Bank	600			
3 Dec	Bank	600			
20X3					
5 Mar	Bank	660			
4 Jun	Bank	720	30 Jun	Prepayment c/d	480
		3,040			3,040
20X3					
1 Jul	Prepayment b/d	480			

Statement of financial position as at 30 June 20X3 (extract)

	N'000
Current assets	
Prepayments	480

The amount transferred to the statement of profit and loss is the difference between the two sides of the rent account after entering the prepayment at the end of the year.

3.3 Accruals and Prepayments and the Preparation of Final Financial Statements from the Trial Balance

The statement of profit and loss is usually prepared from the trial balance. This involves adjusting the amounts shown for any accruals and prepayments at the end of the accounting year. It is important to appreciate that, because the trial balance is taken out at the end of the accounting year, the amounts shown in it include any accruals and prepayments at the start of the year. Thus, when preparing a statement of profit and loss from the trial balance, it is only necessary to add to the amount shown in the trial balance any accrual at the end of the accounting year and to subtract any prepayment.

ILLUSTRATION

Extract from the trial balance of A. Trader at the year end:

	Debit	**Credit**
	N'000	**N'000**
Trade receivables	20,000	
Trade payables		6,000
Heat and light	4,000	
Rent	6,000	xxxx
		xxxx

Additional information

1. There is an accrual at the year end of N200,000 for heat and light
2. Rent amounting to N1,000,000 was prepaid at the reporting period end.

Required

a. Prepare the ledger accounts showing the year-end adjustments.

b. Show the adjusted trial balance.

c. Provide extracts from the statement of financial position to show the relevant disclosures for the accrual and the prepayment.

SOLUTION

Heat and light

	N'000		N'000
Balance b/d from TB	4,000		
Closing accrual c/d	200	Profit and loss a/c	4,200
	4,200		4,200
		Opening accrual b/d	200

Rent

	N'000		N'000
Balance b/d from TB	6,000		
		Profit and loss a/c	5,000
		Opening prepayment c/d	1,000
	6,000		6,000
Opening prepayment b/d	1000		

Amended trial balance

	Debit N'000	**Credit N'000**
Trade receivables	20,000	
Trade payables		6,000
Heat and light	4,200	
	5,000	
		200
Accruals	1,000	
	xxxx	xxxx

The shade area shows the accounts that have changed.

Extract from the statement of financial position as at XX

ASSETS	**N'000**
Current assets	
Inventories	xx Trade
receivables	20,000 Prepayments
10,000 Bank	xx
Cash	xx

		x
		xxx
Total assets		
OWNER'S EQUITY AND LIABILITIES		
Owner's capital		**xxx**
Current liabilities		
Trade payables	6,000	Accruals
		200 6,200
Total equity and liabilities		xxx

4.0 CONCLUSION

The accruals concept dictates that costs are recognized as they are incurred, not as money is paid. That is, goods and services are deemed to have been purchased on the date they are received. This gives rise to accrued and prepaid expenses. Accrued expenses are payables in respect of services received that have not been paid for at the end of an accounting year. Prepaid expenses are receivables in respect of services that have been paid for, but not received, at the end of an accounting year.

5.0 SUMMARY

In this unit we have discussed the nature and ledger entries for accrued expenses, the nature of and ledger entries for prepaid expenses and accruals and prepayments and the preparation of final financial statements from the trial balance.

SELF ASSESSMENT EXERCISES

6.0 TUTOR MARKED ASSIGNMENT

1. a. Explain the nature of accrued and prepaid expenses.
   b. Describe how the amount of each may be ascertained.

2. Wills has an accounting year ending on 31 December. The following amounts were paid in respect of rent and gas:

xpense	ate paid	uarter ended	N'000
ent	Nov 20X1	31 Jan 20X2	900
ent	9 Jan 20X2	30 Apr 20X2	930
as	Mar 20X2	28 Feb 20X2	420
ent	May 20X2	31 July 20X2	930
as	Jun 20X2	31 May 20X2	360
ent	0 Jul 20X2	31 Oct 20X2	930
as	Sep 20X2	31 Aug 20X2	270
ent	Nov 20X2	31 Jan 20X3	960
as	Dec 20X2	30 Nov 20X2	390
as	Mar 20X3	28 Feb 20X3	450

You are required to show the ledger entries in the rent and light and heat accounts for the year ended 31 December 20X2.

7.0 REFERENCES/FURTHER READING

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UNIT 13 THE FINANCIAL STATEMENT (WITH ADJUSTMENTS)

CONTENTS

1.0 INTRODUCTION

In this unit, we shall be considering the preparation of the statement of financial position also referred to as the balance sheet. We will see how the net profit from the income statement can be transferred to the capital account in the statement of financial position.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Prepare income statement from the trial balance
- Prepare the statement of financial position

3.0 MAIN CONTENT

3.1 Format of the Income Statement and Statement of Financial Position

Statement of Comprehensive Incomes for the year ended 30th June 20XX

	N‘000	N‘000	N‘000
Sales			X
Less returns inward			x
Less cost of sales:			X
Opening inventories		X	
Add Purchases	x		
Less returns outwards	x	X	
Carriage inwards		x	
Less Closing inventories		X	
Gross profit		x	
Add Investment income			x
			X
			x
			X
Less expenses:			
Electricity	x		
Add owings	x	X	
Administrative expenses	x		
Less rent prepaid	x	X	
Selling expenses		X	

Vehicle running expenses	x	X	
Add owings	x	X	
		X	
Discount allowed			
		X	
Provision for bad debts			
			x
Salaries			
	x		X x
Provision for depreciation:			
	x		Xx
Motor vehicles			
	x	x	
Buildings			
	x		
Office equipment			
Furniture & fittings			

Net profit before tax

Less Provision for tax

Net profit after tax

Statement of Financial Position as at 30th June 20xx

	N‘000	N‘000	N‘000
Non-Current Assets:	Cost	Depreciation	NBV
Land & buildings	x	X	x

Office equipment	X	X	x
Motor car	X	X	x
Furniture & fittings	X	X	x
	x	x	X
Investment			x
			x
Current assets:			
Inventory			x
Trade receivables		X	
Less provision		x	X
Prepaid expenses			x
Bank and cash			x
Total Assets			xx
Capital and Liabilities:			
Capital			x
Add net profit after tax			x
			x
Less drawings			x
	A		x
Current liabilities:			
Accounts payables			x
Accrued expenses			x

Provision for tax		x
	B	x
Total capital and Liabilities	a + b	xx

3.2 Illustration Of Income Statement And Statement Of Financial Position

The following Trial Balance was extracted from the books of Elizabeth a sole proprietor, whose business is known as Lizzy Enterprise as at 31st December, 2011.

	DR N'000	CR N'000
Capital		112,000
Motor Van	40,000	
Inventories	32,800	
Balance at bank	24,800	
Purchases	320,000	
Sales		446,000
Trade receivables	58,000	
Trade payables		33,120
Rent and rates	11,216	
Salaries	70,080	
General expenses	8,944	
Motor expenses	5,120	
Discount allowed	8,080	

Discount received	7,920	
Insurance	3,920	
Bad debts	6,080	
Drawings	10,000	
	599,040	599,040

The following matters are to be taken into account:

a.Inventories in trade as at 31st December 2011 was N40,320,000

b.Salaries and wages outstanding as at 31/12/11 amounted to N24,000,000.

c.Insurance paid in advance was N1,400,000

One fourth of the general expenses was for private purposes.

Required:

Prepare an Income statement of Comprehensive Incomes for the year ended 31st December, 2011 and a Statement of financial position as at that date.

Suggested solution

Lizzy Enterprise Income statement for the year ended 31st December, 2011

	N'000	N'000	N'000
Sales			446,000
Less cost of sales:			
Opening Stocks		32,800	
Add Purchases		320,000	
		352,800	
Less closing stocks		40,320	312,480
Gross profit			133,520
Add Discount received			7,920
			141,440
Less expenses:			
Salaries	70,080		
Add owings	24,000	94,080	
Rent and rates		11,216	
General expenses	8,944		
Less drawings	2,236	6,708	
Motor expenses		5,120	
Discount allowed		8,080	
Bad debts		6,080	
Insurance	3,920		
Less prepaid	1,400	2,520	133,804
			7,636

Statement of Financial position as at 31st December 2011

N '000 N'000 N '000

ASSETS

Non-current Asset: Motor Van		40,000
Current Assets: Inventory		40,320
Accounts receivables		58,000
Insurance prepaid		1,400
Balance at bank		24,800
Total Assets		**164,520**
Capital and Liabilities:		
Capital		112,000
Net profit		7,636
		119,636
Less Drawing	10,000	
Add private expense	2,236	12,236
		107,400
Current liabilities:		
Accounts Payable		33,120
Accrued salaries		24,000
		57,120
Total capital and liabilities		164,520

Alaskan Enterprise is a dealer in special traditional medicine for female piles. He sometimes imports similar medicines from China whenever there is shortage in the local market. The Trial Balance of the enterprise as at 31st December 2005 is detailed below:

	DR	CR
	N‘000	N‘000
Investment income		550
Purchases	7,970	
Sales		40,250
Receivables and Payables	4,850	2,380
Inventory of finished goods	1,140	
Motor vehicles	3,800	
Electricity expenses	325	
Land and buildings (cost of land N2,000)	14,000	
Office Equipment	4,550	
Drawings	1,825	
Returns	930	485
Carriage inwards	300	
Administrative expenses	980	
Salaries and wages	3,650	

Vehicle running expenses	320	
Provision for bad debts		450
Investments	8,500	
Bank and cash balances	4,380	
Selling expenses	4,785	
Furniture & fittings	5,000	
Capital		13,455
Provision for Deprecation:		
- Office equipment		2,250
- Motor vehicles		2,270
- Land & Building		5,500
Discount allowed	285	
	67,590	67,590

The following additional information is relevant:

1. The inventories at 31st December 2005 were recorded at N950,000.

2. The Enterprise depreciates its assets on cost as follows:

Assets:	%
Buildings Motor	4
Vehicles	20

Office Equipment	15
Furniture & fittings	10

3. Administrative expenses include rent of N250,000. This represents rent for the period of 1st July 2005 to 31st May 2006.

4. The Enterprise is to make a provision of N345,000 in respect of Personal income tax for 2005 accounting year.

5. Provision for bad debt is N500,000.

6. Amount owing in respect of electricity and vehicle running expenses are N55,000 and N75,000 respectively.

Required: Prepare statement of comprehensive income and statement of financial position for 2005.

Suggested solution

Alaskan Enterprise Statement of Comprehensive Incomes for the year ended 30th June 2005

	N‘000	N‘000	N‘000
Sales			40,250
Less returns inward			930
Less cost of sales:			39,320
Opening inventories		1,140	
Add Purchases	7,970		
Less returns outwards	485	7,485	
Carriage inwards		300	
		8,925	

Less Closing inventories		950	7,975
Gross profit			31,345
Add Investment income			550
			31,895
Less expenses:			
Electricity	325		
Add owings	55	380	
Administrative expenses	980		
Less rent prepaid	114	866	
Selling expenses		4,785	
Vehicle running expenses	320	395	
Add owings	75	285	
		50	
Discount allowed			
		3,650	
Provision for bad debts			
Salaries			
	760		
Provision for depreciation:			
	480		
Motor vehicles			
	683	2,423	
Buildings			12,834
	500		
Office equipment			
Furniture & fittings			
Net profit before tax			19,061
Less Provision for tax			345

Net profit after tax	18,716

Alaskan Enterprise

Statement of Financial Position as at 30th June 2005

	N'000	N'000	N'000
Non-Current Assets:	Cost	Depreciation	NBV
Land & buildings	14,000	5,980	8,020
Office equipment	4,550	2,933	1,617
Motor car	3,800	3,030	770
Furniture & fittings	5,000	500	4,500
	27,350	12,443	14,907
Investment			8,500
			23,407
Current assets:			
Inventory			950
Trade receivables		4,850	4,350
Less provision		500	114
Prepaid expenses			4,380
Bank and cash			9,794
Total Assets			33,201
Capital and Liabilities:			
Capital			13,455
Add net profit after tax			18,716

Less drawings		32,171
		1,825
	a	30,346
Current liabilities:		
Accounts payables		2,380
Accrued expenses		130
Provision for tax		345
	b	2,855
Total capital and Liabilities	a + b	33,201

4.0 CONCLUSION

The statement of financial position can also be referred to as Balance sheet. It contains details of assets, liabilities and capital. Information used in preparing this statement is obtained from the trial balance. The balance sheet does not form part of the double entry system, so all we do is to lift balances carried forward from the accounts and place them in an appropriate position in the statement.

5.0 SUMMARY

In this unit, we have discussed the preparation of the statements of financial position. Assets, liabilities and were discussed in details.

6.0 TUTOR-MARKED ASSIGNMENT

Explain in details and with examples what you understand by asset, liabilities and capital.

7.0 REFERENCES/FURTHER READING

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UNIT 14 FINANCIAL RATIOS

CONTENTS

1.0 INTRODUCTION

In this unit, you will be introduced to the various financial ratios that are used to analyse the financial statement. Ratio is the relationship between two or more financial or statistical data in a financial statement. Ratio is a quantitative factor which expresses the relationship between two or more values. Financial ratio is a proportion or fraction or percentage which expresses the relationship between items contained in different financial statements. It is mostly used to determine or rather evaluate performance. For example company A can utilize financial ratio to analyse financial statements prepared in say 2007. The company could in like manner analyse the body of records prepared in 2007 and 2008 for comparism purposes (which is intra company analysis). A situation which company A compares her records using financial ratios with the records of another company, it is said to have done intercompany analysis. Financial ratios are also simply referred to as accounting ratios. It is a powerful tool in that it reveals to the company a picture capable of company's resuscitation and sustainability. Various categories of financial ratios are in use and will be considered for this study.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- mention the various financial ratios
- calculate any of the ratios

3.0 MAIN CONTENT

3.1 Liquidity ratios: These are ratios used in judging the ability of an enterprise to meet its short term maturing obligations. It is also called short term solvency ratios. The ratios under this category are:

3.1.1 Current ratio: This ratio compares total current assets with total current liabilities. In other words, it measures the ability of a company to meet its current liabilities as they fall due, out of its current assets. It is calculated thus;

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

A low current ratio is an indication that the business may be unable to pay its future bills on time, while a high current ratio may indicate an excessive amount of current asset and management's failure to properly utilize the resources of the business to meet obligations thereof. A current ratio of 2:1 is accepted to be ideal. This ratio is also called working capital ratio.

3.1.2 Quick assets ratio : This ratio shows the extent to which cash and assets most readily convertible to cash can meet the demand of short term creditors. It is also referred to as acid test ratio. A ratio of 1:1 is normally considered appropriate.

It is calculated thus; $\dfrac{\text{Current Assets-Stock}}{\text{Current Liabilities}}$

3.2 Profitability ratios: Profitability is the ability to sell goods and services above cost and earn reasonable returns on capital. Therefore, profitability ratios are those concerned with efficiency and performance in terms of return.

3.2.1 Net Profit Margin: This is the ratio of net profit before tax to sales. It measures the rate at which income accrues from sales. This ratio offers a ready means of comparing the operating efficiency of two or more firms or the same firm for two different periods. In other words, it is calculated thus;

$$\frac{\text{Net profit before tax}}{\text{Sales}} \times \frac{100}{1}$$

3.2.2 Return on assets managed: This ratio is defined as the relationship between net profit before tax and total assets. They also opined that, it attempts to measure the rate of efficiency in the use of the firm's total assets. It is worthy of note that net profit for this purpose should strictly include interests. This is mathematically obtained as;

$$\frac{\text{Trading profit + loan interest + debentures interest}}{\text{Fixed assets + current assets}}$$

3.2.3 Return on capital employed : This ratio relates earnings to long term funds only. They affirm that the ratio measures efficiency in the use of long term funds after stating capital employed as equity funds plus all long and medium term loans. ROCE shows the efficiency of management in utilization of the resources placed at its disposal. It is also called primary ratio being the most important measure of profitability and efficiency. It is calculated as;

$$\frac{\text{Trading profit + loan interest + debentures interest}}{\text{Long term funds}} \times \frac{100}{1} \quad \text{OR}$$

$$\frac{\text{Profit}}{\text{Capital employed}} \times \frac{100}{1}$$

3.2.4 Return on equity: This ratio shows the relationship between earnings and net equity, that is the total funds due to the ordinary shareholders which usually comprise nominal capital plus all retention and reserves. Earnings here is, not profit after interest and taxes. It is calculated thus;

$$\frac{\text{Earnings (or profit after taxation)}}{\text{Net equity (or shareholder's fund)}} \times \frac{100}{1}$$

ILLUSTRATION

OAU LIMITED

FIVE YEAR FINANCIAL SUMMARY

YEAR ENDED 31ST MAY	1978	1979	1980	1981	1982	
	N'000	N'000	N'000	N'000	N'000	
FUNDS EMPLOYED						
Ordinary share capital	14,797	14,797	14,797	18,497	23,121	
Capital reserve	16,518	32,166	32,472	30,902	31,252	
Revenue reserve	13,226	17,589	21,609	24,674	23,968	
Shareholder's fund	44,541	64,502	68,878	74,073	78,341	
Deferred taxation	5,427	11,154	10,810	13,004	15,479	
Deferred income	-	-	5,979	6,066	4,666	
9.75% Debenture stock	-	-	-	20,000	20,000	
Unsecured loans	9,342	10,158	9,080	7,000	11,000	59,310
	85,814	94,747	120,143	129,486		
EMPLOYMENT OF FUNDS						
Fixed assets	34,977	70,575	73,309	87,274	106,657	
Net current assets	24,333	15,239	21,538	32,869	22,829	
TURNOVER AND PROFIT						
Turnover	229,796	291,572	319,731	367,966	380,033	
Profit before taxation	12,283	7,272	14,090	16,474	15,508	
Profit after taxation	5,733	4,353	6,979	8,816	7,617	
Dividends	1,835	2,072	2,959	3,699	3,699	

Additional information:

Some of the assets and liabilities of the company are indicated thus;

	1982	1981
	N'000	N'000
Fixed assets	106,657	87,274
Current assets	160,231	138,126
Current liabilities	137,402	105,257

Stock 142,934

The interest on unsecured loans is 8.02%

Required: Calculate liquidity and profitability ratios of OAU limited for 1982.

SOLUTION

For liquidity ratios:

i. Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$

$= \frac{N160,231}{N137,402} = 1.2 : 1$

ii. Quick assets ratio = $\frac{\text{current assets - stock}}{\text{current liabilities}}$

$= \frac{N160,231 - N142,934}{N137,402} = 0.13 : 1$

For profitability ratios:

i. Net profit margin = $\frac{\text{net profit before tax}}{\text{Sales}} = \frac{N15,508,000}{N380,033,000}$

$= 4.08\%$

ii. Return on assets margin = $\frac{\text{trading profit + loan interest + debenture interest}}{\text{fixed assets + current assets}}$

$= \frac{N15,508,000 + N882,000 + N1,950,000}{N106,657,000 + N160,231,000}$

$= 6.08\%$

iii Return on capital employed =

$\frac{\text{trading profit + loan interest + debentures interest}}{\text{long term funds}}$

$$= \frac{N15,508,000 + N882,000 + N1,950,000}{N129,486,000}$$

$$= \frac{N18,340,000}{N129,486,000} = 14.16\%$$

iv Return on equity $= \frac{N7,617,000}{N78,341,000} = 9.72\%$

4.0 CONCLUSION

This unit concludes that financial ratios are important for the analysis of the financial statement.

5.0 SUMMARY

In this unit, the various financial ratios such as Liquidity and Profitability ratios were examined.

6.0 TUTOR-MARKED ASSIGNMENT

The summarized balance sheets and operating results of Wellington limited for two years are as follows;

Balance sheet as at 30th September

	20x1	20x2
	N'000	N'000
Fixed assets (net)	16,222	6,941
Current assets		
Stock	62,294	52,196
Debtors	54,859	50,052
Bank	7,234	14,565
	124,387	116,813
Current liabilities		
Creditors	47,055	42,885
Taxation	4,154	3,219
Dividends	2,500	2,250

	53,709	48,354
Net current assets	70,678	68,459
10% Debentures	25,000	25,000
Net assets	61,900	50,400
Financed by		
Ordinary shares of N1 each	12,500	12,500
Revenue reserves	35,874	29,787
Deferred taxation	13,526	8,113
	61,900	50,400

Operating results for the year ended 30th September

	20x1	20x2
	N'000	N'000
Sales	672,944	559,071
Profit before int. & tax	23,412	20,882
Interest payable	2,500	2,500
Taxation	10,506	8,747
Dividend	3,750	3,500

The shares of the company were quoted at N1.20 at 30th September 20x2.

Required: calculate two ratios that are of immense interest to

- **i. Management**
- **ii. Creditors.**

7.0 REFERENCES/FURTHER READING

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UNIT 15 CASH FLOW STATEMENT

CONTENTS

1.0 INTRODUCTION

In this unit, you will be introduced into the significance of cash flow statement. Its objectives and the major activities under the cash flow statement.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

-Define the cash flow statement

- Explain the significance of cash

- Explain the major classifications of the cash flow statement

3.0 MAIN CONTENT

3.1 Definition of Cash flow Statement

A statement showing the inflows and outflows of cash and cash equivalents for a business over a financial period. The inflows and outflows are classified under the headings of operating activities, investing activities and financing activities.

3.2 Working Capital

In the interpretation of balance sheets, working capital ratio is one of the most important ratios. It ascertains or measures the wellbeing of a business enterprise. This is so because the profit making ability and hence the long term survival of a business concern, to a large extent, is tied to the availability of the working capital. Working capital is a term used to represent the excess of current assets over current liabilities. In most business organizations, working capital is represented by:

Current Assets:

Stock	
Debtors	Total
Cash	

Less Current liabilities:

Creditors	
Bank overdraft	Total
Short-term loans	

Working capital (Net Current Asset) becomes significant because of its ability to be converted to cash. This is so because its only when working capital is converted to cash can profit be earned. A business carries stock to be able to sustain its business activities with the hope that such stocks will eventually be converted to cash. Debtors arise in a business as a result of credit sales with the hope that cash will be received in due course. Conversely, creditors arise from purchases which carry a liability of payment on a future date. When credit is allowed to a customer (debtors), it leads to an increase in the working capital requirement, but when credit is received (creditors) it reduces the requirement for working capital.

3.3 The Significance of Cash

Cash flows (in and out) of a business enterprise is the most fundamental event upon which investors base their decisions. Cash attains this significance because it represents generally the purchasing power, which can be transferred readily in an exchange economy.

With only few exceptions, businesses acquire assets and rights to goods and services for sale to customers at a profit. Most accounting measurements are based on past, present and expected flows of cash. Revenue is generally measured in terms of net cash expected to be received from the sale of goods or services. Expenses are generally measured in terms of cash paid or payable for goods and services.

Accruals represent the allocation to the current period of future or expected receipts and payments for services. Deferrals represent the allocation to a future period of current receipts or payments. The theoretical measurement of assets, liabilities, income and expenses are based heavily on actual and expected cash flows. The present value of an asset is usually defined as the discounted value of expected net receipts to be derived from the asset. Liabilities can be measured in terms of the total discounted amounts to be paid in the future.

3.4 The objectives of a cash flow statement

SAS 18 (Statement of Cash Flows) requires that a Cash Flow Statement be prepared, in accordance with the standard, and presented as an integral part of the financial statement for each period for which financial statements are presented. The Cash Flow Statement is prepared with the following objectives in view:

i. to evaluate an entity's ability to generate cash and cash equivalents and the timing and certainty of their generation,

ii. to evaluate an entity's financial structure which affects it liquidity and solvency and its ability to meet its obligations and to pay dividends,

iii. to understand the difference between profit or loss for the period and net cash flow from operating activities,

iv. to compare the operating performance of different entities since the net operating cash flow reported in a cash flow statement is unaffected by accounting choices and judgments under accruals basis and accounting policies used in determining the profit or loss of an entity, and

v. to enable users develop models to assess and compare the present value of future cash flows of different entities.

Related to the above objectives are the following advantages of using cash flow accounting over the former funds flow accounting method.

a. The survival of an entity depends on its ability to generate cash. Hence Cash Flow accounting directs attention towards this critical issue.
b. flow is more understandable than profit performance which is dependent on accounting conventions and concepts.
c. Creditors are more interested in the ability of the company to pay its debts than in its profitability. Profit is an indication that cash is likely to be available whereas cash accounting shows exactly the cash that is available.
d. Cash flow reporting provides a better means of comparing the result of different companies than the traditional profit reporting.
e. Cash flow reporting satisfies more the needs of users, for instance:

    i. It provides management the relevant information for decision making, and
    ii. It provides shareholders a more realistic basis of stewardship: the ability to pay dividend rather than the profit made.

f. Cash flow forecasts are easier to prepare and are more useful than the profit forecast.
g. Cash flow accounts are easier to audit than accounts based on the accruals concept
h. Unless to someone with a good knowledge of accounting, cash flow is easier to understand than the accruals concept.
i. Cash flow can be both retrospective and a forecast of the future. This is of great accounting value to users of accounting information
j. Forecast can be subsequently monitored by the use of variance analysis which compares actual cash flows with the forecast.

3.5 Definition of Cash:

Cash includes cash in hand and deposits repayable on demand with any bank or other financial institutions. It also includes deposits in foreign currency.

i. **Cash Equivalents** : These are short term highly liquid investments which are readily convertible into known amounts of cash without notice and which were within three months of maturity when acquired less advances from banks repayable within three months from the date of the advance. They also include investment and advances in foreign currencies provided that they are highly liquid and are readily convertible to known amounts of cash without notice and are within three months of maturity.

ii. **Cash flow:** This is an increase or decrease in the amount of cash or cash equivalents resulting from a transaction.

3.6 Classification of cash flows

A statement of cash flow, present cash flows according to the activities, which give rise to them. The classification is as stated below:

3.6.1 Operating Activities: These include normal trading activities of an enterprise e.g. production and delivery of goods and services and other supporting activities included in determining operating profit.

3.6.2 Investing Activities: These relate to acquisition and disposal of fixed assets, statement of properties and other productive assets held for use in producing the usual goods and services other than stock held for processing or resale.

3.6.3 Financial Activities: These include resources obtained from lenders and awareness of enterprises and reporting the amount obtained either as they become due or when there is surplus for the needs of the enterprise. They also include the payment of returns to providers of such financing in form of interest and dividends as well as expenses directly related to obtaining the finance.

XYZ LTD

Cash Flow Statement for the Year Ended 31st Dec. 2012

	N	N
Operating Activities		
Operating profit		
Adjustment for items not involving		
Movement of cash:		
Depreciation	X	
Amortization	X	
Profit/loss on sale of fixed assets		X
Profit/loss on sale of investment		X
Deferred income recognized	X	
Cash inflow before working capital changes		X
Increase/Decrease in stock	X	

Increase/Decrease in Debtors		X
Increase/Decrease in Credits		X
Increase Accruals	X	X
Tax paid		(X)
Cash inflow from operation activities		
Investing Activities		
Purchase of fixed assets		X
Purchase of investment		X
Sale of fixed asset	X	
Sale of fixed asset investment		X
Dividend received	X	
Interest received	X	
Net cash inflow from investing activities		
Financial Activities		
Issue of shares		X
Redemption of shares		(X)
Issue of debentures	X	
Redemption of debentures	(X)	
Dividend paid		(X)
Interest paid	(X)	X
Net cash inflow from investing activities		
Increase/decrease in cash and cash enquires		X
Cash and cash equivalent of the beginning		X
Cash and cash equivalent of the end		X

Illustration

From the following information in the books of Kate Ltd, prepare a cash flow statement for the year ended 31st December 2009.

Balance Sheet as at 31st December

	2008		2009	
	N`000	N`000	N`000	N`000
Fixed Asset at cost		8,300		5,600
Less Depreciation		3,150		2,300
		5,150		3,300
Current Assets:				
Stock		5,516		7,204
	180	3,994		3,120
		3,814	210	2,910
		90		60
Cash		9,420		
			10,174	
Current Liabilities due within one year: Creditors		1,416		1,520
Taxation		735		580
Proposed Dividend		1,200		800

Bank Overdraft	629	3,980		
			105	3,005
			5,400	7,169
			10,590	10,489
Working Capital				
Less: Creditors Failing				
Due after one year		500		3,000
Loan Capital		10,090		7,469

Financed By:

Capital and Reserves:	**N`000**	**N`000**
Share Capital	5,000	4,000
Share Premium	1,000	-
Profit and Loss Account	4,090	3,469
Profit for the year	10,090	7,469
Less Taxation for the accounting year		
Undistributed profit b/f		2,556
Less: Proposed dividend	735	1,821
	3,469	5,290
	1,200	4,090

Notes:

1. An item of fixed asset which has cost of N1,1200,000 and having been depreciated at N740,000 was sold during the year for N465,000. The profit thereof had been included in the net profit for the year.
2 1,000,000 shares of N1.00 had been issued at a par of 1 per share.

Solution

KATE LTD

Cash Flow Statement for the year ended 31st December 2009

	N`000		**N`000**
Cash Flow From Operation Activities			
Profit Before Taxation			2,556
Adjustment For Items Not Involving Cash			
Depreciation Of Fixed Assets			1,590
Profit On Sale Of Fixed Asset	(85)		1,505
Working Capital Charges:			
Decrease In Stock	1,688		
Increase In Debtors	(904)		
Decrease In Creditors And Accruals	(104)	680	4,741
Tax Paid			(580)
Cash Inflow From Operation Activities			4,161
Cash Inflow Investing Activities:			
Purchase Of Fixed Asset		(3,820)	
Proceeds From Sale Of Fixed Asset		465	

Net Cash Inflow From Investing Activities		(3,355)
Cash Flow From Financing Activities:		
Net Proceed Of Capital Floatation	2,000	
Debenture Redemption	(2,500)	
Dividend Paid	(800)	
Net Cash Inflow From Financing Activities		(1,300)
Net Decrease In Cash And Cash Equivalent		(494)
Cash And Cash Equivalent At 1st Jan		(45)
Cash And Cash Equivalent At 31/12/2009		(539)

4.0 CONCLUSION

For any business it is important to ensure that sufficient profits are made to finance the business activities and sufficient cash funds are available as and when needed.

5.0 SUMMARY

In this unit we have been able to discuss the cash flow statement, working capital, and the various classification of cash flow.

6.0 TUTOR-MARKED ASSIGNMENT

1. What is a cash flow statement?
2. Mention the three major activities under the cash flow statement.

7.0 REFERENCES/FURTHER READING

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UNIT 16 COST ACCOUNTING

CONTENTS

1.0 INTRODUCTION

The unit introduces you to the concept of cost accounting, its definition, the range of information that could be supplied by the system, the relationships of cost accounting to management accounting and to financial accounting; and determine how raw data are transformed into information.

2.0 OBJECTIVES

At the end of this you unit, you should be able to:

(i) define cost accounting;
(ii) itemize the range of information that could be supplied by the cost accounting system;
(iii) determine the relationships between cost accounting to management accounting and to financial accounting;

3.0 MAIN CONTENT

3.1 Cost Accounting Information

The cost accounting system of any organization is the foundation of the internal financial information system. Management needs a variety of information to plan, to control and to make decisions. Information regarding the financial aspects of performance is provided by the cost accounting system. The table below shows the examples of cost accounting information and their uses.

S/N	Information provided by Cost Accounting System	Possible Uses by Management
1.	Cost per unit of production or service or for a process.	As a factor in pricing decisions, production planning and cost control.
2.	Cost of running a section, department or factory.	Organisational planning cost control.
3.	Wage costs for a unit of production or per period of production.	Production planning, decisions on alternative methods, wages cost control.
4.	Scrap/Rectification costs.	Material cost control, production planning.
5.	Cost behaviour with varying levels of activity.	Profit planning, make or buy decisions, cost control.

3.2 Cost Accounting – Definition

Cost accounting (traditionally termed 'costing') may be defined as:

> " *Gathering of cost information and its attachment to cost objects, the establishment of budgets, standard costs and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds*".

An important part of the managerial task is to ensure that operations, departments, processes and costs are under control and that the organization and its constituent parts are working efficiently towards agreed objectives. Although there are numerous other control systems within a typical organization, for example, Production Control, Quality Control, and Inventory Control, the Cost Accounting system is the key financial control system and monitors the results of all activities and all other control systems. The detailed analysis and location of all expenditure, the calculation of job and product costs, the analysis of losses and scrap, the monitoring of labour and departmental efficiency and the other outputs of the Cost Accounting system provide a sound basis of information for financial control.

Decision making is concerned with making a choice between alternatives and frequently an important factor in making that choice is the financial implications of the various alternatives.

Correctly presented cost information can be of great value to management in decision making and accordingly material on short and long term decision making shall be included later in this unit.

The analysis and recording of past costs and activities is but one element of cost accounting. Management is also concerned to know what costs will be in the future so that appropriate plans and decisions can be made in good time. Also, having some standard or target against which to compare actual costs greatly assists the control function.

Pricing decisions are complex and many interacting factors need to be considered including: the type of market in which the firm operates, the degree of competition, demand and the elasticity of demand, the cost structure of the product and firm, the state of the economy and numerous other factors. Pricing is not simply a cost based decision although past costs and expected future costs are factors to be considered in pricing decisions.

3.3 Development of Cost Accounting

While reviewing the development of cost accounting, Lucey (2009) stated that ever since the use of money replaced barter, people have been concerned with costs. However, it was the concentration of manufacturing facilities into factories which gave impetus to the development of recognizable cost accounting systems. Whilst the early developments were almost entirely related to manufacturing concerns, nowadays cost accounting is used very widely indeed; in hospitals, transport undertakings, local authorities, offices, banks as well as in every manufacturing concern.

3.4 Usefulness of Cost Accounting

It cannot be emphasised too strongly that if the information produced by the cost accounting system is not useful for managerial decision making, for control or for planning, then it has no value and should not be prepared. To ensure its usefulness, the following questions should be considered:

(a) Is the cost accounting system appropriate to the organization the way services are provided or goods manufactured?
(b) Do the reports, statements and analyses produced by the cost accounting system contain the relevant information for the intended purpose?
(c) Are the reports and statements produced at appropriate intervals and early enough to be effective?
(d) Are they addressed to the person responsible for planning/decision making/control?
(e) Is the information produced in a relevant form and to a sufficient degree of accuracy for the intended purpose?

It follows from the above that every cost accounting system will, in certain respects, be unique, because it must be designed to suit the particular organization, products and processes and personalities involved.

3.5 Cost Accounting and Management Accounting

The definition of management accounting is:

> Management accounting is the application of the principles of accounting and financial management to create, protect, preserve and increase value for the stakeholders of for- profit and not-for-profit enterprises in the public and private sectors.

Management accounting is an integral part of management. It requires the identification, generation, presentation, interpretation and use of relevant information to:

- Inform strategy and decisions and formulate business strategy;
- Plan long, medium and short-run operations;
- Determine capital structure and fund that structure;
- Design reward strategies for executives and shareholders;
- Inform operational decisions;
- Control operations and ensure the efficient use of resources; Measure and report
- financial and non-financial performance to management and other stakeholders; Safeguard tangible and intangible assets;
- Implement corporate governance procedures, risk management and internal
- controls.

It will be seen that there are similarities between the objectives of both management and cost accounting indeed in practice there is no true dividing line. In general, management accounting is wider in scope and uses more advanced techniques. In addition, management accounting's emphasis is on the future (budgeting) and on influencing the behavior of managers and employees.

However, a fundamental requirement for management accounting is the existence of a sound cost accounting system to provide basic data. Without this, sophisticated techniques will be useless.

Both management accounting and cost accounting are in the main concerned with the provision of information (often in great detail) for internal planning, control and decision making purposes with considerable emphasis on the costs of functions, activities, processes and products.

3.6 Cost Accounting and Financial Accounting

Financial accounting can be defined as:

Classification and recording of the monetary transactions of an entity with established concepts, principles, accounting standards and legal requirements and their presentation, by means of income statements, balance sheets and cash flow statements during and at the end of an accounting period.

Financial accounting originated to fulfill the stewardship function of businesses and this is still an important feature. Most of the external financial aspects of the organization, e.g., dealing with Accounts Payable and Receivable, preparation of Financial Accounts, etc. are dealt with by the financial accounting system. Of course, internal information is also prepared, but in general it can be said that financial accounting presents a broader, more overall view of the organization with primary emphasis upon classification according to type of transaction (e.g. salaries, materials) rather than the cost and management accounting emphasis on functions, activities, products and processes and on internal planning and control information.

Financial accounting statements must conform to legal requirements, for example, Public Limited Companies (PLCs) must produce annual financial statements according to accepted accounting principles. These principles are established by the various regulatory bodies, e.g. the

Financial Reporting Council of Nigeria, Accounting Standards Board (ASB) in the UK, the Financial Accounting Standards Board (FASB) in the USA and International Accounting Standards (IASs). The various standards seek to eliminate ambiguity and to give a certain level of uniformity. This enables accounts to be compared on a reasonable basis.

In contrasts, cost and management accounts can be devised to suit the requirements of individual organizations and presented in any form which suits management.

3.7 Cost Accounting and Management Accounting – The Future

Enormous changes are taking place in the way companies are organized and how goods are manufactured or services supplied. Computers are used extensively not just for administrative purposes but to plan production, design products and to control machines. Production is highly automated, product life cycles are becoming shorter and markets more competitive. In general there is an increasing rate of change which will continue into the foreseeable future.

To deal with this, cost and management accounting (CMA) systems must be flexible and adaptable. Full use must be made of modern information processing and communications systems and, in addition, the principles and methods of CMA must be continually challenged and updated where necessary to meet current and expected conditions.

Much of cost and management accounting developed in the early part of the last century to meet the requirements of the factories which then existed and the way that products were made. Typically there was a low level of mechanization, wages were a high proportion of total costs and there was a relatively slow rate of change of methods and products. Contrast this with a modern factory using Just-in-Time (JIT) systems. A JIT system is where production only takes place to meet demand, there are low or zero inventories, and there is an emphasis on perfect quality. Manufacture is highly automated and typically wages may only be 5 – 10% of total costs. Production is continually changing, there is constant drive for improvement and batch quantities are low because goods are made to meet demand not to move into stock. It is a *demand-pull* system rather than *production-push*.

In addition the service sector has expanded dramatically and manufacturing now accounts for less than 25% of Gross Domestic Product. Service industries also require CMA information so systems, techniques and methods have to be adapted to suit the specific requirements of the enormous variety of service sector organizations. For example the objectives, methods of operations and information requirements of, say, banks, local government and the health service vary greatly yet all need to plan, control and take decisions and consequently need relevant, tailor-made information.

In order to provide relevant information the CMA system must take full account of the production system or methods of supplying services and the nature of the organization. Above all, the greatest care must be taken not to use inappropriate and outmoded principles and techniques which were developed to suit earlier, and now superseded, conditions. As W. Raffish has said, 'It's not that traditional cost accounting doesn't work – it's that the world it was designed for is rapidly disappearing!'

4.0 CONCLUSION

Cost and financial information is not the only information required for management decision-making, but it is usually an important if not a crucial factor.

Decision-making is concerned with the future and with future costs and revenues. Cost accounting, which is based on historical data, can nevertheless provide some guide to future costs and is frequently a critical part of the information upon which a decision is made.

Cost and management accountancy is essentially for internal purposes. Financial accounting is for stewardship purposes and is the basis of external reporting.

5.0 SUMMARY

In this unit, we have learnt that: Cost accounting is concerned with the ascertainment and control of costs; The purpose of cost accounting is to provide detailed information for control, planning and decision-making; To be of use, cost accounting information must be appropriate, relevant, timely, well presented and sufficiently accurate for the purpose intended; Cost accounting and management accounting are closely related; The emphasis of financial accounting is upon classification by type of transaction and type of expenditure rather than the functional analysis of cost accounting; Cost, financial and management accounting all contribute to the financial information system of an organization and increasingly in practice are totally integrated.

6.0 TUTOR-MARKED ASSIGNMENT

1.0 Define cost accounting with reference to its scope and uses
2.0 Explain the relationship between cost accounting, management accounting and financial accounting

7.0 REFERENCES/FURTHER READINGS

Adeniji, A.A. (2013) *An Insight Into: Management Accounting*. Lagos: Value Analysis Publishers

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UNIT 17 THE FRAMEWORK OF COST ACCOUNTING

CONTENTS

1.0 INTRODUCTION

In the last unit, you learnt about the concept of cost accounting, its definition, the range of information that could be supplied by the system and the relationships of cost accounting to management accounting and to financial accounting.

In this unit, you will be introduced to the framework of cost accounting which include key definition of cost accounting terms, determination of overheads, description of the framework of conventional cost ascertainment and introduction activity based costing and accounting.

2.0 OBJECTIVES

At the end of this you unit, you should be able to:

(i) Define key cost accounting terms;
(ii) Describe how overheads are determined;
(iii) Discuss Activity Based Costing

3.0 MAIN CONTENT

3.1 A Cost

This may be defined as:

Cost *as a noun – The amount of cash or cash equivalent or the fair value of other consideration given to acquire an asset at the time of its acquisition or construction* (IAS 16).

The word 'cost' may also be used as a verb, in which case, it can be defined thus:

To ascertain the cost of a specified thing or activity. The word cost can rarely stand alone and should be qualified as to its nature and limitations.

It will be clear from a study of these definitions that they relate to past costs which are the basis of cost ascertainment. At the simplest level, cost includes two components, quantity used and price, i.e.

cost = quantity used x price

3.2 Cost Object

A cost object is any item, process or activity for which a separate measurement of cost is required.

Examples include: the cost of manufacturing a component or product, the cost of operating a department, the cost of dealing with an enquiry at a call centre, the cost of an operation at a hospital or indeed the cost of running the whole hospital. When an individual unit cost is required it is normal to refer to *cost units*.

3.3 Cost Units

Costs are always related to some object or function or service. For example, the cost of a car, a haircut, a ton of coal etc. Such units are known as *cost units* and can be formally defined as:

A unit of product or service in relation to which costs are ascertained.

The cost unit to be used in any given situation is that which is most relevant to the purpose of the cost ascertainment exercise. This means that in any one organization numerous cost units may be used for particular parts of the organization or for differing purposes. For example, in a factory manufacturing typewriters the following cost units might be used for different purposes in the cost accounting system.

Cost Unit	Used
A typewriter	production cost ascertainment
Kilowatt-hours	electricity cost ascertainment
Computer minutes of operation	computer running cost ascertainment
Tonne-miles	transport cost ascertainment
Canteen meals	catering cost ascertainment

Cost units may be *units of production*, e.g. tones of cement, typewriters, gallons of beer, or *units of service* , e.g. consulting hours, number of invoices processed, patient nights, kilowatt-hours etc.

They may be *identical* units as in the above examples, or they may be dissimilar as in a jobbing engineering factory where the cost unit will be the job or batch, each of which will be costed individually.

3.4 Direct Costs

Costs may be classified in numerous ways, but a fundamental and important method of classification is into *direct* and *indirect costs*.

Direct costs (comprising direct material costs, direct wages cost and direct expenses) are those costs which can be directly identified with a job, batch, product or service. Typical examples are:

Direct materials	The raw materials used in a product, bought in parts and assemblies incorporated into the finished products.
Direct wages or Direct labour cost	The remuneration paid to production workers for work directly related to production, the salaries directly attributable to a saleable service (audit clerks' salaries for example).
Direct expenses	Expenses incurred specifically for a particular product, job, batch or service; royalties paid per unit for a copyright design, plant or tool hire charges for a particular job or batch.

It follow therefore that direct costs do not have to be spread between various categories because the whole cost can be attributed directly to a production unit or saleable service.

The total of direct costs is known as *prime cost*, i.e.:

direct material + direct labour + direct expenses = prime cost

Invariably when direct costs are mentioned, the costing of production cost units is involved. Technically, this need not be so, but unless the context of the question clearly points to some other conclusion, any reference to direct costs should be taken to refer to product costs units.

3.5 Indirect Costs

All material, labour and expense costs which cannot be identified s direct costs are termed *indirect costs*. The three elements of indirect costs: indirect materials, indirect labour and indirect expenses are collectively known as **overheads**. Typical examples of indirect costs in the production area are the following:

INDIRECT MATERIALS: Lubricating oil, stationery, consumable materials, maintenance materials, spare parts for machinery, etc.
INDIRECT LABOUR: Factory supervision, maintenance wages, storemen's wages, etc.

INDIRECT EXPENSES: Rent and rates for the factory, plant insurance, etc. INDIRECT

MATERIAL + INDIRECT LABOUR + INDIRECT EXPENSES = OVERHEADS

Note:
In practice, overheads are usually separated in categories such as Production Overheads, Administration Overheads, Selling Overheads. The above are examples of Production Overheads.

It must be emphasised that the choice of cost object determines what can be classified as a direct or indirect cost. For example, in a manufacturing firm, the cost object may be to find the cost of running the Inspection Department; in which case the salaries of the inspectors would be a direct cost. However, if the cost object was to find a unit component cost then the inspector's salaries would be an indirect cost because they cannot be directly identified with an individual component. The more costs that can be classified as direct; the more accurate will be the cost assignment.

3.6 Cost Build-up

Having defined direct and indirect costs, the framework of cost build-up can be shown thus:

DIRECT MATERIAL	INDIRECT MATERIAL
+	+
DIRECT LABOUR	INDIRECT LABOUR
+	+
DIRECT EXPENSE	INDIRECT EXPENSE

PRIME COST + OVERHEADS = TOTAL COSTS

3.7 Conversion Cost

This is the term used to describe the costs of converting purchased materials into finished or semi-finished products.

It is thus total production cost minus initial material input costs, i.e., the sum of, direct wages, direct expenses and absorbed production overhead. The above is the definition given in Terminology, but learners should be aware that alternative interpretations exist. For example, economists define conversion cost as total cost less material cost, i.e., all overheads are included, not just production overheads. Alternatively, the term conversion cost is sometimes used to describe the cost of converting materials from one stage of manufacture to the next stage which need not be the finished state.

3.8 Cost Centre

This can be defined as:

> *A production or service location, function, activity or item of equipment for which costs are accumulated.*

Typical examples of cost centres are: The Plating shop, The Works Office, The 1,000 ton Power Press, The Milling Machines (consisting of 20 similar machines), Sales Representatives, Invoicing Section, Inspection, etc.

In practice a cost centre is simply a method by which costs are gathered together, according to their incidence, usually by means of cost centre codes. Thus, a purchase of copy paper for use in the Invoicing Section would have a code representing say Office sundries – 457, and a code representing the Invoicing section as a cost centre, say 303, and would be coded:

303 – 457

Cost centre code for	Expenditure code for
Invoicing section	Office Sundries

Similarly another purpose of copy paper but for use in Data Processing (cost centre code 106) would be coded:

106 – 457

Cost centre code for	Expenditure code for
Data Processing	Office Sundries

3.9 Cost Allocation

This can be defined as:

> *To assign a whole item of cost, or of revenue, to a single cost unit, centre, account or time period.*

The key part of this definition is 'whole item'. Where a cost, without division or splitting, can be clearly identified with a cost centre or cost unit, then it can be allocated (via the cost accounting coding system) to that cost centre or cost unit. It follows that direct costs can be allocated to a particular cost units or groups of particular cost units, but cost allocation can, of course, apply equally to indirect costs. The examples shown in 3.9 are examples of cost allocation of a material cost which would be classed as indirect if the cost object was the product cost.

3.10 Cost Apportionment

Frequently it is not possible to identify a discrete item of cost with a cost centre and it is necessary to split a cost over several cost centres on some agreed basis. A classic example is that of Rates which are levied upon the premises as a whole, but which, for internal cost ascertainment purposes need to be shared or apportioned between the cost centres. The basis normally used for Rates being the floor area occupied by the various cost centres. The formal definition of cost apportionment is:

> *To spread revenues or costs over two or more cost units, centres, accounts or time periods. This may also be referred to as 'indirect allocation'.*

The basis upon which the apportionment is made varies from cost to cost. The basis chosen should produce, as far as possible, a fair and equitable share of the common cost for each of the receiving cost centres. The choice of an appropriate basis is a matter of judgement to suit the particular circumstances of the organization and wherever possible there should be a cost/cause relationship.

Conventional bases used are as follows:

Basis	**Costs which may be apportioned on this basis**
Floor Area	Rates, Rent, Heating, Cleaning Lighting, Building Depreciation
Volume or Space Occupied	Heating, Lighting, Building Depreciation Number of Employees in
Canteen, Welfare, Personnel, General Administration, Industrial	
each Cost Centre	Relations, Safety
Book (or Replacement)	Insurance, Depreciation Value of Plant, Equipment, Premises, etc.
Stores Requisition	Store-Keeping
Weight of Materials	Store-Keeping, Materials Handling

The process of apportionment is an essential part of the build-up of overheads, because many indirect costs apply to numerous cost centres rather than just to one.

Note:
Although cost apportionment is a normal part of the cost ascertainment process, it must be realized that it is a convention only and costs so apportioned are not verifiable.

3.11 Overhead Absorption

Direct costs, by definition, are readily identifiable traceable to cost objects or cost units, but overheads, which are often considerable, cannot be related directly, but nevertheless form part of the total cost of a product or service. Accordingly, overheads must be shared out in some equitable fashion among all of the cost units produced or services supplied.

Conventionally, the process by which this is done is known as *overheads absorption* or *overhead recovery*. Typically an overhead absorption rate, based on factors such as direct machine or labour hours is calculated and the overheads 'shared out' over the cost objects concerned according to the number of machine or labour hours involved.

3.12 Activity Based Costing (ABC)

The approach to cost ascertainment outlined above is what may be termed the *traditional approach*. This is widely used and must be thoroughly understood by learners.

Figure 1.1: The conventional build-up of total costs

DIRECT INDIRECT

ITEMS OF COST

COST ALLOCATION

COST ALLOCATION AND APPORTIONMENT

Production Cost Centres

Administrative Selling Distribution Cost Centres

PRODUCTION OVERHEAD ABSORPTION

GENERAL OVERHEAD ABSORPTION

COST UNITS

Prime Cost

Prime Cost + Production Overhead = Factory Cost

Factory Cost + General Overhead = Total Cost

Key Allocation Apportionment Absorption

ABC is a more recent approach to product costing, pioneered by Professors Kaplan and Cooper of Harvard University. ABC is an attempt to reflect more accurately in product costs those activities which influence the level of support overheads. Support overheads include such items as Inspection, Despatch, Production Planning, Set-up, Tooling and similar costs.

Traditionally all overheads were absorbed on production volume, as measured by labour or machine hours. This means that high volume standardized products would be charged with most overheads and short run production with lower overheads in spite of the fact that short run production causes more set-ups, retooling, production planning and thereby generates more support overhead costs. Thus, traditional volume related overhead absorption tends to overcost products made in *long runs* and *undercost* products made in *short runs*.

ABC seeks to overcome this problem by relating support overheads to products, not by production volume, but by a number of specific factors known as *cost drivers*. A cost driver is an activity which causes cost.

The formal definition is as follows:

> ***Cost driver*** *Factor influencing the level of cost. Often used in the context of ABC to denote the factor which links activity resource consumption to product outputs, for example the number of purchase orders would be a cost driver for procurement cost*.

The table below shows some typical cost drivers and the costs which the activity influences (or drives).

Table

Examples of cost drivers	**Typical costs influenced or 'driven' by cost driver**
Number of production runs	Inspection, production planning and scheduling, set-up, tooling
Number of despatches	Dispatch department, invoicing etc.
Number of purchase orders	Purchasing department, stock-holding etc.
Number of engineering changes	Technical department, production planning, stock-holding etc.

ABC seeks to deal with the fact that many overhead costs vary not with the *volume* of items produced but with the *range* of the items, i.e. the complexity of the production processes. Using ABC a product cost consists of items direct costs plus a share of overheads related to the number of cost driver units the production causes. Direct costs are dealt with in the same way as in traditional systems. Support overheads are collected into what are termed *cost pools*, cost driver rates calculated and the overheads charged (or traced) to the product depending on the product's usage of the particular support activity.

Figure 1.2: Outline of activity-based costing

Support Overheads

Direct Costs

Activity Cost Pools

Activity Cost

Driver Rates Overheads traced on Cost Driver Usage

Products

Products

The formal definition is:

Cost pool *Grouping of costs relating to a particular activity in an activity-based costing system.*

In traditional systems overheads are collected via cost centres which tend to be based on departments and sections. In ABC systems overheads are grouped according to the activity performed not by conventional departments. For example, if there were people dealing with Order Handling in three departments: Sales, Production Planning, and Accounts then their costs would be placed in the Order Handling Pool.

In a traditional system, overheads would be charged to products using at the most two absorption bases (labour hours and/or machine hours). On the other hand, ABC systems use many drivers as absorption bases (e.g. number of set-ups, number of orders, number of despatches and so on). Because of this, it is claimed that the use of ABC and several cost driver rates produces more realistic product or service costs, especially where support overheads are high.

In outline an ABC system is developed and used as follows:

Step 1 Identify the main activities in the organization. Examples include: materials handling, purchasing, reception, dispatch, machining, assembly and so on.

Step 2 Identify the factors which determine the costs of an activity. These are known as *cost drivers*. Examples include: number of purchase orders, number of orders delivered, number of set-ups and so on.

Step 3 Collect the costs of each activity. These are known as *cost pools*.

Step 4 Charge support overheads to products on the basis of their usage of the activity, expressed in terms of the chosen cost driver(s). for example, if the total costs of Purchasing were N200,000 and there were 1,000 Purchase orders (the chosen cost driver), products would be charged N200 for each purchase order. Thus a batch generating three purchase orders would be charged 3 x N200 = N600 for Purchasing overheads.

The use of ABC also requires a change in the way overheads are classified.

4.0 CONCLUSION

The word cost is rarely used on its own. It is invariably qualified in some way, e.g. Prime Cost, Factory Cost, Indirect Cost, etc. The process of apportionment is sometimes known as *pro-rating costs* . Although many of the bases used, e.g. Rates apportioned on floor area, appear sensible, it must be realized that the whole process of apportionment is merely a convention. It is not possible to verify that apportioned costs are correct.

Alternative names for overheads include *burden* and *on-cost,* but learners are recommended to always use the term overheads.

The ascertainment of product cost relies on clear identification of the product of service. In manufacturing companies this is usually self-evident but in many service organisations the problem is more complex. For example, a major clearing bank defined well over 150 products/ services which it supplied. Many of these were interrelated and many shared common facilities. In such circumstances product cost ascertainment becomes a difficult operation containing many subjective judgements.

5.0 SUMMARY

In this unit we have treated various concepts such as: cost object; Prime Cost; Conversion cost; overhead; cost centres; Cost allocation; Overhead absorption. We have also treated Activity Based Costing (ABC)

6.0 TUTOR-MARKED ASSIGNMENT

1.0 Differentiate between Direct and Indirect cost
2.0 Describe with the aid of a diagram Activity Based Costing

7.0 REFERENCES/FURTHER READINGS

Adeniji, A.A. (2013) *An Insight Into: Management Accounting*. Lagos: Value Analysis Publishers

Lucey, T. (2009). *Costing*. Hampshire: CENGAGE Learning.

UNIT 18 ELEMENTS OF AUDITING AND INVESTIGATION

CONTENTS

1.0 INTRODUCTION

As you will learn in this unit, auditing consists of a set of practical conceptual tools that help a person to find, organize and evaluate evidence about the assertions of another party. The demand for capable accountants and auditors of high integrity has never been greater. Opportunities for auditors are plentiful and rewarding, and can lead to attractive career opportunities in other areas. Those who practice as auditors often later go into financial management, becoming controllers, Chief Financial Officers (CFOs) and even Chief Executive Officers (CEOs). But even those who do not plan to become an auditor can benefit greatly from an understanding of financial statement auditing and its underlying concepts. Learning these tools will be valuable to any business decision maker.

2.0 OBJECTIVES

Upon completion of this chapter you will:

- be able to explain why there is a demand for auditing and assurance.
- be able to discuss the relationships between auditing and assurance.
- be able to describe the phases in which an audit is carried out.

3.0 MAIN CONTENT 3.1

The Study of Auditing

You will find that the study of auditing is different from any of the other accounting courses you have taken, and for good reason. Most accounting courses focus on learning the rules, techniques and computations required to prepare and analyse financial information. Auditing focuses on learning the analytical and logical skills necessary to evaluate the relevance and reliability of the systems and processes responsible for recording and summarizing that information, as well as the information itself. As such, you will find the study of auditing to be much more conceptual in nature than your other accounting courses.

Learning auditing essentially helps you understand how to gather and assess evidence so you can evaluate assertions (or claims) made by others. Reliable information is important for managers, investors, creditors, regulatory bodies and others to make informed decisions. Auditing helps ensure that information is understandable, relevant, reliable and timely.

3.2 The Demand for Auditing and Assurance

Why would an entity decide to spend money on an audit? This is an important question in view of the fact that many of the largest companies spend substantial amounts each year on their annual audit. Some might 'answer that audits are required by law. While true in certain circumstances, this answer is far too simplistic. Audits are often utilized in situations where they are not required by law, and audits were in demand long before laws required them. In fact, evidence shows that some forms of accounting and auditing existed in Greece as early as 500 BC;; However, the development of the corporate form of business and the expanding world economy over the last 200 years have given rise to an explosion in the demand for the assurance provided by auditors.

Some of the reasons for an independent professional opinion on the financial statement include:

a. The separations of ownership from management and the need to safeguard the interest of the owners who do not participate in the day-to-day decision of the organization by the management. This can be referred to as the principal-Agent relationship.

Principal provides capital and hires
agent to manage resources

Principal

(Absentee Owner)

Information asymmetry
and conflicts of interest lead to information risk
for the principal

Agent
(Manager)

Agent is accountable to principal;
provides financial reports

Auditor gathers evidence
agent's financial reports. to evaluate fairness of

Agent hires auditor
to report on the
fairness of agent's
financial reports.
Agent pays auditor
to reduce principal's
information risk

Auditor issues audit opinion
to accompany agent's
financial report, adding
credibility to the reports
and reducing principal's
information risk

Auditor

Source: Eilifsen, Messier, Glover & Prawitt (2010)

(a) The Companies and Allied Matters Act, 2004, provides that every company shall at each Annual General Meeting (AGM) appoint an Auditor or Auditors to audit the financial statement of the company.

(b) To provide credibility on reports and accounts prepared by the Directors which may:

I. Contain errors
II. Not disclose fraud
III. Be unintentionally misleading
IV. Be deliberately misleading
V. Fail to conform with regulations
VI. Not disclose relevant information

3.3 Auditing and Assurance Defined

In addition to auditing, professional literatures refer to the more general concept of assurance. An audit of financial statements is a specialized form of an assurance engagement. Assurance engagements, however, also include engagements beyond audits, for example assurance of non-financial information such as an entity's reporting on its environmental performance. Many times the terms audit and assurance are used interchangeably because they are related, and, at a general level, they encompass the same process: *the evaluation of evidence to determine the correspondence of some information to* a *set of criteria, and the issuance* of a *report to indicate the degree* of *correspondence.*

Auditing

A widely cited definition of auditing is the following:

Auditing is a *systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users':*

A number of phrases in this definition deserve attention. The phrase 'systematic process' implies that there should be a well-planned and thorough approach for conducting an audit. This plan involves 'objectively obtaining and evaluating evidence'. Two activities are involved here. The auditor must objectively search for and evaluate the relevance and validity of evidence. While the type, quantity and reliability of evidence may vary between audits, the process of obtaining and evaluating evidence makes up most of the auditor's activities on an audit.

Assurance

Auditors *have* a reputation for independence and objectivity. As a result, various users in the past requested that auditors provide assurance on information beyond historical financial information, but traditional auditing standards did not provide for such services. The international standard setters responded to this demand by establishing a framework for assurance engagements and standards for non-audit assurance engagements. An assurance engagement is defined as follows:

> *An* assurance **engagement** *is an engagement in which* a *practitioner expresses* a *conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of* a *subject matter against criteria.*

Because assurance engagements also include other engagements than audits, the term *practitioner* is used stead of auditor. The definition of an assurance engagement is broader than the one previously discussed *for* an audit. The *subject matter* of an assurance engagement may take many forms, including an entity's financial or non-financial performance (e.g. environmental performance) or performance of systems and processes (e.g. effectiveness of internal control). However, the practitioner's role is similar to that in an audit; he or she must determine the correspondence of the subject matter information to criteria. The subject matter information is the outcome of the evaluation or measurement of the subject matter, for example an entity's published environmental report. Criteria are the benchmarks used to evaluate or measure the subject matter, for example established guidelines for environmental reporting. The practitioner gathers sufficient appropriate evidence to provide a reasonable basis for expressing a conclusion on the subject matter information in an assurance report. The intended users are those for whom the practitioner prepares the assurance report. Before you continue, consider the following questions. What are the subject matter information and the criteria in a financial statement audit? Which party is responsible for subject matter information in an audit?

3.4 Objectives of Auditing

The primary objective of an audit under CAMA 2004, is for an appointed auditor to express a professional opinion on the financial position of an enterprise as contained in the financial statement prepared by the management so that any person reading and using them can have faith in them. Other secondary objectives include:

To prevent fraud and errors

To detect any form of irregularity

To evaluate the effectiveness or otherwise, of the internal control system within the enterprise

To assist the management in the establishment of effective auditing system

To advise on financial matters for efficient decision making by the management

To ascertain and ensure that an enterprise conform with statutory and professional requirement

3.5 Qualities of an auditor

An auditor should have the following qualities

Integrity: an auditor must be honest and be seen to be honest in the implementation of the audit assignment

Independence and objectivity: during the course of the audit assignment, auditors must be objective and be independent as much as possible within the enterprise. He must not have financial involvement in the business (affairs) of the enterprise. He must be able to plan, execute and report his findings on the statement examined to members of the enterprise without being biased and without undue influence either from within or outside the business centre.

Conformity with confidentiality principles: auditor must not disclose information about his clients to third parties except where the permission to do so have been granted.

Maintenance of technical competence: an auditor must be technically competent in the implementation of audit assignment.

Conformity with technical standard: an auditor must comply with the provision of auditing standards as well as guidelines being issued from time to time by the regulatory body

3.6 Auditing services and the expectation gap

An appointed or statutory auditor is expected to examine the financial statement of an enterprise and also express a professional opinion on them. However, auditor also performs other services. For instance, small audit firms may spend more time on other services than auditing. These may include: writing up books; balancing books; preparing final accounts; tax negotiations; government form filling; financial advice; management and systems advice; liquidation and receivership work; investigations; risk management; and corporate governance.

There are some common misconceptions in relation to the role of the auditors, even among "financially aware" people, these includes the following examples:

Many people think that the auditors report to the directors of a company, rather than members Some think that a qualified audit report is more favourable than an unqualified audit report, whereas the reverse is the case

There is a perception that it is the auditor's duties to detect fraud, when in fact the detection of fraud is the responsibility of the directors.

Large companies that recently collapsed have emphasized the need to reduce the expectation gap.

3.7 Major Phases of an Audit

The audit process can be broken down into a number of audit phases. While the description of each phase suggests that these phases are sequential, they are actually quite iterative and interrelated in nature. Phases often include audit procedures designed for one purpose that provide evidence for other purposes, and sometimes audit procedures accomplish purposes in more than one phase.

Phase 1: Client Acceptance/Continuance and Establishing an Understanding with the Client

Professional standards require that audit firms establish policies and procedures for deciding whether to accept new clients and to retain current clients. The purpose of such policies is to minimize the likelihood that an auditor will be associated with clients who lack integrity. If an auditor is associated with a client who lacks integrity, the risk increases that material misstatements may exist and not be detected by the auditor. This can lead to lawsuits brought by users of the financial statements, For a prospective new client, auditors would ordinarily confer with the predecessor auditor and frequently conduct background checks on top management. The knowledge that the auditor gathers during the acceptance/continuance process provides valuable understanding of the entity and its environment, thus helping the auditor assess risk and plan the audit. Once the acceptance/continuance decision has been made, the auditor establishes an understanding with the client regarding the services to be performed and the terms of the engagement. Such terms would include, for example, the responsibilities of each party, the assistance to be provided by client personnel and internal auditors, the timing of the engagement and the expected audit fees.

Phase 2: Preliminary Engagement Activities

There are generally two preliminary engagement activities: (1) determining the audit engagement team requirements and (2) ensuring that the audit firm and engagement team are in compliance with ethical requirements, including being independent of the entity subject to the audit.

Phase 3: Plan the Audit

Proper planning is important to ensure that the audit is conducted in an effective and efficient manner. In order to plan the audit properly, the audit team must make a preliminary assessment of the client's business risk and determine materiality. The audit team relies on these judgements to then assess risk relating to the likelihood of material misstatements in the financial statements.

As part of the planning process, the auditor may conduct preliminary analytical procedures (such as ratio analysis) to identify specific transactions or account balances that should receive special attention due to an increased risk material misstatement. Audit planning should take into account the auditor's understanding of the entity internal control system. The outcome of the auditor's planning process is a written plan that sets forth the overall audit strategy and the nature, extent and timing of the audit work.

Phase 4: Consider Internal Control

Internal control is designed and affected by an entity's board of directors or other body charged with governance, management and other personnel to provide reasonable assurance regarding the achievement of objectives in the following categories: (1) reliability of financial reporting; (2) effectiveness and efficiency of operations; and (3) compliance with applicable laws and regulations. When obtaining an understanding of the entity and its environment, the auditor should gain an understanding of internal control to help the auditor assess risk and identify areas where financial statements might be misstated.

Phase 5: Audit Business Processes and Related Accounts

The auditor typically assesses the risk of material misstatement by examining the entity's business processes or accounting cycles (e.g. purchasing process or revenue process). The auditor then determines the audit procedures that are necessary to reduce the risk of material misstatement to a low level for the financial statement accounts affected by a particular business process. Individual audit procedures are directed towards specific assertions in the account balances that are likely to be misstated. For example, if the auditor is concerned about the possibility of obsolete inventory, the auditor could conduct lower- of-cost- or-value tests to determine if the inventory on hand is properly valued. On most engagements, actually conducting the planned audit tests comprises most of the time spent on a financial statement audit.

Phase 6: Complete the Audit

After the auditor has finished gathering evidence relating to financial statement assertions, the sufficiency of the evidence gathered is evaluated. The auditor must obtain sufficient appropriate evidence in order to reach and justify a conclusion on the fairness of the financial statements. In this phase, the auditor also assesses the possibility of contingent liabilities, such as lawsuits, and searches for any events subsequent to the balance sheet date that may impact the financial statements.

Phase 7: Evaluate Results and Issue Audit Report

The final phase in the audit process is to evaluate results and choose the appropriate audit report to issue. The audit report, also referred to as the audit opinion, is the main product or output of the audit. Just as the report of a building surveyor communicates the surveyor's findings to a prospective buyer, the audit report communicates the auditor's findings to the users of the financial statements.

During and at the completion of the audit, the auditor requests the client to correct the identified misstatements. If at the end of the audit any remaining uncorrected misstatements are judged to be material, the auditor issues an audit report that expresses and explains that the financial statements are materially misstated. If the uncorrected misstatements do not cause the financial statements to be materially misstated, the auditor may issue an audit report with an unmodified (i.e. 'clean') opinion. In this context, unmodified means that because the auditor has concluded that the financial statements are free from material misstatements, the auditor does not find it necessary to modify his or her opinion about the fairness of the financial statements.

3.8 The Audit Report with an Unmodified Opinion

The audit report with an unmodified opinion is by far the most common type of report issued. While it is fairly common for the auditor to find misstatements needing correction, audit clients are ordinarily willing to make the necessary adjustments to receive a 'clean' opinion. Below presents an audit report issued on Butterfly Clothiers' consolidated financial statements. The left margin refers to the standard elements of an audit report with an unmodified opinion.

The Auditor's Report with an Unmodified Opinion

Title:	**INDEPENDENT AUDITOR'S REPORT**
Addressee:	To the Shareholders of Butterfly Clothiers
Introductory paragraph:	We have audited the accompanying consolidated financial statements of Butterfly Clothiers and its subsidiaries, which comprise the consolidated balance sheet as at 31 December 2013, and the consolidated income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.
Management Responsibility paragraph	Management's Responsibility for the Consolidated Financial Statements Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.
Auditor's responsibility Paragraph	Auditor's Responsibility Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.
Auditor's Opinion Paragraph	In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of Butterfly Clothiers and its subsidiaries as at 31 December 2013, and their financial performance and cash flows for the year ended in accordance with International Financial Reporting Standards.
Auditor's signature:	Willis & Adams International *m.j Willis* M. J. Willis, Partner
Date of the author's report:	15 February 2014
Auditor's Address:	Ikeja, Lagos.

4.0 CONCLUSION

You can see from this chapter that a good financial statement auditor needs to understand not only accounting but also the concepts and techniques of gathering and evaluating evidence to assess management's financial statement assertions. In addition, an auditor needs a deep understanding of business in general, as well as of the specific industries in which his or her clients operate. This is why professionals with auditing experience frequently have attractive opportunities to move into other areas of business and management. Chief executive officers, business owners, chief financial officers, consultants and controllers are often former auditors.

5.0 SUMMARY

In this unit, we have discussed auditing and assurance. We also considered the objectives and qualities of an auditor. We also mentioned the need to reduce the expectation gap between the auditor and their clients. The major phases of an audit was thoroughly discussed

6.0 TUTOR MARKED ASSIGNMENT

1. Differentiate between auditing and assurance
2. State the objectives of auditing
3. What are the qualities of an auditor?
4. Explain the major phases of an audit

7.0 REFERENCE/FURTHER READING

Adeniji, A.A. (2012). *Auditing and Assurance Services*. Isheri: Value Analysis Consult.

Eilifsen, A., Messier, W.F., Glover, F.M. & Prawitt, D.F. (2010). *Auditing and Assurance Services*. Berkshire: McGraw-Hill Higher Education.

UNIT 19 THE AUDITING ENVIRONMENT

CONTENTS

1.0 INTRODUCTION

This unit covers the context or environment in which auditors function, starting with an overview of the far-reaching changes in the accounting profession over the past several years. The chapter then addresses auditors' legal liability and explains how it affects the accounting profession and the audit markets. The accounting profession operates globally and is increasingly governed by international organizations and initiatives taken at the international level. The chapter discusses the International Federation of Accountants (IFAC) and other major international organizations and explains how they impact the accounting profession worldwide.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- explain the professional and statutory regulations guiding the auditing profession;
- describe auditor's negligence and legal liability;
- discuss the various types of auditors

3.0 MAIN CONTENT

3.1 A Time of Challenge and Change for Auditors

The environment in which auditors work has been dramatically reshaped by the events taking place in the business world during the past several years. In fact, the profession has gone through a period of almost unprecedented change, including changes in regulation and public oversight, professional standards, and organization of audit firms. Because of the global nature of the events leading up to these changes, the primary initiatives for and responses to changes were taken at the international level. This section briefly discusses some of the issues and controversies that led up to the many changes experienced by the profession. While the profession has undergone profound changes, the events of the past several years have served to solidify the crucial role of accounting and auditing in protecting public interests.

During the economic boom of the late 1990s and early 2000s, audit firms aggressively sought opportunities to market a variety of high-margin non-audit services to their audit clients. The consulting revenue of the largest audit firms grew extremely quickly, until in many instances consulting revenues from audit clients greatly exceeded the fee for the external audit.

3.2 Professional Regulations

The fundamental function of auditing in the economy and its role of serving the public interest have for a long time implied substantial government involvement and regulation of the auditing sector. The degree of regulation has varied among countries, from a fairly self-regulated profession to a strongly governmental regulated auditing sector. Individual countries and jurisdictions found their own balance of self-regulation by the profession and regulation by the government. Following the corporate scandals and the undermining of public confidence in the financial reporting and auditing process, a reconsideration of the regulatory systems and measures took place. Overall, this resulted in stricter regulation and stronger public oversight. For example, in the USA the Sarbanes-Oxley Act of 2002 (commonly known as SOX) transferred authority to set auditing standards for public company audits from the profession to the Public Company Accounting Oversight Board (PCAOB). Specifically, the International Standards on Auditing have become more comprehensive and are today established as global auditing standards. Other professional accounting bodies that issue rules and regulations guiding the conduct of audit include:

1. The International Financial Reporting Standard (IFRS) – promulgated by the International Financial Reporting Standard Board (IFRSB)
2. The International Auditing Guideline (IAG) – promulgated by the International Auditing Practice Committee (IAPC)
3. The auditing guidelines issued by the Institute of Chartered Accountants of Nigeria (ICAN)
4. Auditor-General Guidelines
5. Guidelines for audit alarm committee
6. Financial memoranda for Local government accounts
7. Guideline for National council on Government accounting.

3.3 Statutory regulations

These are pronouncements or statements being issued through government legislation, which regulates the implementation/auditing functions. All auditors must adhere strictly to these regulations e.g. Auditing under CAMA 2004, Auditing under BOFIA'91, Auditing functions under Insurance Act 2003 as amended.

3.4 Auditors' Negligence and Legal Liability

Negligence means act or omission which occurs because the person concerned failed to exercise that degree of professional care and skill, appropriate to the circumstances of the case, which is expected of accountants and auditors. Claims for negligence generally arise when an auditor has failed to discover a fraud and the company has suffered financial loss subsequent to the audit.

The auditor adds value to the principal-agent relationship by providing an objective, independent opinion on the quality of the information reported. However, what prevents the auditor from cooperating with management and issuing an unmodified opinion on financial statements that are materially misstated? The main deterrent, other than an individual's ethical principles, is the threat of liability. If a client or a third party suffers loss from such fraudulent behaviour, the auditor's personal and professional reputation will be affected by litigation.

Legal liability regimes of auditors and auditors' exposure to litigation vary between countries and jurisdictions. Legal liability rules differ according to which actions the auditor can be held liable for, which third parties auditors are liable to, joint and several liability or proportional liability, existence of legal liabilities caps and allowance to contract liability caps, and rules for allocation of litigation costs between parties.

3.5 Auditor's Responsibilities

Financial statement audits play an important role in the functioning of our economy, and thus our society expects auditors to exercise professional judgement and maintain professional scepticism in their work. Professional judgement means that the auditor, within the context provided by auditing and ethical standards, applies relevant training, knowledge and experience in making informed decisions during the Professional scepticism means an attitude that includes a questioning mind and a critical assessment of audit evidence. If the auditor fails to exercise professional judgement and to maintain professional sceptism, he or she may be held liable.

Many readers of financial statements believe that auditors are ultimately responsible for the financial statements or at least that they have a responsibility to detect all errors and fraud. This is simply not true. While auditors must exercise professional judgement and maintain professional scepticism in their work, the financial statements ultimately are the responsibility of management (note that the assertions are called management assertions). It is important to remember that while auditors do have important responsibilities, management is primarily responsible for the fairness of the entity's financial statements.

Auditing standards (ISA 240) provide the following responsibility to detect errors and fraud for auditors:

An auditor conducting an audit in accordance with ISAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the IASs.

The auditor's responsibility to provide reasonable assurance with respect to errors and fraud clearly shapes the auditor's environment.

3.6 Types of Auditors

A number of different types of auditors can be identified; however, most can be classified under *four* headings: external auditors, internal auditors, government auditors and forensic auditors. One important requirement for each type of auditor is independence, in some form, from the entity being audited. As described below, each different type of auditor usually specializes in a particular type of audit work. However, they often provide a number of the types of services described in the previous section.

External Auditors

External auditors are often referred to as *independent auditors* or *professional accountants in public practice. Such aud* itors are called 'external' because they are not employed by the entity being audited. In *this book, the terms external auditor, independent auditor, professional accountants in public practice, practitioner or sim* ply *auditor* will be used interchangeably. A *statutory auditor* is an external auditor approved to carry out an audit of the financial statements required by law. Typically, auditors hold some form of licence authorization. For instance, they are certified, chartered, registered or state-authorized.

External auditors audit financial statements for publicly traded and private companies, partnerships, municipalities, other types of entities and individuals. They may also conduct other services for such entities. However regulation and codes of ethics restrict some types of services such as certain advisory services that an external auditor can provide to financial statement audit clients.

The professional qualifications to act as an auditor are regulated. The requirements for licensing vary among nation and jurisdictions. Typically a university or college degree with selected courses in topics such as accounting, auditing, business administration, and business and tax law is required. Before a licence is granted, a period of professional practice is ordinarily needed.

Internal Auditors

Auditors that are employees of individual companies, government bodies and other entities are called internal auditors. In major corporations, internal audit staff may be very large and the director of internal auditing usually a major position within the entity.

The institute of Internal Auditors (IIA) is the global organization supporting internal auditors. Its mission is to be ‘the primary international professional association, organized on a worldwide basis, dedicated to the promotion and development of the practice of internal auditing'. The IIA has developed a set of standards to be followed by internal auditors and has established a certification programme. An individual who meets the certification requirements established by the IIA, including passing a uniform written examination, can become a certified internal auditor (CIA). Many internal auditors also hold a licence as external auditor.

The Institute of Internal Auditors (IIA) defines internal auditing as 'an independent, objective assurance and consulting activity designed to add value and *improve* an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.'

Internal auditors may conduct financial, internal control, compliance, operational and forensic audits, as well as consulting within their organizations. They in some cases may assist the external auditors with the annual financial statement audit. Chapter 20 offers more detail on the IIA and the internal auditing profession.

Government Auditors

Government auditors are employed by national or local governmental institutions and public bodies. The majority of government auditors provide assurance on compliance and operational performance, ordinarily termed compliance audits and operational performance audits. A compliance audit determines the extent to which rules, policies, laws or government regulations are followed by the entity being audited, for example an examination of tax returns of individuals and companies by the tax law enforcement authorities for compliance with the tax laws. An operational performance audit involves a systematic review of part or all of an organization's activities to evaluate whether resources are being used effectively efficiently.

At the national level most countries have established an Office of Auditor General (Supreme Audit Institution). Such offices are normally empowered by the constitution and are responsible to parliament or a similar legislative institution. Offices of Auditor General monitor the use of public funds, conduct assurance of activities, financial transactions and accounts of the government. They may also assist Parliament by performing special audits, surveys and investigations. The fact that they report directly to Parliament provides the Offices of Auditor General with an organizational arrangement that ensure objectivity and independence.
Most regional and local governments and municipals also have audit offices that perform functions similar to the Office of the Auditor General. Such offices include tax auditors that ensure that individuals and organizations are complying with tax laws. Finally, there are international organizations that support the government audit profession such as the International Organization of Supreme Audit Institutions (INTOSAI).

Forensic Auditors

Forensic auditors are employed by corporations, government agencies, audit firms, and consulting and investigative services firms. They are trained in detecting, investigating and deterring fraud and white-collar crime (see the discussion of forensic auditing earlier in the chapter). Some examples of situations where forensic auditors have been involved include:

- Reconstructing incomplete accounting records to settle an insurance claim over inventory valuation.
- Probing money-laundering activities by reconstructing cash transactions.
- Investigating and documenting embezzlement and negotiating insurance settlements.

The Association of Certified Fraud Examiners (ACFE) is the global organization supporting forensic auditors. The ACFE is a 40,000-member professional organization dedicated to educating certified fraud examiners (CFEs), who are trained in the specialized aspects of detecting, investigating and deterring fraud and white-collar crime.

The ACFE offers a certification programme for individuals wanting to become CFEs. Individuals interested in becoming a CFE must pass the Uniform CFE Examination. Certified fraud examiners come from various professional backgrounds, including auditors, accountants, fraud investigators, loss prevention specialists, lawyers, educators and criminologists. They gather evidence, take statements, write reports and assist in investigating fraud in its varied forms.

4.0 CONCLUSION

To fully understand auditing, you must be aware of the factors that shape the auditing environment, including the dramatic events over the past several years that led to fundamental change; auditors' legal liability; professional, regulatory and standard setting bodies that govern the accounting profession; auditing standards and how they affect auditor's responsibilities;

5.0 SUMMARY

In this unit, we have discussed professional and statutory regulations, auditor's negligence and legal liability, auditor's responsibility and types of auditor.

6.0 TUTOR MARKED ASSIGNMENT

1. Discuss in details auditor's responsibilities
2. List the various types of auditors.

7.0 REFERENCE/FURTHER READING

Adeniji, A.A. (2012). *Auditing and Assurance Services*. Isheri: Value Analysis Consult.

Eilifsen, A., Messier, W.F., Glover, F.M. & Prawitt, D.F. (2010). *Auditing and Assurance Services*. Berkshire: McGraw-Hill Higher Education.