T05 PRINCIPLES OF ACCOUNTING & AUDITING

PRINCIPLES OF ACCOUNTING & AUDITING

STUDY TEXT

T05

Accounting Technician Level II

THE NATIONAL BOARD OF ACCOUNTANTS AND AUDITORS TANZANIA (NBAA)

T05

PRINCIPLES OF ACCOUNTING AND AUDITING

STUDY TEXT

NBAA

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FOREWORD.

The National Board of Accountants and Auditors is a professional body in Tanzania, established under the Auditors and Accountancy Registration Act No 33 of 1972 (CAP 286 R.E.2002). The Board has been charged with among other things, the responsibility to promote, develop and regulate the accountancy profession in the country.

In fulfilling its statutory obligations, NBAA prepares National Accountancy Examination Scheme for students aspiring to sit for Accounting Technician and Professional Examinations. Further, for effective implementation of the examination scheme and improve examination results, the Board provides Study Guides for all subjects to assist both examination candidates and trainers in the course of learning and teaching.

The Study Guides have been prepared in the form of text books with examples and questions to enable the user to have comprehensive understanding of the topics. The Study Guides cover a wide range of topics in the NBAA syllabi and adequately cover the most comprehensive and complete knowledge base that is required by a leaner to pass the respective examination levels.

Furthermore, the Study Guides have been prepared to match with the Competency Based Syllabi to enable the learners to be exposed to practical understanding of issues rather than memorisation of concepts. In this case, the Study Guides are characterized by the following features:-

1. Focus on outcomes – The outcomes shown in every topic provides clear understanding on what to be learnt.

2. Greater workplace relevance – the guides emphasize on the importance of applying knowledge and skills necessary for effectively performance in a work place. This is different from the traditional training where much concern has been expressed in theoretical perspectives.

3. Assessments as judgments of competence – The assessment questions embedded in the Study Guides are adequate measures of understanding of the subject matter.

Study Guides are also useful to trainers specifically those who are teaching in the review classes preparing learners to sit for the professional examinations. They will make use of these Study Guides together with their additional learning materials from other sources in ensuring that the learners are getting sufficient knowledge and skills not only to enable them pass examinations but also make them competent enough to perform effectively in their respectively workplace.

NBAA believes that these standard Study Guides are about assisting candidates to acquire necessary skills and knowledge that will enable them to perform as professionals. The outcomes to be achieved are clearly stated so that learners may know exactly the skills and knowledge they are supposed to acquire in a particular topic.

NBAA wishes all the best to NBAA Examination candidates, trainers in their review classes, lecturers in the higher learning institutions and all other beneficiaries of these learning materials in making good use of the Study Guides towards promoting the accountancy profession in Tanzania.

CPA. Pius A. Maneno
EXECUTIVE DIRECTOR
JUNE, 2019

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Features of the book

‘The book covers the entire syllabus split into various chapters (referred to as Study Guides in the book). Each chapter discusses the various Learning Outcomes as mentioned in the syllabus.

Contents of each Study Guide

‘Get Through Intro’: explains **why** the particular Study Guide is important through real life examples.

‘Learning Outcomes’: on completion of a Study Guide, students will be able to understand all the learning outcomes which are listed under this icon in the Study Guide.

The Learning Outcomes include:

‘Definition’: explains the meaning of important terminologies discussed in the learning Outcome.

‘Example’: makes easy complex concepts.

‘Tip’: helps to understand how to deal with complicated portions.

‘Important’: highlights important concepts, formats, Acts, sections, standards, etc.

‘Summary’: highlights the key points of the Learning Outcomes.

‘Diagram’: facilitates memory retention.

‘Test Yourself’: contains questions on the Learning Outcome. It enables students to check whether they have assimilated a particular Learning Outcome.

Self Examination Questions’: exam standard questions relating to the learning outcomes given at the end of each Study Guide.

EXAMINATION STRUCTURE

The syllabus is assessed by a three hour paper based examination.

The examination will consist of

Three conventional question of 20 marks	60 marks
Twenty objective questions of 2 marks	40 marks
	100 marks

SECTION A

THE CONTEXT AND PURPOSE OF PRINCIPLES OF ACCOUNTING

A1

STUDY GUIDE A1: THE REGULATORY FRAMEWORK

Get Through Intro

As with any profession, people who practise accountancy are expected to possess certain expertise. Under this assumption, society accepts advice from professional accountants in good faith and acts on this advice.

The main area in which this faith is evident is the reliance on financial statements prepared by professional accountants. Readers should be able to accept them without any question and base their decisions on them.

There has to be some mechanism to ensure that accounting work is performed according to set principles and standards. Furthermore, an assurance is needed that the assumed professional expertise does actually exist and is applied to the work in hand. This is achieved by means of a regulatory framework.

As an accountant, you can not underestimate the importance of the regulatory framework. Without it, you will not be able to do your job properly. In future, you will need to remain up-to-date on this area; otherwise you will have no idea about any changes that occur in the accountancy profession!

Therefore as an accountant it is important that you understand the various regulations and regulatory bodies that govern the financial reporting process as well as how, where and why International Financial Reporting Standards should be utilised. This Study Guide will cover the concept and importance of International Financial Reporting Standards as well as the regulatory framework and various bodies that produce them.

Learning Outcomes

a) Described the Tanzania accounting regulatory framework.
b) Explain the role of the regulatory system including the roles of the International Accounting Standards Committee Foundation (IASCF), the International Accounting Standards Board (IASB), the Standards Advisory Council (SAC) and the International Financial Reporting Interpretations Committee (IFRIC).
c) Explain the role of International Financial Reporting Standards.
d) Explain the purpose and main aspects of the International Accounting Standard’s Board framework for the preparation and presentation of financial statements.

1. Describe the Tanzania accounting Regulatory Framework.
Explain the role of the regulatory system including the roles of the International Accounting Standards Committee Foundation (IASCF), the International Accounting Standards Board (IASB), the Standards Advisory Council (SAC) and the International Financial Reporting Interpretations Committee (IFRIC).
Explain the role of International Financial Reporting Standards.
[Learning Outcomes a, b and c]

Case Study

You will probably have heard of Enron. This is an example of a situation in which the regulatory framework did not work properly. As a result, one of the largest corporate frauds took place, leading in turn to one of the largest insolvency cases ever. It also indirectly caused the collapse of one of the accounting giants – Arthur Andersen.

Enron manipulated its accounts in such a manner that the assets and profits were inflated or fraudulent and non-existent. Debts and losses were put into entities formed 'offshore' that were not consolidated (included) in the company's financial statements.

A completely misleading picture was created. As a result, Enron was named "America's Most Innovative Company" by Fortune magazine for six consecutive years, from 1996 to 2001, and it was also on Fortune's "100 Best Companies to Work for in America" list in 2000.

Following the discovery of the accounts manipulations, its investors lost their money and the society, its confidence in the system. Enron descended rapidly from the peaks of these accolades.

A proper regulatory framework would have ensured that a misleading picture was not shown to the users of the financial statements who trusted in them, invested large amounts in the company; and suffered a loss when it became insolvent.

In this Study Guide, we discuss the fundamental issues relating to the regulatory framework, so that you can play your part in preventing another 'Enron'!

1.1 What is a Regulatory Framework?

Firstly, let us understand what a regulatory framework is. It is a structure which helps an entity decides how to treat items that need to be included in the financial statements. It is based on

- Company law
- International Accounting Standards (if followed)
- The influence of other national standard-setting bodies
- Stock Exchange requirements
- Overseeing by the professional bodies such as NBAA in Tanzania, ICAEW, or IFAC to ensure that the professional standards for accounting and auditing are followed in practice.

1.2 Role of a Regulatory Framework

The main role of a regulatory system is to help ensure that accountants produce comparable, consistent, accurate and easily understandable financial statements and reports.

Other reasons why a regulatory system is needed include:

1. The separation of ownership and control that exists for many organisations

Having a regulatory system in place helps ensure that the financial statements / reports that owners receive from management with regards to the financial condition and performance of the organisation are true and fair. This better equips the owners to make economic decisions regarding their investments in the business.

2. To remove / reduce the element of subjectivity from accounting

Users of financial statements such as owners and investors need clear and comparable information to assess the financial condition and performance of different organisations. Therefore all preparers of these financial statements should be following the same set of rules or standards.

Example

Alpha Ltd and Beta Ltd have paid Tshs100,000 for salaries to employees. This includes Tshs40,000 of salaries paid to directors. However there is no regulation stating that the salaries paid to directors have to be shown as a separate item. The accountants of both the companies prepare their respective statement of profit or loss as follows:

Statement of profit or loss

	Alpha Ltd	**Beta Ltd**
	Tshs	**Tshs**
Income	1,000,000	1,000,000
Expenses		
- Salaries	(100,000)	(60,000)
- Salaries to directors	- (700,000)	(40,000)
- Other expenses		(700,000)
Profit	**200,000**	**200,000**

Beta Ltd's accountant has decided to segregate the salaries paid into two categories (directors and employees) whilst Alpha Ltd's accountant has decided to group them together. Therefore it appears from Alpha Ltd's statement of profit or loss that its directors did not receive any salaries for that particular period which is inaccurate.

However if a specific regulation existed that directors' salaries were to be shown as a separate item the two statement of profit or loss (s) would look as follows:

Statement of profit or loss

	Alpha Ltd Tshs	**Beta Ltd Tshs**
Income	1,000,000	1,000,000
Expenses		
Salaries	(60,000)	(60,000)
Salaries to directors	(40,000)	(40,000)
Other expenses	(700,000)	(700,000)
Profit	**200,000**	**200,000**

Therefore every country has a regulatory body that produces local accounting standards or generally acceptable accounting practices that all its accountants must follow. For instance:

(a) In the USA, accounting is performed in accordance with US Generally Accepted Accounting Principles (GAAP).
(b) In India, accounting is performed in accordance with the Indian Accounting Standards.
(c) In Arab countries, accounting is performed according to the methods prescribed by the Arab Society of Certified Accountants.
(d) In the UK, accounting is performed in accordance with the Statement of Standard Accounting Practices (SSAP) and Financial reporting Standards (FRS) issued by the Accounting Standard Board, UK.
(e) In Tanzania, accounting is performed in accordance with the Tanzanian Financial Reporting Standards and International Financial Reporting Standards.

3. The need for a set of uniform universal accounting standards or International Financial Reporting Standards (IFRS)

This would facilitate comparing and contrasting the financial condition and performance of organisations that operate in different countries.

For instance, in certain countries (e.g. in Central and Eastern Europe, France etc.) the accounting system was one based on strict rules and was closely interlinked to taxation. In others, such as the UK, the local GAAP aims at faithful representation for the shareholders and are conceptually based and driven by professional judgement.

Given how different these two types of systems are in terms of substance, they will naturally produce financial statements that are not comparable or contrastable. However the adoption of IFRS would greatly facilitate comparison between entities in different countries.

4. Statutory and other regulatory requirements

Company law usually lays down the reporting requirements for companies. It not only lays down the format but also gives guidelines regarding the preparation and presentation of the financial statements e.g. UK company law.

The leading stock exchanges, e.g. the New York Stock Exchange, require companies to comply with certain reporting norms as a part of the listing requirements, i.e. in return for allowing the companies' shares to be listed and traded on the stock exchange.

Security regulators such as the Securities and Exchange Commission monitor the reporting practices of the companies.

5. Requirements of other countries

Whenever an entity operates in more than one country, it has to comply with the accounting requirements of each of these countries. This often results in organisations having to produce multiple financial statements and reports. However with the adoption of IFRS, an organisation can produce one set of statements that would satisfy the statutory requirements of all concerned countries.

1.3 Structure of IFRSF / IASB

The International Accounting Standards Committee (IASC)

The International Accounting Standards Board (IASB) was previously run as the IASC, which operated from 1973 until 2001. The **IASC was founded in June 1973** as a result of an agreement by accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the UK and Ireland and the US. These countries formed the Board of IASC initially. The purpose of the Board was to **work towards the improvement and harmonisation of accounting standards and reporting**. In March 2001, as part of a restructuring, the IASC Foundation was set up in Delaware as a not-for-profit entity. The IASC in turn gave approval for the IASB to assume standard-setting responsibilities.

IASC Foundation became IFRS Foundation on 1 July 2010.

On 1 July 2010, the IASC Foundation has formally changed its name to the IFRS Foundation. The change represents the next step in a process to simplify the names in use across the organisation which was announced following the conclusion of the Constitutional Review in 2010. The International Financial Reporting Interpretations Committee and the Standards Advisory Council are also renamed as the IFRS Interpretations Committee and the IFRS Advisory Council, respectively. The name of the International Accounting Standards Board (IASB) remains unchanged.

The objectives of the IFRS Foundation, as stated in its constitution, are:

To **develop,** in the public interest, a **single set of high-quality, understandable and enforceable global accounting standards** that require high-quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions.

To **promote the use** and rigorous application of those standards.

In fulfilling the objectives associated with (a) and (b), **to take account**, as appropriate, of the special needs of **small and medium-sized entities** and emerging economies.

To bring about **convergence of national accounting standards** and IASs and IFRSs to high-quality solutions.

1. The structure of the IFRS Foundation

(a) The monitoring board

(b) The Foundation is governed by trustees.

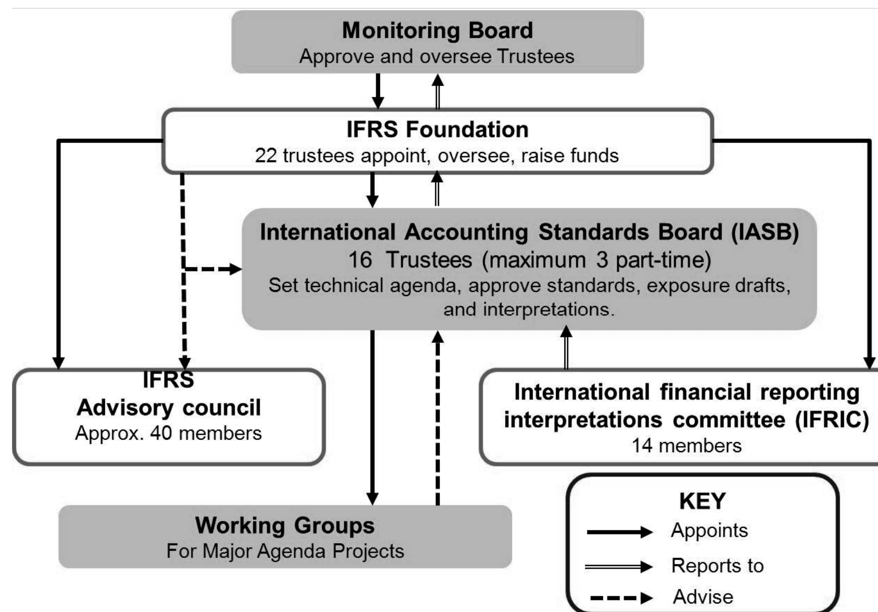
(c) There are 22 trustees, appointed as follows:

i. 6 from North America;
ii. 6 from Europe;
iii. 6 from the Asia / Oceania region; and
iv. 4 from any area, subject to establishing overall geographical balance.

(d) The trustees should comprise individuals from different professional backgrounds such as auditor's preparers, users and academicians.

(e) They should meet at least twice each year.

Diagram 1: The structure of the IFRS Foundation and its components



(Source: www.iasb.org)

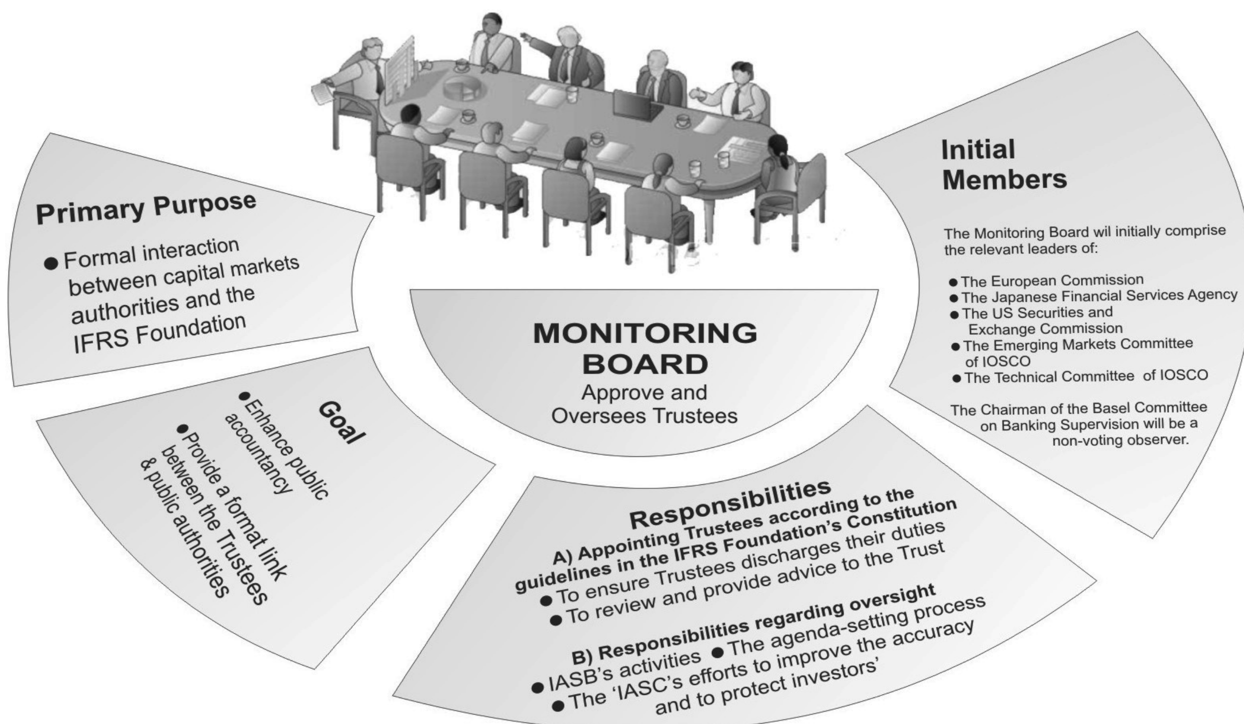
Monitoring Board

The primary purpose of the Monitoring Board is to serve as a mechanism for formal interaction between the IFRS Foundation and the capital market authorities that allow or require the use of IFRS in their jurisdictions to effectively discharge their mandates relating to investor protection, market integrity and capital formation.

This step has increased the public accountability of the IFRS Foundation while not impairing the standard setting process.

The following diagram provides details regarding the primary purpose, goals, responsibilities and members of the monitoring board:

Diagram 2: Monitoring Board



Name of body	Structure	Role
1. The Monitoring Board	Given in detail in diagram 2 above	Given in detail in diagram 2 above
2. The International Accounting Standards Board (IASB) It was previously run as the IASC, which operated from 1973 until 2001.The purpose of the Board was to work towards the improvement and harmonisation of accounting standards and reporting. In March 2001, as part of restructuring, the new IASB took over from the IASC, the responsibility for setting International Accounting Standards.	(a) The IASB comprises sixteen individual members; thirteen full-time and three part-time. (b) Members have professional competence and practical experience. (c) Trustees appoint one of the full-time members to be the Chairman of the IASB, who is also the Chief Executive of the IFRS Foundation. (d) Each member of the IASB has one vote. A quorum is formed by at least 60% of the members of the IASB.	To achieve the following objectives: (a) To **develop high quality**, understandable and enforceable global **accounting standards**. (b) To **promote** the **use** and rigorous **application of those standards**. (c) **Take account** of special **needs of small and medium sized entities** and emerging economies. (d) To **bring about convergence of national accounting standards** and IASs and IFRSs to high-quality solutions. The IASB has complete responsibility for all IASB technical matters, including preparing and issuing IFRS, IAS, and Exposure Drafts.
3. The IFRS Advisory Council It is a formal body which gives advice to the IASB and individuals relating to the various accounting standards	(a) It comprises forty or more members, and a chairman, all appointed by the trustees. (b) The members are expected to be from diverse professional and geographical backgrounds.	(a) To provide a forum where the IASB consults individuals and the representatives of the organisations. (b) To support the IASB in the promotion and adoption of IFRSs throughout the world.
4. The IFRS Interpretation Committee (IFRIC) It is a formal body which assist the IASB in establishing and improving standards of financial accounting and financial reporting. It does this by giving an opinion on any areas that have given rise to disputes or confusion in the standards. It attempts to settle these disputes by issuing interpretations to clarify the particular matter.	The Interpretations Committee comprises 14 voting members drawn from a variety of countries and professional backgrounds. They are appointed by the Trustees of the IFRS Foundation and are selected for their ability to maintain an awareness of current issues as they arise and the technical ability to resolve them.	The main role of the committee include: 1. Issuing interpretations. 2. Providing guidance on the application of standards. 3. Liaising with the local accounting setters to reduce the differences between international accounting standards and the respective local accounting standards. 4. Inviting public comments / inputs on any areas of confusion or dispute in the International Accounting Standards.

Test Yourself 1

Who governs the IFRS Foundation?

A Members of IASB
B Members of IFRS Interpretations Committee
C IFRS advisory Council
D None of the above

Test Yourself 2

Who appoints the members of the IFRS Advisory Council?

A Members of IASB
B Members of IFRS Interpretations Committee
C Trustees of the IFRS Foundation
D None of the above

Test Yourself 3

What is the main duty of the IFRS Interpretation Committee?

A To appoint members of IFRS advisory council
B To draft accounting standards
C To withdraw accounting standards
D To guide on accounting standards

1.4 Regulatory framework of accounting in Tanzania

Subject to the provisions of Companies Act 2002 Act, every company's is required to prepare its balance sheet, profit and loss account and cash flow statement in accordance with the requirements specified in regulations prescribed by the Minister, or the National Board of Accountants and Auditors or such other body as the Minister may decide.

Tanzania migrated to IFRSs, IPSASs and ISAs with effect from 1st July, 2004 and therefore, every entity in the country, whether small or large, was required to prepare its financial statements in accordance with the IFRSs or IPSASs as the case may be.

Following the issuance of the IFRSs for SMEs by the International Accounting Standards Board (IASB) on 9 July, 2009, some entities in Tanzania are permitted to use the IFRSs for SMEs issued by IASB.

The National Board of Accountants and Auditors Tanzania issued a technical pronouncement on 15 October 2009 to clarify on the scope of the applicability of those standards in the country. The scope of applicability of IFRS/IAS is as follows:

Sr.No	Type of Standard	Category of entities
1.	Full IFRS	Publicly accountable entities or entities that represent public interest such as entities that take deposits or loans from the public; offer shares to the public; have essential public responsibility or privilege essential public service or entities that hold assets in a fiduciary capacity for a broad group of outsiders. Example of entities that should use full IFRSs include but not limited to: 1. Listed Companies, 2. Banks and Financial Institutions, 3. Insurance Companies, 4. Pension Funds 5. Utility Companies, 6. Government Agencies, 7. Mutual Funds, 8. SACCOs, 9. Cooperative Societies, 10. Securities brokers/dealers, 11. All Entities which receive subvention from the Government, except those which are required to use IPSASs. 12. All entities including Government Business Entities (GBEs) with 100 or more employees***, 13. All entities including GBEs with capital investment in non- current assets of above TShs.800,000,000***

Continued on the next page

2.	IPSAS's	Public sector entities including ministries, regional governments, government departments, agencies and local government provided that they are no Government Business Entities (GBEs).Entities using Accrual based IPSASs are encouraged to use full IFRSs
3.	IFRS for SME's	1. Entities that are not publicly accountable or representing public interest, 2. Entities including GBEs with less than 100 employees provided that they are not in categories 1 and 2 above, 3. Entities including GBEs with capital investment in non-current assets of less than TShs.800,000,000 provided that they are not in categories 1 and 2 above.

NB: Entities in categories 2 and 3 are free to use full IFRS provided that they fully comply with it.

*****A Government Business Entity (GBE) is defined as an entity that has ALL of the following characteristics:**

(a) Is an entity with the power to contract in its own name,
(b) Has been assigned the financial and operational authority to carry on a business,
(c) Sells goods and services, in the normal course of its business, to other entities at a profit or full cost recovery,
(d) Is not reliant on continuing government funding to be a going concern (other than purchases of output at arm's length), and
(e) Is controlled by a public sector entity.

Below is the list of current standards of IASB

Standard Number	Title
IAS 1	Presentation of financial statements
IAS 2	Inventories
IAS 7	Statement of cash flows
IAS 8	Accounting policies, changes in accounting estimates and errors
IAS 10	Events after the reporting period
IAS 11	Construction contracts
IAS 12	Income taxes
IAS 16	Property, plant and equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee benefits
IAS 20	Accounting for government grants and disclosure of government assistance
IAS 21	The effects of changes in foreign exchange rates
IAS 23	Borrowing costs
IAS 24	Related party disclosures
IAS 26	Accounting for reporting by Retirement Benefit Plans
IAS 27	Separate financial statements (revised 2011)
IAS 28	Investments in associates and joint ventures
IAS 29	Financial reporting in hyperinflationary economies
IAS 30	Disclosure in the financial statements of banks and similar financial institutions
IAS 32	Financial instruments – disclosure and presentation
IAS 33	Earnings per share
IAS 34	Interim financial reporting
IAS 36	Impairment of assets
IAS 37	Provisions, contingent liabilities and contingent assets
IAS 38	Intangible assets
IAS 39	Financial instruments - recognition and measurement
IAS 40	Investment Property
IAS 41	Agriculture
IFRS 1	First time adoption of IFRS
IFRS 2	Share-based payment
IFRS 3	Business combinations
IFRS 4	Insurance contracts
IFRS 5	Non-current assets held for sale and discontinued operations
IFRS 6	Exploration for and evaluation of mineral resources

IFRS 7	Financial instruments: disclosures
IFRS 8	Operating segments
IFRS 9	Financial instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint arrangements
IFRS 12	Disclosure of interests in other entities
IFRS 13	Fair Value Measurement

1.5 International Accounting Standards and their role

International Accounting Standards are a single set of high quality, understandable and enforceable global accounting standards. The idea is that these same standards are used across the globe by companies, so financial statements can be prepared and compared on the same basis.

International accounting standards are an important part of the regulatory framework.

The term International Financial Reporting Standard (IFRS) covers:

1. International Financial Reporting Standards **(IFRSs)** issued by the International Accounting Standard Board (IASB).

2. International Accounting Standard **(IAS**) issued by the former International Accounting Standard Committee (IASC).

3. **Interpretations** issued by the International Financial Reporting Interpretations Committee (IFRIC)

The main role of IFRS

(a) IFRS, by promoting uniformity, have removed much of the subjectivity in accounting. This was achieved by a timely revision of existing accounting standards and introduction of new standards.

Earlier inventories could be presented either using the last in first out (LIFO) method or the first in first out (FIFO) method. However the IAS-2 Inventories standard prohibited use of the last in first out (LIFO) method. (You will study LIFO and FIFO methods in detail in Study Guide D3). This has subsequently been adopted by many local accounting bodies.

(b) IFRS have helped the IASCF and its supporting bodies move the world closer towards adopting global accounting standards. For instance, the European Community has made it mandatory for all listed companies (i.e. companies whose shares are listed on a stock exchange to be publicly traded) in the European Union to adopt IFRS by 2005 for group financial statements.

SUMMARY

2. Explain the purpose and main aspects of the International Accounting Standard's Board framework for the preparation and presentation of financial statements

[Learning Outcome d]

2.1 Meaning of conceptual framework of accounting

The IFRS Framework issued by the IASB gives a set of concepts in certain basic areas about the why, what and how of the accounting process and the financial statements e.g. whether an item should be recognised as an asset or not. In this Study Guide, we take an overview of these concepts, so as to understand what the overall framework is. Many of these important concepts have been covered in separate Study Guides within these materials. For example the Qualitative characteristics have been discussed in detail in Study Guide B1.

It is to be noted that the Framework is concerned with **general purpose financial statements.** It does not cover special statements such as prospectuses. Similarly, the Framework **is not itself an International Accounting Standard;** it does not define standards for any particular measurement or disclosure issue.

There may be different accounting models depending upon the measurement basis selected and the concept of capital maintenance selected. However, most concepts discussed in the Framework are so fundamental that **they apply irrespective of the model selected.**

2.2 Need for a conceptual framework

A framework is necessary for several reasons. It:

1. provides a common reference-point, and helps in developing principles-centred standards;
2. assists in development / review of accounting standards;
3. assists national standard-setting bodies in setting national standards;
4. assists in harmonisation of standards and procedures worldwide;
5. assists auditors in forming an opinion on whether the statements comply with IAS;
6. assists the users in interpreting financial statements;
7. provides information about IASB's approach;
8. provides a basis to resolve accounting disputes;
9. assists in the preparation of financial statements;
10. assists management in making judgements on accounting policies, where there is no standard or interpretation;
11. assists in presenting a true and fair view.

2.3 This IASB's Conceptual Framework includes:

(i) the objective of financial statements;
(ii) the qualitative characteristics that determine the usefulness of information in financial statements;
(iii) the definition, recognition and measurement of the elements from which financial statements are constructed; and
(iv) concepts of capital and capital maintenance.

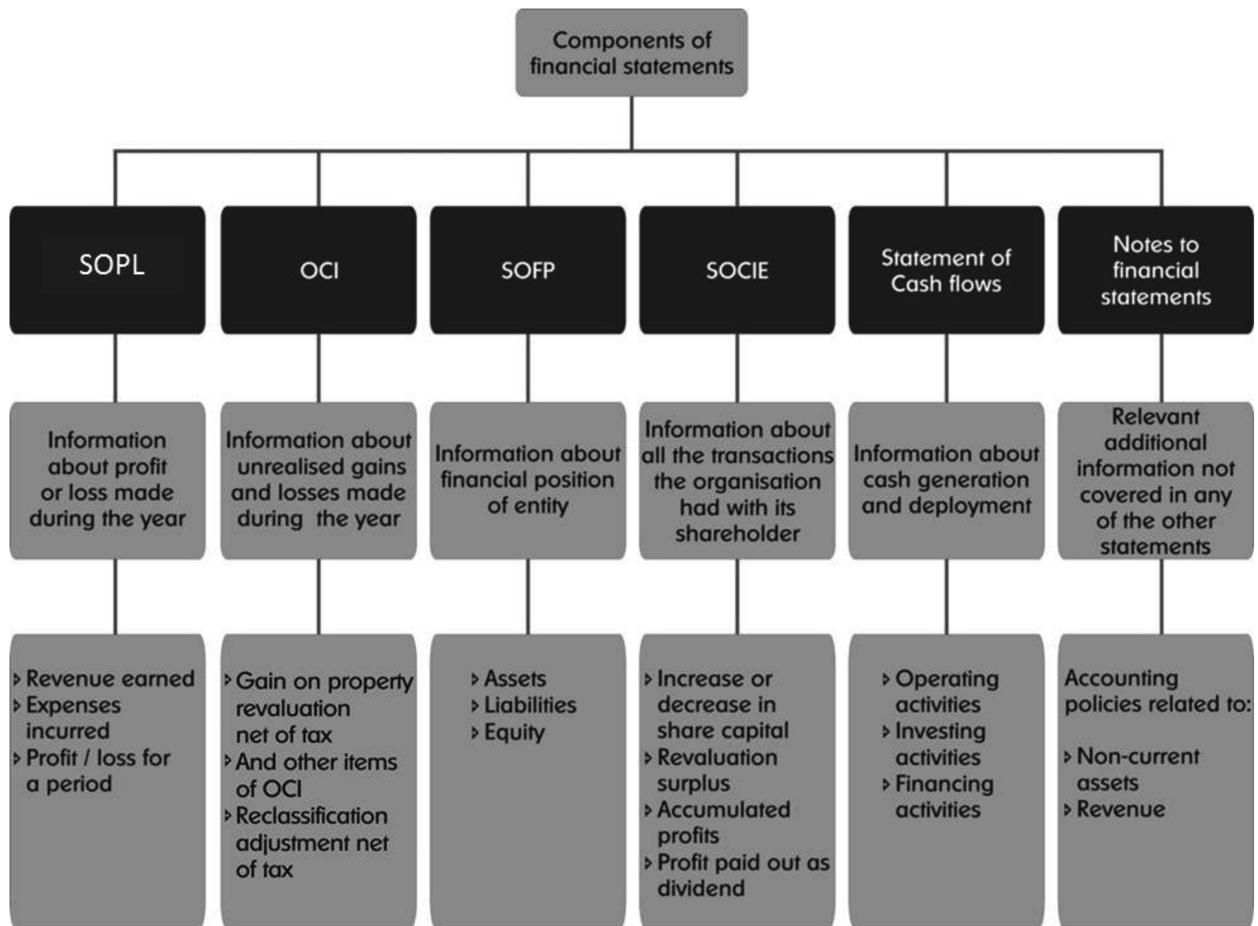
1. Objectives / purpose of financial statements

This is a fundamental concept. Before we do anything, we need to be clear about why we are doing it, i.e. why we are preparing financial statements. This concept tells us as to why we perform accounting.

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

2. Components of financial statements

Diagram 3: Components of financial statements



3. Qualitative characteristics

In order to fulfil their purpose, the statements must possess certain qualities. These are essential qualities, without which the statements would lose their value.

In accordance with the Conceptual Framework for the preparation and presentation of financial statements, the qualitative characteristics are divided into two main groups:

Fundamental qualitative characteristics
Enhancing qualitative characteristics

The qualitative characteristics are explained in detail in Study Guide B1.

4. The elements of financial statements

The items reflected in financial statements are the financial effects of transactions and events. Based on their economic characteristics, they need to be grouped into broad classes for presentation in the financial statements. These broad classes are called the ‘elements’ of financial statements. They are as follows:

(a) Definition of asset

Definition

An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

The Conceptual Framework for Financial Reporting, Para 4.4

Breaking down this definition

A resource controlled by the entity	The important word is 'control'. If the resource is not controlled by the entity, it cannot be considered an asset in financial accounting terms. For example, a building is a resource which is 'controlled', as the entity has the option of using the building in whichever way it wants to. However, staff of the entity cannot be considered an asset, as they can leave the company at any time, therefore are not 'controlled' by the entity
As a result of past events	Something must have happened in the past, to ensure that the asset has the right to be controlled by the entity. So, the building discussed above, was purchased by the company this act, in the past, means that the right to use the building passed to the company.
From which future economic benefits are expected to flow	The whole point of an asset is that it should help generate revenue for the entity. Thus the building could be used to produce goods for sale, or to provide services for customers. Hence the building meets this part of the definition. Conversely, a receivable who has now become insolvent, should be removed as an asset as there are no longer expected to produce future benefits (the money owed will not be received).

An asset may be classified as 'current' or 'non-current'. Examples of assets include buildings, property, plant and machinery, inventories, etc.

(b) Definition of liabilities

Definition

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The Conceptual Framework for Financial Reporting, Para 4.4

The same logic shown above in the case of assets can be applied here for liabilities. Similarly, a liability may be classified as 'current' or 'non-current'. Examples of liabilities include trade payable, provisions, outstanding expenses, etc.

(c) Definition of Equity

Definition

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

The Conceptual Framework for Financial Reporting, Para 4.4

Effectively this is the remaining amount after deducting all liabilities from assets, which is owed to the equity holders of the entity. Examples of equity include ordinary shares, capital reserves, revenue reserves etc.

(d) Definition of Income

Definition

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

The Conceptual Framework for Financial Reporting, Para 4.25

Breaking down this definition

Increase in economic benefits	The entity should see an increase in economic benefits e.g. cash through sales etc.
Inflows or enhancements of assets or decreases of liabilities	This shows a SOFP approach. All inflows are measured in terms of increasing assets or decreasing liabilities.
Result in increases in equity, other than those relating to contributions from equity	The resultant effect should be to see that equity increases. So if a dividend is received, it means cash (asset) increases and correspondingly profit for the period increases (dividend income), thereby increasing equity. The definition specifically removes any contributions for shares from shareholders from being counted as income.

Examples of income include sales revenue, dividends received, consultancy receipts etc.

The concept of income for the purpose of IFRS is much wider than its usual meaning. The concept also includes within its scope gains and incomes such as unrealised gains, revaluation gains etc.

(e) Definition of Expenses

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

The Conceptual Framework for Financial Reporting, Para 4.25

The same logic shown above in income can be used here for expenses. Examples of expenses include operating expenses, administrative expenses, selling expenses etc.

Do the following classify as an asset or liability within the definitions given by the Framework? Give reasons.

(a) Mitchell Ltd has purchased machinery for Tshs100 million. It also purchased a patent for Tshs10 million. The patent will give the company exclusive use of a particular manufacturing process which will save TShs9 million a year for the next four years.

(b) Adams Car Sales intends to purchase four imported cars, in the coming international car show to be held in London.

(c) Poolwhirl Co provides a warranty with every refrigerator sold.

Which of the following items is not an asset?

A Plant and equipment
B Bank loan
C Computer software and hardware
D Land and buildings

Which of the following items represents income?

A Interest received
B Share capital
C Cash received from sale of a non-current asset
D Salaries and wages to employees

5. Recognition

In addition to giving the definitions of the elements of financial statements, the Framework also explains the recognition criteria i.e. the conditions subject to which items may be shown in the financial statements.

An **item can be recognised** in the financial statements if:

i. It meets the **definition** of an element
ii. It satisfies the recognition criteria:

It is **probable** that any **future economic benefit** associated with the item will flow to or from the entity.
The cost or value of the element can be **measured reliably.**

6. Measurement Bases

The Framework also tells us about the manner of determining the value of the different elements i.e. measurements of the elements. There are the following **measurement bases:**

Historical cost
Replacement cost
Net realisable value
Economic value

These measurement bases are explained in detail in Study Guide B2.

7. Capital

There are two different concepts of capital prescribe by the IASB's Conceptual Framework:

(a) Financial concept

Under the financial concept, capital is the same as the net assets or the equity of an entity. This concept is **adopted by most entities.**

The financial concept of capital is suitable if the users of the financial statements are primarily concerned with the maintenance of the nominal invested capital.

Example

An entity has invested Tshs1 million of its own resources in a business. This amount is its capital (the financial concept).

(b) Physical concept

Capital is regarded as a productive capacity of the entity. The productive capacity may be defined in a suitable manner for example, in the number of units, or in the weight or volume of production.

The physical concept of capital is suitable if the users of the financial statements are primarily concerned with the operating capability of the entity.

Example

Dolchem has a productive capacity of 100,000 MT of chemicals per annum. This capacity is therefore its capital. At current costs of Tshs200 per MT; it is equivalent to Tshs20 million.

8. Capital maintenance and determination of profits

The capital maintenance concept stems from the going concern concept. Since an entity is assumed to be a going concern, the capital that it introduces in the business is expected to be maintained.

That leads us to the determination of profits. If an entity can maintain the capital that was present at the beginning of the period and earn something over and above that, only then a profit is considered earned.

The measurement of profit will depend upon the concept of capital followed. If the financial concept is followed, then profit is earned only if the financial or money amount of the net assets at the end of the period exceeds that at the beginning of the period. However, any contributions from or distributions to the owners need to be adjusted.

Test Yourself 7

Suppose the capital was Tshs1 million at the beginning of the period, and Tshs1.4 million at the end of the period, and there was a distribution of profits of Tshs0.2 million.

Required:

What is the profit?

Similarly, if the physical concept is followed, then profit is earned only if the physical productive or operating capacity of the entity at the end of the period exceeds that at the beginning of the period. Any contributions from or distributions to the owners are to be adjusted for.

Test Yourself 8

The capital of Yash Inc. was 100,000 MT of physical capacity in the beginning of the period when the current cost was Tshs200 per MT and the total value of capacity was 100,000 x 200=Tshs20 million. It was 120,000 MT at the end of the period when current cost was Tshs210 per MT.

The value of capital at the end is Tshs120,000 x 210 = Tshs25.2 million.

Required:

What is the profit for the period under physical capital maintenance?

Test Yourself 9

The funds needed under the productive capacity model to achieve physical productive capacity of Mars Inc. at the beginning and at the end of the year were Tshs43,000 and Tshs50,000 respectively. The owners had introduced funds amounting to Tshs10,000 during the year.

Required:

What is the profit or loss made by Mars Inc.?

Answers to Test Yourself

Answer to TY 1

The correct option is **D.**

The IFRS Foundation is the legal entity under which the IASB operates. The Foundation is governed by a board of 22 trustees.

Answer to TY 2

The correct option is **C.**

The trustees of the IFRS Foundation appoint the members of IFRS Advisory Council. Members are appointed by the Trustees for a renewable term of three years. They have diverse geographic and functional backgrounds.

Answer to TY 3

The correct option is **D.**

The main duty of the IFRS Interpretation Council is to provide Interpretations of the IAS / IFRS, and provide advice on the other matters not included in the IFRS / IAS.

Answer to TY 4

The analysis of the given transactions is given below:

(a) Machinery purchased is an asset as there is a past event (purchase), control (by Mitchell) and future economic benefit (use of the machine to create income).

The patent purchased is an (intangible) asset - there is a past event, control and future economic benefit through cost savings.

So, both are assets and will be recognised in the financial statements.

(b) This cannot be classified as an asset.

Adams Car Sales only has an intention to purchase – this intention is only in the mind, not in hand.
In order to recognise an item as an asset, a past event, control and future economic benefits are required.

The intention to purchase a car cannot become an asset as there is no past event, no control and no future economic benefits.

(c) This is a liability: the business has taken on a present obligation as a result of a past event (the sales), there is a probability of future outflow of economic resources (replacing the fridge) and a reliable estimate can be made of the obligation (cost of replacing the fridge).

This liability would be recognised when the warranty is issued rather than when a claim is made.

Answer to TY 5

The correct option is **B**.

As the name itself suggests, a bank loan is a liability. All other items are assets.

Answer to TY 6

The correct option is **A**.

Interest received is income. Share capital will be included in equity; salaries and wages to the employees are expenses of the business. While cash has been received in exchange of an asset; the income in this transaction would be the amount received over the fair value (value) of the asset. This amount would be known as gain on sale of asset.

Answer to TY 7

The profit is calculated as:

Profit = Capital at the end of the period – capital at the beginning of the period + distribution to shareholders (or drawings) – capital introduced

= Tshs1.4 million + Tshs0.2 million – Tshs1.0 million =Tshs0.6 million

Answer to TY 8

The value of closing capacity also includes price increase related to the opening capacity.

Opening capacity equivalent in Tshs terms was 100,000 MT x Tshs200 = Tshs20 million.

The same capacity at the end of the period at Tshs210 (current cost at the end of the period) is equivalent to 100,000 MT x Tshs210 = Tshs21 million.

That part of the increase in value due solely to current cost changes is Tshs21 million – Tshs20 million = Tshs1 million.

The total difference between closing and opening physical capital in Tshs terms is:

	Tshs million
Physical capital at the end	25.2
Less: Physical capital at the beginning	20.0
	5.2

Out of this, the effect of current cost change on the opening capacity, as discussed earlier, is Tshs1 million. Therefore, the real profit during the period, using current cost at the end of the period, is Tshs5.2 million – Tshs1 million= Tshs4.2 million.

Answer to TY 9

	Tshs
Funds at the end of the year	50,000
Less: Funds introduced by owners	10,000
Revised balance of funds at the end of the year	40,000
Funds at the beginning of the year	43,000
Loss for the year	**(3,000)**

Self Examination Questions

Question 1

Who issues the IFRS?

A IFRS IC
B IASB
C IFRSF
D IFRS AC

Question 2

What does the term IFRS encompass?

A US GAAP, IAS
B IAS, IFRS, interpretations issued by IFRIC
C SAC statements IAS
D Stock exchange guidelines

Question 3

What is the role of the IFRS Interpretations Committee?

A To issue International Accounting Standards
B To provide guidance on application of International Financial Reporting Standards
C To formulate a regulatory framework
D To provide the work agenda for the International Accounting Standard Board.

Question 4

Why are a statement of financial position and statement of profit or loss prepared?

A To help declare the dividend and share price
B To please the owners
C To portray the financial position and performance of the entity over a given time period
D To publish in a newspaper

Question 5

Which of the following items is not an asset?

A Plant and equipment
B Bank loan
C Computer software and hardware
D Land and buildings

Question 6

Which of the following items represents income?

A Interest received
B Share capital
C Cash received from sale of a non-current asset
D Salaries and wages to employees

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

The IASB is responsible for writing, reviewing and issuing IFRS.

Answer to SEQ 2

The correct option is **B**.

IFRS comprise the IFRSs themselves that had been issued by IASB, the IASs issued by IASC and the interpretations issued by IFRIC.

Both the IASB and the IASC were formed by the IASCF to develop a set of uniform accounting standards that could be adopted globally. The IASC was formed in 1973 and was eventually replaced by the IASB after a restructuring in 2001.

Answer to SEQ 3

The correct option is **B**.

IFRS IC provides guidance and interpretations of the IFRSs.

Answer to SEQ 4

The correct option is **C**.

The main purpose of the financial statement is to portray the financial position and performance of the entity and thus to satisfy the information needs of the stakeholders.

Answer to SEQ 5

The correct option is **B**.

As the name itself suggests, a bank loan is a liability. All other items are assets.

Answer to SEQ 6

The correct option is **A**.

Interest received is income. Share capital will be included in equity; salaries and wages to the employees are expenses of the business. While cash has been received in exchange of an asset; the income in this transaction would be the amount received over the fair value (value) of the asset. This amount would be known as gain on sale of asset.

SECTION B

THE CONCEPTUAL FRAMEWORK AND FUNDAMENTAL BASES OF ACCOUNTING

B1

STUDY GUIDE B1: CONCEPTUAL FRAMEWORK

Get Through Intro

The main area in which the faith of the users of financial statements is based, is the reliance on financial statements prepared by professional accountants. Preparers of these financial statements should be able to prepare them in accordance with the standards, the regulatory and conceptual framework, so that users can to accept them without question and in turn base their decisions on them.

There has to be some mechanism to ensure that accounting work is performed according to set principles and standards. Furthermore, an assurance is needed that the assumed professional expertise does actually exist and is applied to the work in hand. This is achieved by means of a regulatory framework.

As an accountant, you can not underestimate the importance of the conceptual framework, since without it, you will not be able to prepare the financial statements properly.

Learning Outcomes

a) Identify and present the financial effects of accounting for events and transactions under the IASB Conceptual Framework.
b) Explain the general purpose financial statements according to IASB.
c) Explain the accounting reporting concepts, framework and practices governing presentation of financial statements.
d) Explain and present the qualitative characteristics of financial statement information and disclosures.
e) Explain the meaning of true and fair or fairly presented in relation to financial reporting.
f) Describe the accrual, cash, going concern and breakup basis concept in presentation of financial statements.
g) Present and explain the differences between financial statements prepared using accruals and cash bases.
h) Explain the objectives and limitations of financial statements using appropriate examples or using a given scenario.
i) Identify, present and explain to professional accountants or general users the different bases of measurement or of capital and capital maintenance that may be used under accrual-based accounting.
j) Describe the accounting concepts and theories governing presentation of financial statements.

1. **Identify and present the financial effects of accounting for events and transactions under the IASB Conceptual Framework.**
2. **Explain the general purpose financial statements according to IASB.**
3. **Explain the accounting reporting concepts, framework and practices governing presentation of financial statements.**

[Learning Outcomes a, b and c]

1.1 Conceptual framework and general purpose financial statements

The IFRS Framework gives a set of concepts in certain basic areas about the why, what and how of the accounting process and the financial statements e.g. whether an item should be recognised as an asset or not. In this Study Guide, we take an overview of these concepts, so as to understand what the overall framework is.

General purpose financial statements are also referred to as 'financial statements'.

It is to be noted that the Framework is concerned with **general purpose financial statements.** It does not cover special statements such as prospectus. General purpose financial statements are those intended to serve users who are not in a position to require financial reports tailored to their particular information needs.

The Framework **is not itself an International Accounting Standard;** it does not define standards for any particular measurement or disclosure issue.

This IASB's Conceptual Framework deals with:

(i) the objective of financial statements;

(ii) the qualitative characteristics that determine the usefulness of information in financial statements;

(iii) the definition, recognition and measurement of the elements from which financial statements are constructed; and

(iv) concepts of capital and capital maintenance.

The framework is concerned with financial statements, including consolidated financial statements. These are presented at least annually, and are directed towards the needs of a wide range of users. The concepts and practices suggested by the Framework are discussed throughout this Study Guide. We will be discussing objective of financial statements, qualitative characteristics and recognition / measurement of elements in this Learning Outcome, followed by a discussion on concepts of capital and capital maintenance in the subsequent Learning Outcome.

1.2 Objectives of financial statements

This is a fundamental concept. Before we do anything, we need to be clear about why we are doing it, i.e. why we are preparing financial statements. This concept tells us as to why we perform accounting.

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

1.3 Components of financial statements

Note: Amendment to IAS 1 on 16th June 2011 has introduced change in the title of the statement of comprehensive income. The revised title is 'Statement of profit or loss and other comprehensive income'.

* Changes in entity's economic resources and claims not resulting from financial performance.

1. **Definition of asset**

Definition

An **asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
The Conceptual Framework for Financial Reporting, Para 4.4

Breaking down this definition

A resource controlled by the entity	The important word is 'control'. If the resource is not controlled by the entity, it cannot be considered an asset in financial accounting terms. For example, a building is a resource which is 'controlled', as the entity has the option of using the building in whichever way it wants to. However, staff of the entity cannot be considered an asset, as they can leave the company at any time, therefore are not 'controlled' by the entity
As a result of past events	Something must have happened in the past, to ensure that the asset has the right to be controlled by the entity. So, the building discussed above, was purchased by the company this act, in the past, means that the right to use the building passed to the company.
From which future economic benefits are expected to flow	The whole point of an asset is that it should help generate revenue for the entity. Thus the building could be used to produce goods for sale, or to provide services for customers. Hence the building meets this part of the definition. Conversely, a receivable who has now become insolvent, should be removed as an asset as there are no longer expected to produce future benefits (the money owed will not be received).

An asset may be classified as 'current' or 'non-current'. Examples of assets include buildings, property, plant and machinery, inventories, etc.

2. **Definition of liabilities**

Definition

A **liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The Conceptual Framework for Financial Reporting, Para 4.4

The same logic shown above in the case of assets can be applied here for liabilities. Similarly, a liability may be classified as 'current' or 'non-current'. Examples of liabilities include trade payable, provisions, outstanding expenses, etc.

3. **Definition of equity**

Definition

Equity is the residual interest in the assets of the entity after deducting all its liabilities.

The Conceptual Framework for Financial Reporting, Para 4.4

Effectively this is the remaining amount after deducting all liabilities from assets, which is owed to the equity holders of the entity. Examples of equity include ordinary shares, capital reserves, revenue reserves etc.

4. **Definition of income**

Definition

Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
The Conceptual Framework for Financial Reporting, Para 4.25

Breaking down this definition

Increase in economic benefits	The entity should see an increase in economic benefits e.g. cash through sales etc.
Inflows or enhancements of assets or decreases of liabilities	This shows a SOFP approach. All inflows are measured in terms of increasing assets or decreasing liabilities.
Result in increases in equity, other than those relating to contributions from equity	The resultant effect should be to see that equity increases. So if a dividend is received, it means cash (asset) increases and correspondingly profit for the period increases (dividend income), thereby increasing equity. The definition specifically removes any contributions for shares from shareholders from being counted as income.

Examples of income include sales revenue, dividends received, consultancy receipts etc.

The concept of income for the purpose of IFRSs is much wider than its usual meaning. The concept also includes within its scope gains and incomes such as unrealised gains, revaluation gains etc.

5. **Definition of expenses**

Definition

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.
The Conceptual Framework for Financial Reporting, Para 4.25

The same logic shown above in income can be used here for expenses. Examples of expenses include operating expenses, administrative expenses, selling expenses etc.

Important

An entity shall classify an asset as current when:

(a) it expects to realise the asset, or intends to sell or consume it, in its normal operating cycle;
(b) it holds the asset primarily for the purpose of trading;
(c) it expects to realise the asset within twelve months after the reporting period; or
(d) the asset is cash or a cash equivalent (as defined in IAS 7) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

An entity shall classify all other assets as non-current. A similar logic applies to classification of liabilities into current and non-current.

1.4 Recognition

According to the Conceptual Framework, recognition is the process of incorporating in the statement of financial position and the statement of profit or loss and other comprehensive income an item that meets the definition of an element and satisfies the following criteria for recognition:

- It is **probable** that any **future economic benefit** associated with the item will flow to or from the entity.

- The cost or value of the element can be **measured reliably.**

It should be noted that the first criteria is that the element meets the definition of an element of financial statement.

Test Yourself 2

Do the following classify as an asset or liability within the definitions given by the Framework? Give reasons.

(a) Mitchell Ltd has purchased machinery for Tshs100 million. It also purchased a patent for Tshs10 million. The patent will give the company exclusive use of a particular manufacturing process which will save TShs9 million a year for the next four years.

(b) Adams Car Sales intends to purchase four imported cars, in the coming international car show to be held in London.

(c) Poolwhirl Co provides a warranty with every refrigerator sold.

1. **Explain and present the qualitative characteristics of financial statement information and disclosures.**
2. **Explain the meaning of true and fair or fairly presented in relation to financial reporting.**

[Learning Outcomes i and j

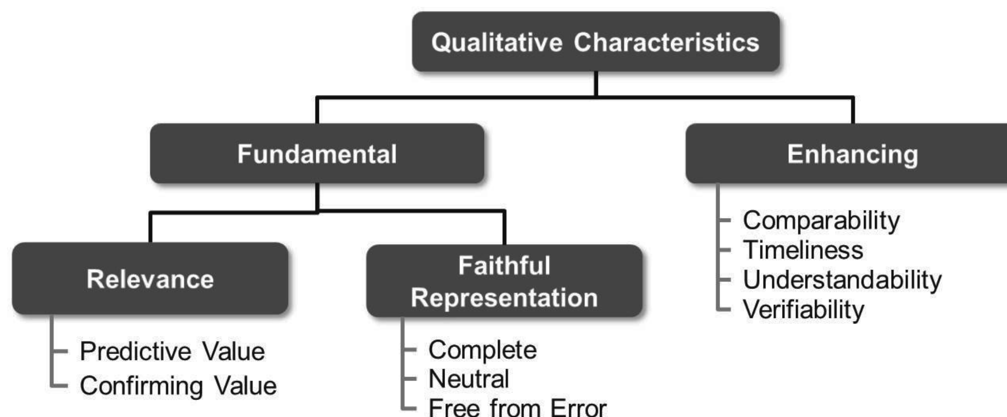
2.1 Qualitative characteristics

In order to fulfil their purpose, the statements must possess certain qualities. These essential qualities, without which the statements would lose their value, are listed in the diagram given below.

In accordance with the Conceptual Framework for the preparation and presentation of financial statements, the qualitative characteristics are divided into two main groups:

1. Fundamental qualitative characteristics
2. Enhancing qualitative characteristics

Diagram 2: Characteristics of financial statements



1. Fundamental qualitative characteristics

(a) Relevance

Relevant financial information is capable of making a difference in the decisions made by users. Information may be capable of making a difference in a decision even if some users choose not to take advantage of it or are already aware of it from other sources.
The Conceptual Framework for Financial Reporting, Para QC6

The relevance of the information is related to the decision-making needs of users. How does the information help in making decisions? A person evaluates past, present and future events and then arrives at a decision. He can also confirm or correct his past evaluations. Financial information is capable of making a difference in decisions if it has **confirmative value, predictive value or both.** The predictive value and confirmatory value of financial information are interrelated. Information that has predictive value often also has confirmatory value.

- Financial information has predictive value if it can be used as an input for processes employed by users to predict future outcomes.

- Financial information has confirmatory value if it provides feedback (confirms or changes) about previous evaluations.

The financial statements give information about an intangible asset in the form of a licence valid for a period of five more years in the future. The user is able to confirm the past event as well as predict future events. He can confirm from the financial statements that the licence does indeed belong to the company, and can also predict with a fair amount of certainty that after five years, the licence will expire and the entity may be open to more competition.

(b) Faithful representation (True and fair view)

People say that the financial statements 'talk' to us. Each statement and each figure in the financial statements communicates or 'represents' something to us. Representation is information that the item purports to give or is expected to give. Therefore, the statement of financial position represents the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria. The statement of profit or loss represents the transactions and other events that result in revenue or expenses of the entity which meet the recognition criteria.

Similarly, the **cash flow statement** represents the flows of cash and cash equivalents during the period.

Faithful

The word 'faithful' or its alternative, 'true and fair', indicates truthfulness and fairness in the representations. In the financial statements each element therein (asset, liability, equity, income and expense) represents something to us. If all representations regarding these elements are reliable and fair, we call them faithful representations.
The question is when do we treat a representation as being faithful or true and fair?

Financial information that faithfully represents economic phenomena has three characteristics:

(i) Complete: a complete depiction would include all the information necessary for the user to understand the phenomenon being depicted along with all necessary description and explanations.

Example

In the case of a group of assets, a complete depiction would include, at a minimum:

- description of nature of assets
- numerical depiction of all the assets in the group
- special classification, if any (assets held for sale)

(ii) Neutral: a neutral depiction is without bias in the selection or presentation of financial information. A neutral depiction is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourably by users.

It should be noted that neutral information does not mean information with no purpose or no influence on behaviour. On the contrary, relevant financial information is, by definition, capable of making a difference in users' decisions.

(iii) Free from errors: this means there are no errors or omissions in the description of the phenomenon, and the process used to produce the reported information has been selected and applied with no errors in the process. In this context, free from error does not mean perfectly accurate in all respects.

Faithful representation, however, is achieved if no errors or omissions affect the description of economic phenomena and the process applied to produce reported information has been selected and applied without errors.

Example

Delta Ltd estimated an allowance for bad and doubtful debts to be 5% of the value of the closing receivables. The allowance for bad and doubtful debts is an estimate. A representation of this estimate can be faithful if the amount is described clearly and accurately as being an estimate, along with the nature and limitations of the estimating process. Also, it is necessary that no errors are made in selecting and applying an appropriate process for developing the estimate.

Therefore, in order to achieve the above characteristics (which are important criteria to determine whether financial information is faithfully represented), one needs to ensure:

- compliance with the definitions and recognition criteria set out in the Framework for assets, liabilities, income and expense

- application of IFRSs, with additional disclosures when necessary

The Conceptual Framework generally gives definitions of the elements and detailed guidance on their recognition. IFRSs give guidance on the specialised areas.

In fact, if an entity's financial statements comply with all the requirements of IFRSs, IAS 1 requires that it shall make an explicit and unreserved declaration to that effect. This is probably designed not only to ensure good quality financial statements but also to reassure users.

Let us take an asset (e.g. a plant erected) and check whether it satisfies the recognition and measurement criteria given by the Framework (discussed later in this Study Guide) and IAS. If it does so, we can assume that the asset is faithfully represented in the financial statements.

---

2. Enhancing qualitative characteristics

(a) Comparability

Comparability is one of the enhancing qualitative characteristics in accordance with the Conceptual Framework for Financial Reporting 2010. Comparability helps the users to identify and understand similarities in, and differences among items. A comparison requires at least two items for comparison.

Comparability in financial statements is of two kinds

(i) Within the entity over time: the user should be able to compare the amounts of different periods and identify trends, if any, in the financial position and performance.

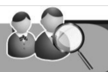
(ii) Between different entities: the user should find it possible to evaluate the relative financial position, changes in financial position and performance of the entity.

In order to make the financial statements comparable in this manner, certain requirements have to be fulfilled.

- There should be **consistency in the measurement and display** of the financial effects of like transactions and events.

- **Users** should be **informed of the accounting policies, changes in those policies and effects of the changes**. Compliance with IFRSs helps in ensuring comparability. (This is an important issue and is discussed separately in the next sections of this Study Guide.)

- **Corresponding information** for the previous period should be **disclosed**.



An entity consistently had a gross profit margin of around 20%. During 20X6, it fell to 18%. A user compared the ratio with industry averages and found that the industry average had also gone down from 17% to 16%.

Both these facts could be established because there was comparability among the financial statements of the entity over the period of time and among the statements of different entities for the same period.

Also, the existence of industry data enables one to see the performance of the entity in the context of the industry average.

The data shows that the reduction in the gross profit margin for the company is more than the reduction in the industry averages. However, still the percentage of its margin is higher than the industry average.

(b) Understandability

Financial statements are intended to provide certain information to users. These users are likely to use the information to make economic decisions and must therefore be able to understand the contents of the statements.

The objective of understandability is achieved with the help of the following **essential components**:

- Those preparing the statements **present / disclose full information that is essential** for the **understanding** of the statements, and present it in an understandable manner.

The schedule or note number (in the notes to accounts, of the financial statements of an entity) where the method and rates of depreciation are disclosed should be given next to the figure for depreciation. If the note is placed away from the depreciation schedule and the user finds it difficult to locate it, understandability is impaired.

- Users have a **reasonable knowledge** of business and economic activities and accounting principles, and show willingness to study the information.

Example

The financial statements disclose an amount of depreciation. The user is expected to know what depreciation means and why it is charged. It is not practicable to explain these things in the financial statements.

(c) Verifiability

Information has the quality of verifiability when different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation. If **users are to take decisions** based on the financial statements, the information in the statements has to be verifiable; otherwise **it would not be of any help even if it is relevant.**

(d) Timeliness

Timeliness means having information available to decision-makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it is. For the users of general purpose financial statements, the information is useful for decision making only if it is timely.

Test Yourself 3

Sollato Co-operates in the field of mining. There was an estimate total of 1,000,000 MT of the mineral dynasia, out of which it had extracted 600,000 MT to date. During the current year, the local government had declared a limit on production, since new research had confirmed grave health hazards associated with dynasia.

The government gave the companies one year to stop extracting dynasia. Sollato managed to extract only 200,000 MT in that year. It did not report in the financial statements the fact that the government had stopped production.

Required:

Has Sollato violated any principles? If so, which ones?

3. **Describe the accrual, cash, going concern and breakup basis concept in presentation of financial statements.**
4. **Present and explain the differences between financial statements prepared using accruals and cash bases.**
5. **Explain the objectives and limitations of financial statements using appropriate examples or using a given scenario.**

[Learning Outcomes f, g and h]

3.1 Basis of accounting

1. Accrual basis

According to IAS 1 Preparation and Presentation of Financial Statements, an entity shall prepare its financial statements, except for cash flow information, using the accrual basis of accounting.

It means that when the financial statements are prepared, the transactions and events are recognised as and when they are earned or incurred (and not as and when money is received or paid) and recorded in the financial statements of the periods to which they relate.

IAS 1 further specifies that under accrual basis, the elements of financial statements i.e. assets, liabilities, equity, income and expenses are recognised when they satisfy the definition and recognition criteria for those elements in the framework. These are already discussed earlier in this Study Guide.

Accrual basis accounting matches revenues to the time period in which they are earned and matches expenses to the time period in which they are incurred. While it is more complex than cash basis accounting, it provides much more information about the business.

2. Going concern basis

Under going concern, it is assumed that the entity will continue to operate for the foreseeable future and it has neither the intention nor the necessity of liquidation or of curtailing the scale of the operations materially. While

preparing the financial statements, management should make an assessment of the company's going concern status. If the management assesses that the going concern status of the company will not be maintained during the foreseeable future, then the financial statements would be prepared on a different basis (named as the break up basis).

Example

Tom purchased a machine to manufacture toys. The measurement of the machine is made on the basis that it can be utilized throughout its useful life. If this assumption is not followed, the machine would have to be valued at its net realisable value.

The accrual basis and going concern are referred to by the Conceptual Framework as 'underlying assumptions'.

3. Cash basis

The cash basis of accounting is not permitted by IFRSs / IASs. Only the cash flow statements are prepared using the measurement base of cash.

Smaller companies that haven't formally incorporated and most sole proprietors use cash-basis accounting because the system is easier for them to use on their own, meaning they don't have to hire a large accounting staff.

Under cash basis of accounting, expenses are recorded when expenses are actually paid and revenue is recorded when cash is actually received. The primary focus is on the amount of cash in the bank, and the secondary focus is on making sure all bills are paid. Little effort is made to match revenues to the time period in which they are earned, or to match expenses to the time period in which they are incurred.

The cash basis may be used, however, for small unincorporated entities, for example clubs and societies.

Example

Tom buys 100 tables for Tshs50,000 each in the month of April 20X2. The purchase is made for cash. During April 30, tables are sold for cash at Tshs70,000 each.

Using accrual based accounting, the results for January would be as follows:

	Tshs	Tshs
Revenue (30 × Tshs70,000)		2,100,000
Cost of sales		
Purchases (100 × Tshs50,000)	5,000,000	
Closing inventory (70 × Tshs50,000)	(3,500,000)	1,500,000
Profit		**600,000**

Using cash accounting, the results for January would be as follows:

	Tshs
Revenue (30 × Tshs70,000)	2,100,000
Cost of sales (100 × Tshs50,000)	(5,000,000)
Loss	**(2,900,000)**

You will notice from above that the cash basis of accounting shows an overall loss of Tshs2.9 million. Under accrual basis, the costs are matched with the revenue earned and the value of the closing inventories is carried forward as an asset under accrual based accounting.

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4. Break-up basis

A generally acceptable alternative authoritative basis other than the going basis is the "break-up basis" or the "liquidation basis". In certain situations when going concern assumption is no longer valid, financial statements may have to be re-drafted on a break-up basis.

Under the break-up or the liquidation basis, all assets are stated at the lower of carrying value and their estimated realizable amounts and provision is made for any further estimated liabilities. All assets and liabilities are classified as current.

Break-up basis of accounting is adopted when a company has either the necessity or the intention to:

 enter into a scheme of arrangement with its payables; or be placed into administrative receivership or liquidation.

Test Yourself 4

Jacques runs a small dress-designing business in Singapore. He operates his business from a small shop. The cost of the shop is Tshs60 million. He also has to repay a bank loan of Tshs10 million. Jacques has an opportunity to move to Paris and work for a top designer, and so decides to close down his business in Singapore. A customer has offered him Tshs35 million for the shop. The bank has agreed to accept Tshs9.5 million in full settlement of the loan.

Required:

State, with reasons, how the shop and the loan need to be recognised in the financial statements.

3.2 Difference between financial statements prepared using cash basis and those prepared using accrual basis

In accordance with the IASB's Conceptual Framework, accrual basis of accounting is one of the underlying assumptions for preparing financial statements. In other words, IASB's Framework clearly prohibits cash basis of accounting.

Accrual basis of accounting helps to record the event more accurately, as events are recorded when they happen, and not when they are paid for. Thus, assets or liabilities arising out of the event are recognised in the financial statements. This way, the users of the financial statements will have a better understanding of the business's financial position and performance in the past as well as in future.
Cash basis of accounting has the effect of delaying reporting until the cash flows in or out of the business. Therefore, the users of financial statements may not have a complete understanding of the financial statements as events may not be reported in the period to which they relate. Furthermore, when the event will be reported under cash basis, the information would have become too stale to be used for decision making purposes or irrelevant for other information needs of the user.

Example

Star Ltd made sales worth Tshs2 million in the month of July 20X2 on credit basis. Half of the price is paid upfront by the customer (i.e. Tshs1 million) and the rest is promised to be paid in October. Let us understand the reporting of this transaction under accrual basis and cash basis:

Accrual basis

Under this basis, sales revenue of Tshs2 million will be recorded and Tshs1 million will be reported as receivable from the customer.

Cash basis

Under this basis, sales revenue of Tshs1 million will be recorded as only Tshs1 million was received from the customer in cash. No receivables will arise, as under cash basis, the accounting entry is recorded only when cash flow occurs. The remaining sales of Tshs1 million will be recorded in October when the customer pays.

In the above example, it can be seen that the accrual basis of accounting helps to reflect on past events, the entity's current financial standing and also the expected future events.

On the other hand, under cash basis, information was incomplete in the month of July; the user will have incomplete information of the actual amount of sales and the possible inflow of cash in future. Furthermore, when the receipt of Tshs1 million is recorded in the financial statements, this information would be irrelevant as it relates to the month of July. This will distort the results pertaining to October; i.e. wrongly inflating the revenue of October by Tshs1 million, as this amount actually relates to July's sales.

3.3 Objectives and limitation of financial statements

Objectives of financial statements

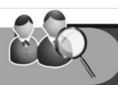
The objective of financial statements is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

Limitations of financial statements

The following are the limitations:

1. Even though financial statements tend to give an appearance of finality, the historical costs of assets reflected in them may not represent either their realisable or replacement value.

Thus, if future predictions are based on the existing figures, they are also likely to suffer from the defect of being unrealistic.



Example

An entity is setting aside the amount of depreciation, and investing it into sinking fund investments. (A sinking fund is an arrangement where an entity invests specified amount of money in securities each period. This amount is calculated in such a manner that the amount with interest earned will be equal to the cost of the asset to be replaced).

When it is the time to replace the asset, the entity may find that the amount is not sufficient to replace the asset. The original calculations may not remain relevant for a long time. It may be necessary to review the position regularly.

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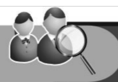
2. There are many non-monetary factors that affect the future of the business as much as the assets and liabilities in the statement of financial position.



Example

The reputation, credit rating, efficiency and integrity of management, and the efficiency and loyalty of employees, are important factors that determine the future performance of an entity. However, these are not reflected in the financial statements.

If one or two members of key management leave a company, it may make a big difference to the entity's future, and relying only on past financial statements may not be sufficient for estimating the future.

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3. Individual primary users have different, and possibly conflicting, information needs and desires. The financial statements may not cater to the needs of all the stakeholders. Sometimes the financial statements may not provide all the information needed by the various stakeholders and they have to obtain information from other sources.

6. Identify, present and explain to professional accountants or general users the different bases of measurement or of capital and capital maintenance that may be used under accrual-based accounting.
7. Describe the accounting concepts and theories governing presentation of financial statements.
8. Describe various types of financial statements according to the concepts used.

[Learning outcomes i, and j]

4.1 Measurement Bases

The IASB's Conceptual Framework also tells us about the manner of determining the value of the different elements i.e. measurements of the elements. There are the following **measurement bases:**

1. Historical cost
2. Current cost
3. Realisable (settlement) value
4. Present value

1. Historical cost

According to the Framework, under historical cost accounting, assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.

Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Simply put this means that - **Historical cost accounting (HCA)** is where **accountants record transactions at historical cost** that is, the actual amounts of money, or money's worth, **received or paid** to complete the transaction.

Assets are recorded at

- The amount of cash or cash equivalents paid. For example assets purchased on cash basis will be recorded at the amount of cash paid for purchase of the asset.

- The fair value of the consideration given to acquire the assets, at the time of their acquisition.

Example

No. of shares

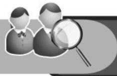
Market value on the date of sale

Affluent Company will reflect the machine at Tshs8,214,000 (3,000 x Tshs2,738)

Affluent Co took over a branch of Dazzle Co by giving 3,000 ordinary shares of Brilliant Inc. The market value of the shares as on the date of sale is Tshs2,738 per share and the market value of the shares as at the end of the reporting period is Tshs2,950.

Liabilities are recorded at

- The amount of proceeds received in exchange for the obligation or
- In some circumstances, the amounts of cash (or cash equivalents) expected to be paid to satisfy the liability in the normal course of business.



Example

If the amount of tax payable for an accounting period works out to be Tshs24 million, then a provision for tax payable will be recorded at Tshs24 million.

This is the amount of cash that will be required to satisfy the liability in the normal course of business.

2. Current cost

This base is also referred to as the fair value. According to the Framework, under fair value accounting, assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

3. Realisable (Settlement) value

According to **the Conceptual Framework for Financial Reporting**, under **Realisable (settlement) value** accounting, assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.

Liabilities are carried at their settlement values; that is the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.

Test Yourself 5

Sure Co owns a building which was bought for Tshs230 million. The current estimated selling price of the building is Tshs400 million and the estimated selling expenses would be at 0.5%.

Required:

What would the net realisable value of the building be?

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4. **Present Value**

According to the Conceptual Framework for Financial Reporting, under **present value accounting,** assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Test Yourself 6

Tom has taken an interest-free loan of Tshs12 million from his friend William. He will repay this loan by paying Tshs2 million every year for the next 6 years. He uses a discount rate of 8% for recording his transactions at net present value in his accounts.

Required:

What is the net present value?

The IASB's Conceptual Framework does not prescribe the application of any particular basis. Under IFRSs reporting the historical and the present cost are the most common basis. The other basis may be applied wherever appropriate. For example the inventory is valued at cost or net realisable value whichever is lower in accordance with the prudence principle.

4.2 Financial reporting Concepts

Concept of capital

The IASB's Conceptual Framework identifies two concepts of capital:

1. **Financial concept**

Under the financial concept, capital is the same as the net assets or the equity of an entity. This concept is **adopted by most entities.**

The financial concept of capital is suitable if the users of the financial statements are primarily concerned with the maintenance of the nominal invested capital.

Example

An entity has invested Tshs1 million of its own resources in a business. This amount is its capital (the financial concept).

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2. **Physical concept**

The capital maintenance concept stems from the going concern concept. Since an entity is assumed to be a going concern, the capital that it introduces in the business is expected to be maintained.

That leads us to the determination of profits. Only if an entity can maintain the capital that was present at the beginning of the period and earn something over and above that is a profit earned.

The measurement of profit will depend upon the concept of capital followed. If the financial concept is followed, then profit is earned only if the financial or money amount of the net assets at the end of the period exceeds that at the beginning of the period. However, any contributions from or distributions to the owners need to be adjusted.

Example

Suppose the capital was Tshs1 million at the beginning of the period, and Tshs1.4 million at the end of the period, and there was a distribution of profits of Tshs0.2 million. The profit is calculated as:

Profit = Capital at the end of the period – capital at the beginning of the period + distribution to shareholders (or drawings) – capital introduced

= Tshs1.4 million – Tshs1.0 million + Tshs0.2 million – Nil = Tshs0.6 million

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4.3 Various types of financial statements based on the capital concepts

Similarly, if the physical concept is followed, then profit is earned only if the physical productive or operating capacity of the entity at the end of the period exceeds that at the beginning of the period. Any contributions from or distributions to the owners are to be adjusted for.

Example

The capital of Yash Inc was 100,000 MT of physical capacity in the beginning of the period, and 120,000 MT at the end of the period. The cost of the capacity in the beginning of the period was Tshs2,000 per MT, while the current cost at the end of the period is Tshs2,100 per MT.

Opening capacity equivalent in Tshs terms was 100,000 x Tshs2,000 = Tshs200 million.
The same capacity at the end of the period at Tshs 210 (current cost at the end of the period) is equivalent to 100,000 x Tshs2,100 = Tshs210 million.

That part of the increase in opening capacity due solely to current cost changes is Tshs 22m – Tshs 21m = Tshs 1m.

At current cost of Tshs 210 per MT, the value of capital at the end of the period is Tshs 120,000 x 210 = Tshs 25.2m.

This also includes price increase related to the opening capacity.

Difference between closing and opening physical capital in Tshs terms is:

	Tshs million
Physical capital at the end	25.2
Less: physical capital at the beginning	20.0
	5.2

Out of this, the effect of current cost change on the opening capacity is Tshs 1m.

Therefore, the profit during the period, using current cost at the end of the period, is Tshs 5.2 million – Tshs 1 million= Tshs 4.2 million.

Test Yourself 7

Suppose the capital was Tshs1m at the beginning of the period, and Tshs1.4m at the end of the period, and there was a distribution of profits of Tshs0.2m.

Required:

What is the profit?

Similarly, if the physical concept is followed, then profit is earned only if the physical productive or operating capacity of the entity at the end of the period exceeds that at the beginning of the period. Any contributions from or distributions to the owners are to be adjusted for.

Test Yourself 8

The capital of Yash Inc was 100,000 MT of physical capacity in the beginning of the period when the current cost was Tshs 200 per MT and the total value of capacity was 100,000 x 200= Tshs 20m. It was 120,000 MT at

the end of the period when current cost was Tshs 210 per MT. The value of capital at the end is Tshs 120,000 x 210 = Tshs 25.2m.

Required:

What is the profit for the period under physical capital maintenance?

Test Yourself 10

“Accounting for the substance of a transaction is always different from accounting for the legal form of the same transaction.”

Required:

Comment on the above statement.

Answers to Test Yourself

Answer to TY 1

The correct option is **A**.

Management accounting is tailor made for management purposes. As such, it makes use of both cost and financial accounting records to extract appropriate and complete information. It can be anything about which management needs information and therefore information needs to be extracted from all the relevant areas.

Answer to TY 2

The analysis of the given transactions is given below:

(a) Machinery purchased is an asset as there is a past event (purchase), control (by Mitchell) and future economic benefit (use of the machine to create income).

The patent purchased is an (intangible) asset - there is a past event, control and future economic benefit through cost savings.

So, both are assets and will be recognised in the financial statements.

(b) This cannot be classified as an asset.

Adams Car Sales only has an intention to purchase – this intention is only in the mind, not in hand.
In order to recognise an item as an asset, a past event, control and future economic benefits are required.

The intention to purchase a car cannot become an asset as there is no past event, no control and no future economic benefits.

(c) This is a liability: the business has taken on a present obligation as a result of a past event (the sales), there is a probability of future outflow of economic resources (replacing the fridge) and a reliable estimate can be made of the obligation (cost of replacing the fridge).

This liability would be recognised when the warranty is issued rather than when a claim is made.

Answer to TY 3

The government order was relevant but was not notified to the shareholders.

The value of the mine, i.e. a wasting asset in the statement of financial position, should have been tested for impairment and written down if required. Since this is not done, the assets values shown in the financial statements are not correct and hence do not meet the characteristic of:

a. **Relevance** as the value of the mine is not predictive i.e. users are not aware that the value of mine reduced;

b. **Faithful representation** as the value of the mine is not complete, neutral or free from error.

Answer to TY 4

a. Jacques's business is not a going concern.

b. Jacques has to sell the shop (no matter how low the realisable value is) and pay off the liability.

c. When the entity is not a going concern the assets are recognised at disposable value and liabilities at settlement value.

d. **Disposable value:** is the realisable value of an asset under a forced sale. Jacques is forced to sell the shop at Tshs35 million hence the disposable value is Tshs35 million.

e. **Settlement value:** is the value of a liability for immediate settlement. Jacques can settle the liability immediately by paying Tshs9.5 million hence its settlement value is Tshs9.5 million.

Below is a comparative statement of financial position for Jacques under the two conditions

	Going concern
	Tshs'000
Shop Premises	60,000
Total	**60,000**
Bank loan	10,000
Capital (balancing amount)	50,000
Total	**60,000**

	Not a Going concern
	Tshs'000
Shop Premises	35,000
Total	**35,000**
Bank loan	9,500
Capital (balancing amount)	25,500
Total	**35,000**

Capital decreased because of a decrease in the asset value. It increased partially by Tshs0.5 million because of a decrease in the bank loan.

Answer to TY 5

	Tshs'000
Current estimated selling price of the building	400,000
Estimated selling expenses are (0.5% x Tshs400,000)	(2,000)
Net realisable value of the building	**398,000**

Answer to TY 6

The net present value of the future net cash outflows is Tshs9,246,000 (calculations shown in the table below). Hence, the loan will be recorded at this amount in the accounts of Tom.

	Future net cash outflows	NPV per Tshs at 8%	NPV of future net cash outflows
	Tsh000	**Tsh000**	**Tsh000**
Year 1	2,000	0.926	1,852
Year 2	2,000	0.857	1,714
Year 3	2,000	0.794	1,588
Year 4	2,000	0.735	1,470
Year 5	2,000	0.681	1,362
Year 6	2,000	0.630	1,260
		Total	**9,246**

Answer to TY 7

The profit is calculated as:

Profit = Capital at the end of the period – capital at the beginning of the period + distribution to shareholders (or drawings) – capital introduced

= Tshs1.4 + Tshs0.2 – Tshs1.0 = Tshs0.6m

Answer to TY 8

The value of closing capacity also includes price increase related to the opening capacity.

Opening capacity equivalent in Tshs terms was 100,000 x 200 = Tshs20m.

The same capacity at the end of the period at Tshs210 (current cost at the end of the period) is equivalent to 100,000 x 210 = Tshs21m.
That part of the increase in value due solely to current cost changes is Tshs21m – Tshs20m = Tshs1m.

The total difference between closing and opening physical capital in Tshs terms is:

	Tshs
Physical capital at the end	25.2m
Less: physical capital at the beginning	20.0m
	5.2m

Out of this, the effect of current cost change on the opening capacity, as discussed earlier, is Tshs1m. Therefore, the real profit during the period, using current cost at the end of the period, is Tshs5.2m – Tshs1= Tshs4.2m.

Answer to TY 9

(a) Since there is a potential loss to members of the public or external stakeholders then there may be a public interest and an accountant may regard this as overriding obligations of confidentiality.

(b) Jack should either confront the directors themselves or may approach a non-executive director. He should avoid being associated with fraud and may resign.

(c) If he wishes to he can inform regulators or crime authorities and whilst he has some legal protection he may find this comes at a cost when he tries to get future work that is his moral decision.

Answer to TY 10

The statement is incorrect.

In most cases, the legal form and the substance of a transaction are one and the same. In these situations, the accounting treatment for both the legal form and substance will remain the same.

It is only when the legal form differs from the substance of the transaction that the accounting treatment differs. Faithful representation of any transaction is only possible if it is accounted for according to its **substance and economic reality,** and not according to its **legal form.**

Quick Quiz

1. What is the objective of financial statements?

2. With which kind of financial statements does the Framework deal?

3. What are the enhancing qualitative characteristics of the financial statements?

4. What decides whether an item of expenditure gets recognised as an expense or an asset?

5. Why are accounting standards on their own not a complete regulatory framework?

Answers to Quick Quiz

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

2. The Framework deals with general purpose financial statements.

3. The qualitative characteristics are given below:

   (a) Understandability
   (b) Timeliness

(c) Verifiability
(d) Comparability

4. The probability of whether the **economic benefits** that flow to the entity will spill over to the subsequent **accounting period/s,** or **remain restricted to the current accounting period,** will determine whether an item of expenditure is to be recognised as an asset or an expense.

5. Accounting standards may not cover all the possible situations. Further, education and training of persons who are involved in the process of preparing and auditing financial statements is also important.

Self Examination Questions

Question 1

Do the following classify as an asset or liability within the definitions given by the Framework? Give reasons.

(a) Mitchell Ltd has purchased machinery for Tshs100 million. It also purchased a patent for Tshs10 million. The patent will give the company exclusive use of a particular manufacturing process which will save Tshs9 million a year for the next four years.

(b) Adams Car Sales intends to purchase four imported cars, in the coming international car show to be held in London.

(c) Poolwhirl Co provides a warranty with every refrigerator sold.

Question 2

Robot Co, a dealer in toys, has an inventory of 'computer games of tennis' amounting to Tshs30 million. He fears that, as now the Grand Slam tournaments for the year are over, he will be able to sell these games for Tshs15 million only.

Required

What will be the 'historical cost' and the 'fair value' of the inventory?

Question 3

Explain why a regulatory framework is needed? What is the regulatory framework based on?

Question 4

State the advantages and the disadvantages of historical cost accounting.

Question 5

The net assets of Stardust Inc. at the beginning and the end of the year were Tshs22.50 million and Tshs24.35 million respectively. Tshs3.40 million was introduced into the business by the owners during the year.

Required:

What is the amount of profit or loss made during the year under the financial capital maintenance model? Give reasons for your answer.

Answers to Self Examination Questions

Answer to SEQ 1

The analysis of the given transactions is given below:

(a) Machinery purchased is an asset as there is a past event (purchase), control (by Mitchell) and future economic benefit (use of the machine to create income).
The patent purchased is an (intangible) asset - there is a past event, control and future economic benefit through cost savings.
So, both are assets and will be recognised in the financial statements.

(b) This cannot be classified as an asset.

Adams Car Sales only has an intention to purchase – this intention is only in the mind, not in hand.
In order to recognise an item as an asset, a past event, control and future economic benefits are required.

The intention to purchase a car cannot become an asset as there is no past event, no control and no future economic benefits.

(c) This is a liability: the business has taken on a present obligation as a result of a past event (the sales), there is a probability of future outflow of economic resources (replacing the fridge) and a reliable estimate can be made of the obligation (cost of replacing the fridge).

This liability would be recognised when the warranty is issued rather than when a claim is made.

Answer to SEQ 2

Historical cost accounting (HCA) is the situation in which **accountant's record transactions at historical cost** that is, the actual amounts of money, or money's worth, received or paid to complete the transaction.

Hence, the **historical cost** of the inventory will be **Tshs30 million.**

Fair value is defined as a **rational** and **unbiased** estimate of the potential market price of goods, services, assets, or liabilities taking into account various relevant factors.

Hence, the **fair value** of the inventory will be **Tshs15 million.**

Answer to SEQ 3

Regulatory framework is a structure which helps an entity decides how to treat items that need to be included in the financial statements.

A regulatory framework is needed mainly for the following reasons:

a. to prevent material manipulations or errors
b. to ensure that the financial communication is in a standardised manner
c. to help in global harmonisation

The regulatory framework is based on:

a. company law
b. international Accounting Standards (if followed)
c. the influence of other national standard-setting bodies
d. stock Exchange requirements
e. overseeing by the professional bodies such as ACCA or IFAC to ensure that the professional standards for accounting and auditing are followed in practice.

Answer to SEQ 4

The advantages of historical cost accounting are:

a. It leads to **absolute certainty** by providing **definite values.**
b. It tells us **exactly what has been paid** and **what has been received** and it **fits in perfectly with the statement of cash flow.**

The disadvantages of historical cost accounting are:

a. The values recorded may be of **old transactions. As changing prices** in the economy, are **not reflected** these values could be **outdated.**

b. Any profit or loss on account of sale / disposal of asset is accounted for only in the year of sale / disposal.

c. Depreciation of non-current assets could be more than / less than the amount required to replace the non-current asset.

d. It does not consider the additional costs required to sell an asset or to settle a liability.

e. Present values of future cash flows / current purchasing power is not reflected.

Answer to SEQ 5

In this case, the profit / (loss) for the year will be calculated as follows:

	Tshs'000
Net assets at the end of the year	24,350
Less: Capital introduced in the business	3,400
Revised balance of net assets at the end of the year	**20,950**
Less: Net assets at the beginning of the year	22,500
Loss made during the year	**(1,550)**

As per the financial capital maintenance model capital is synonymous with the net assets or equity of the entity. Stardust Inc. has made a loss because

a. It has not been able to maintain its opening capital of Tshs22.5 million.

b. The financial amount of the net assets at the **beginning** of the period **exceeds** the financial amount of net assets at the **end** of the period, after excluding contributions from owners during the period.

SECTION B

THE CONCEPTUAL FRAMEWORK AND FUNDAMENTAL BASES OF ACCOUNTING

B2

STUDY GUIDE B2: ALTERNATIVE BASES USED IN THE PREPARATION OF FINANCIAL INFORMATION

Get Through Intro

While **preparing financial statements** you may come across **different alternative bases** of accounting to measure assets and liabilities. For example real estate assets can be measured using various **alternative** valuation **methods** like:

Historical cost
Market value
Replacement value
Realisable value etc.

Knowledge gained through this Study Guide will be useful for determining the appropriate measurement base to be used. In the course of this Study Guide we will look at **each** of **these methods** and their respective advantages and disadvantages. As an accountant you may have to value your company's assets and liabilities choosing any one of these methods.

Learning Outcomes

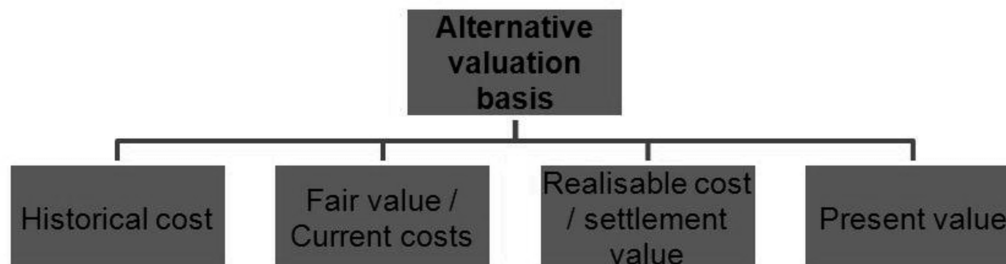
a) Identify and explain in simple terms the main characteristics of alternative measurement bases such as historical cost, current cost, realisable value (settlement value) and present value.
b) Explain the provision of International Financial Reporting Standards governing financial statements regarding changes in accounting policies.
c) Identify the appropriate accounting treatment if a company changes a material accounting policy.

1. Identify and explain in simple terms the main characteristics of alternative measurement bases such as historical cost, current cost, realisable value (settlement value) and present value.

[Learning Outcome a]

The different alternative methods for valuation of the elements of financial statements are shown below:

Diagram 1: Alternative measurement bases



1.1 Historical cost

Under the historical cost method of valuation, **transactions are recorded at historical cost** – that is, the actual **amount of money or money's worth, received or paid to complete the transaction**. Therefore,

1. **Assets** are recorded at the cash or fair value of other consideration given to acquire them.

Example

ICC Plc purchased a building (ICC House) for Tshs500 million on 1 January 20X0. It also incurred additional expenditure of Tshs40 million relating to legal costs.

In this case the historical cost of the building will be Tshs540 million (Tshs500 million + Tshs40 million).

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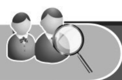
2. **Liabilities** are recorded at the **amount of proceeds received or amount of cash expected to be paid to satisfy the liability.**



Example

Peter gave George machinery worth Tshs35 million as a loan in 20X0. The historical cost of the loan is Tshs35 million.

The historical cost recorded remains constant for ever. There are no changes in the historical cost unless an addition or deduction is made. In the case of the building discussed earlier, the historical cost of the building will remain Tshs540 million, even after 50 years or until the building is sold.

Test Yourself 1

Michael purchased land on 1 January 19W5 for Tshs50 million from Jackson. The value of a similar asset on 1 January 19W5 was Tshs75 million. The current value of this land as at 31 December 20X6 is Tshs200 million.

Among the different values given above, state the historical cost of the land.

A Tshs75 million
B Tshs200 million
C Tshs50 million
D None of the above.

1.2 Fair value / Current cost

According to the Framework, **under fair value accounting**, **assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently**.

Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

Simply put this means that: current cost / fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Assets are recorded at:

The amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently.

Test Yourself 2

Apple Co purchased a building for Tshs350 million. Shortly after it purchased the building, there was an increase in price, and now an equivalent building can be purchased for Tshs400 million.

Required:

What is the fair value of the building?

Liabilities are recorded at:

The **undiscounted amount of cash or cash equivalents** that would be required to settle the obligation currently.

Example

Brainy Co owes Rewards Co Tshs2 million. Rewards Co is badly in need of funds and declares that anyone who pays him his dues within the next month will get a 10% discount. As on the end of the reporting period, Brainy Co is aware of this discount, and has decided to accept it by paying within the next month.

The fair value of the amount due to Rewards Co is Tshs1.8 million (90% x Tshs2 million).

1.3 Net realisable (settlement) value

Under the net realisable (settlement) value basis:

1. **Assets** are recorded at the estimated selling price of the asset, less costs to make the sale.

IAS 2 Inventories defines net realisable value as:

Estimated selling price during the ordinary course of business (-) Estimated cost of completion and the estimated costs necessary to make the sale

Example

Continuing with the example of ICC given in 1.1 above,

Suppose ICC Plc can sell the building for Tshs65 million, but will incur expenses (e.g. advertisement in newspaper and legal fees) of Tshs1 million. Hence the net realisable value of the building will be Tshs64 million (i.e. Tshs65 million – Tshs1 million)

---

2. **Liabilities** are recorded at the estimated settlement price of the liability.

Example

Continuing with the example of George given in 1.1 above,

George's friend has asked George to pay Tshs33 million and settle the liability. In this case, the net settlement value of the liability is Tshs33 million.

Test Yourself 3

Sun Plc owns a building which was bought for Tshs230 million. The current estimated selling price of the building is Tshs400 million, and the estimated selling expenses would be Tshs2 million.

Required:

What would be the net realisable value of the building?

Test Yourself 4

Sure Co owes Tshs24 million to Fire Co. They had a dispute about the service provided and have gone to court. An out-of-court settlement has been arrived at, according to which Sure Co has to pay an additional amount of Tshs2.4 million to Fire Co as settlement charges.

Required:

What is the net realisable value of the liability?

1.4 Present Value

According to the Conceptual Framework for Financial Reporting, under **present value accounting,** assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business.

Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

Simply put this means that the **present value** of a future cash flow is the nominal amount of money which will change hands at some future date, discounted to account for the time value of money.

A given amount of money is **always more valuable sooner** than **later** since this enables one to take advantage of investment opportunities.

Hence, **present values of future cash flows are lower than corresponding future values.** They are arrived at by applying the appropriate discount rate. Present value tables which give us the present value of $1 at different rates of interest (discounting rates) and over different periods of time are readily available.

Assets are recorded at the **present discounted value of the future net cash inflows** that they are expected to generate in the normal course of business.

Example

A machine with an estimated useful life of five years is purchased for Tshs10 million by Futura Inc. The future net cash inflows that this machine is expected to generate in the normal course of business over the next five years is:

	Tshs'000
Year 1	4,000
Year 2	3,500
Year 3	3,000
Year 4	3,000
Year 5	3,000

Futura Inc uses a discount rate of 6% for recording its transactions at net present value in its accounts.

Continued on the next page

The present value can be calculated as follows:

The net present value of future net cash inflows is Tshs14.024 million (calculations shown in the table below). Hence, the machine will be recorded at this amount in the accounts of Futura Inc.

	Future net cash inflows	NPV per 1Tshs at 6%	NPV of future net cash inflows
	Tshs'000		Tshs'000
Year 1	4,000	0.943	3,772
Year 2	3,500	0.890	3,115
Year 3	3,000	0.840	2,520
Year 4	3,000	0.792	2,376
Year 5	3,000	0.747	2,241
Total			**14,024**

Liabilities are recorded at the **present discounted value of the future net cash outflows** that are expected to be required to settle the liabilities in the normal course of business.

Test Yourself 5

Tom has taken an interest-free loan of Tshs12 million from his friend William. He will repay this loan by paying Tshs2 million every year for the next 6 years. He uses a discount rate of 8% for recording his transactions at net present value in his accounts.

Required:

What is the net present value?

Computations using the present value method involve a certain degree of subjectivity. Hence:

The information may not be as useful as the users wish it to be.

Inter-firm comparisons may be difficult as different companies use different discount rates.

2. Explain the provision of International Financial Reporting Standards governing financial statements regarding changes in accounting policies.

[Learning Outcome b]

As you are aware there is more than one method for recording transactions and events in financial accounting. Inventory valuation uses different methods such as FIFO, LIFO, average cost (AVCO) etc.; similarly, different methods are used to measure depreciation on non-current assets, such as straight-line method, reducing balance method, etc. An entity has to select the one most appropriate method and apply it consistently from one accounting period to another.

2.1 Definition of accounting policy

Definition

Accounting policies are the specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

The accounting policies adopted should be followed consistently for similar transactions, events or conditions over a period of time.

Example

If a company is valuing its inventory according to the FIFO method, then the same method should be followed year after year. Also, all items of inventory in that category should be valued under the FIFO method.

Statements of profit or loss

	20X6	20X7	20X8
Sales Cost of sales: Opening inventory **Add:** Purchases	FIFO	FIFO	FIFO
Less: Closing inventory	FIFO	FIFO	**AVCO**
Profit / (loss)			

It is not easy to change this method

2.2 Change in accounting policy

A change in accounting policy means **changing the method used** for preparing and presenting a part of the financial statement from the one which was adopted previously.

An entity can change its accounting policy from the previously adopted policies, only under the following situations:

1. The change is required by a standard.
2. The change is required by law.
3. The change will result in greater accuracy of the financial statements, and therefore increases the understanding of the financial statements.

Example

During 20X7, Menz Co reported depreciation in its expenses. However, the directors feel that they should split depreciation into two parts i.e. depreciation on factory equipment and depreciation on office furniture. Depreciation on factory equipment will be reported in the cost of sales and depreciation on office furniture will be reported in expenses. The proposed financial statements are as follows.

Statement of profit or loss

	20X8	20X7
	Tshs	**Tshs**
Sales **Cost of sales** Purchases **Add: Depreciation on equipment**	 **X**	
Gross profit **Expenses** **Depreciation** **Depreciation on office furniture**	 **X**	 **X**
Profit		

Decide whether this is a permissible change.

Answer

Step 1: Is the change prescribed by a standard? No

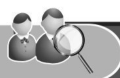
Step 2: Is it required by law? No

Step 3: Will it result in greater accuracy? Yes

Decision- Accept the change

The following items **are not treated as a change** in accounting policy:

1. Change in accounting policy for the same transaction when its **substance has changed**.



Example

ICC Plc manufactured bags until 20X5. It had 5 motor vehicles at that time which were used to deliver the bags. In 20X5 ICC Plc classified all these motor vehicles as non-current assets.

However, in 20X6 shareholders approved a proposal for a change in the nature of the business, from manufacturer of bags to sale of used motor vehicles. ICC Plc classified all the existing 5 vehicles as current assets (not non-current assets) during 20X6, as they will be sold as part of normal business. This change in classification will not be treated as a change in accounting policy.

2. Adoption of new policies for **new transactions** or transactions which were **not material** in earlier periods.

Example

ICC Plc has not incurred any expenditure on the development of an intangible asset during 20X5. In 20X6, it developed a new medicine through research and development and incurred Tshs25 million. ICC Plc classified this expenditure of Tshs25 million as an intangible asset. This will not be treated as a change in accounting policy, as it is a new accounting policy.

Tip

An **intangible asset** is an identifiable non-monetary asset without physical substance e.g. goodwill, patents, copyrights etc.

2.3 Applying changes in accounting policies

The timing or effective date for a change in the accounting policy is as follows:

1. If the change is prescribed by an accounting standard and the effective date is given, then the accounting policy is to be changed from that effective date.

   If the effective date is not given or if the change is voluntary, then retrospective changes are required in the financial statements. This means that the figures in last year's financial statements must be adjusted.

2. If retrospective changes are not possible then the prospective effect is given for the changes in accounting policy.

While applying the change in accounting policy **retrospectively, the prior period figures of equity that is affected should also be changed and disclosed, as if the new policy had always been applied**. This is discussed in detail in the next Learning Outcome, below.

Example

BBG Inc started business in 20X5 and valued its inventory under the Last In First Out (LIFO) method for 20X5. While preparing the financial statements of 20X6, one of the directors suggested changing the valuation method from LIFO to First In First Out (FIFO). Now the question here is what should the date from which the LIFO valuation method is changed to FIFO be – Should it be from 20X6 or 20X5?

Steps to be followed by BBG Inc in applying the changes in accounting policies:

1. BBG Inc should evaluate whether the change proposed by the director can be accepted. BBG Inc should accept the change only if the change is either proposed by a standard required by law or will result in better presentation of the financial statements.

2. In the above case BBG Inc would accept the change because IAS-2 Inventories does not allow LIFO as an acceptable method and therefore requires changing the method of inventory valuation.

Continued on the next page

3. The standard requires changing the policy from the beginning. Hence retrospective effects should be given.

4. BBG Inc should restate the previous year's financial statements as per the new accounting policy.

2.4 Disclosure of changes in accounting policies

If the accounting policies have changed, the following disclosures need to be made in the notes that are attached to the financial statements.

1. Changes due to requirements of standards

(a) The date of application of the standard or interpretation, and its description.

(b) The nature of the change in the accounting policy.

(c) The transitional provisions that might have an effect on future periods.

(d) The changes in earnings per share during the current period and prior periods.

(e) The amount of the adjustment relating to periods before those presented.

(f) If retrospective application is impracticable, the reasons for same.

2. On voluntary changes in accounting policies

(a) The nature of the changes in accounting policy.

(b) The reasons for a change in accounting policy

(c) The changes in earnings per share during the current period and prior periods.

(d) The amount of the adjustment relating to periods before those presented.

(e) If retrospective application is impracticable, the reasons for the same.

Tip

Earnings per share is the amount which an entity has earned per share for the given period. E.g. the total earnings of an entity are Tshs200 million and the total number of shares is 100,000. Earnings per share in this case is Tshs200 (i.e. Tshs200 million/100,000 shares).

The financial statements of subsequent periods need not disclose these facts again.

Example

If a company changes its accounting policy during 20X8 it should disclose the details about the new policy. However, if during 20X9 the company follows the new accounting policy consistently, it is not a change in accounting policy from the previous year, and hence details about the accounting policy need not be given.

Test Yourself 6

Inc valued its inventory by the average cost method from the inception of the business. In July 20X5, the company decided to value inventory by following the first in first out (FIFO) method. In 20X6 they valued inventory by the FIFO method.

Is the company required to disclose the change in accounting policy in 20X6?

---

3. Identify the appropriate accounting treatment if a company changes a material accounting policy.
[Learning Outcome c]

3.1 Accounting for change in accounting policy

ABCL Plc valued its inventory under the Last in First Out (LIFO) method during **20X5.** The **statement of profit or loss** and **statement of financial position** were reported as follows:

SOPL

	Tshs'000	Tshs'000
Sales		100,000
Less: Cost of goods sold		
Opening inventory	**15,000**	
Purchases	80,000	
	95,000	
Closing inventory	**(25,000)**	(70,000)
Gross profit		**30,000**
Expenses		(20,000)
Profit		**10,000**

SOFP

	Tshs'000	Tshs'000
Assets (other than inventory)		25,000
Inventory		**25,000**
Total		**50,000**
Equity		
Share capital	20,000	
Retained earnings	10,000	30,000
Liabilities		20,000
Total		**50,000**

It was proposed by the finance director to value inventory under the First In First Out method during 20X6. The financial statements for **20X6 before adoption of the new accounting policy** were as follows:

SOPL

	Tshs'000	Tshs'000
Sales		150,000
Less: Cost of goods sold		
Opening inventory	**25,000**	
Purchases	90,000	
	115,000	
Closing inventory	**(15,000)**	(100,000)
Gross profit		**50,000**
Expenses		(27,000)
Profit		**23,000**

SOFP

	Tshs'000	Tshs'000
Assets (other than inventory)		65,000
Inventory		**15,000**
Total		**80,000**
Equity		
Share capital	20,000	
Retained earnings		
Opening balance	10,000	
Profit for the year	23,000	53,000
Liabilities		27,000
Total		**80,000**

Notes:

(a) The value of the closing inventory for 20X5 under the FIFO method was Tshs20 million.
(b) The value of the closing inventory for 20X6 under the LIFO method is Tshs15 million.
(c) The value of the closing inventory for 20X6 under the FIFO method is Tshs18 million
(d) There are no details available for the opening inventory of 20X5.

Now let us see whether this change is a valid change.

Step 1: Evaluation of validity of change in accounting policy

Is this change prescribed by a standard, required by law or will it result in a better presentation of the financial statements?

Yes it is prescribed by IAS 2, Inventories.

Step 2: Decide whether to accept the change or not

Accept the change

Step 3: Decide the time from which the changes should be applied

Apply the change retrospectively

SOPL

	20X6 Tshs'000	20X5 Tshs'000
Sales	150,000	100,000
Less: Cost of goods sold		
Opening inventory	20,000[(a)]	15,000[(b)]
Add: Purchases	90,000	80,000
	110,000	95,000
Less: Closing inventory	(18,000)[(c)]	**(20,000)**
	92,000	75,000
Gross profit	**58,000**	**25,000**
Expenses	(27,000)	(20,000)
Profit	**31,000**	**5,000**

(a) We need to use the FIFO value. In note a, in the question, it is given that the closing inventory of 20X5 according to FIFO is Tshs20 million. The closing inventory of 20X5 becomes the opening inventory of 20X6. Therefore we need to consider Tshs20 million.
(b) b) As no prior figures for FIFO are available for the opening inventory of 20X5, the LIFO value is accepted. Refer to note (d) in the question.
(c) We will consider the FIFO value given in note c of the question.
(d) We have applied the new accounting policy for 20X5. (Compare the figures reported in 20X5: you will find a change).

SOFP

	20X6 Tshs'000	20X5 Tshs'000
Assets (other than inventory)	65,000	25,000
Inventory	18,000	20,000
Total	**83,000**	**45,000**
Share capital	20,000	20,000
Retained earnings		
Opening balance	5,000	
Add: Profit for the year	31,000	**5,000**
	36,000	5,000
Liabilities	27,000	20,000
Total	**83,000**	**45,000**

We have applied the new accounting policy during the last year, and changed the last year's figures.

Step 4: Disclosure of the details of the new accounting policy

(a) The title of the standard i.e. IAS 2 Inventories.
(b) The date of application of the standard i.e. 31 December 20X6.
(c) The nature of the change in accounting policy i.e. the method of determining cost of inventory has changed from LIFO to FIFO.
(d) The changes in earnings per share during the current period and prior periods.
(e) If retrospective application is impracticable: only the last year's figures are restated because of the unavailability of the stores records for earlier years.

Step 5: Follow this policy consistently year after year

Summary

Let us summarise the whole process of a change in accounting policy in the following paragraphs:

During 20X5 the company reported income and expenses as per method-A.
During 20X6 it decided to change the method to B.
During 20X6 method-B is applied for financial income and expenses of 20X6 and 20X5.

Financial statements reported in 20X5
SOPL

	20X5	20X4
Income Expense	**Method-A** **Method-A**	Method-A Method-A
Profit		

Financial statements reported in 20X6
SOPL

	20X6	20X5
Income Expense	Method-B Method-B	**Method-B** **Method-B**
Profit		

Test Yourself 7

A company has made a material change to an accounting policy in preparing the current year's financial statements. Which of the following disclosures should be made?

(i) The reason for the change.
(ii) The amount of the adjustment in the current period.
(iii) An estimate of the effect of the change on the following year.

A (i) and (ii)
B (i) and (iii)
C (ii) and (iii)
D (i), (ii), (iii)

3.2 Changes in accounting estimate

There are many items in the financial statements which cannot be measured with precision. In such cases an entity has to make a judgement to estimate the value of these elements.

The following are some examples of items that require estimation:

allowance for bad debts;
inventory obsolescence (inventory that is slow moving or difficult to sell)
the fair value of financial assets or financial liabilities;
the useful lives of, or expected pattern of consumption of, the future economic benefits in depreciable assets

The entity has to make a judgement on the basis of the latest available reliable information. However there may arise a need to change the estimates. The effects of these changes in the estimates should be given looking forward. The effects of the changes should not affect the previous period's financial statements.

Example

Montessori Plc has estimated bad debts at 5% of sales during 20X5. However, during 20X6 it projects bad debts of 2% due to a very efficient credit controller who has decreased the level of bad debts.

In the above case, Montessori Plc should not restate its financial statements for 20X5 (e.g. as we have restated in the example of ABCL Plc para 4.1 above). It is only required to include the new estimate in 20X6.

Answers to Test Yourself

Answer 1

The correct option is **C.**

Tshs50 million is the historical cost of the land because Michael had paid Tshs50 million for acquiring the land on 1 January 19W5.

Answer 2

The fair value of the building is Tshs400 million, being the amount that would have to be paid if the same or an equivalent building was acquired currently.

Answer 3

	Tshs'000
Current estimated selling price of the building	400,000
Estimated selling expenses	(2,000)
Net realisable value of the building	**398,000**

Answer 4

	Tshs'000
Amount due to Fire Co	24,000
Settlement charges	2,400
Net realisable (settlement) value of the liability	**26,400**

Answer 5

The net present value of the future net cash outflows is Tshs9.246 (calculations shown in the table below). Hence, the loan will be recorded at this amount in the accounts of Tom.

	Future net cash outflows	**NPV per Tshs at 8%**	**NPV of future net cash outflows**
	Tshs'000		**Tshs'000**
Year 1	2,000	0.926	1,852
Year 2	2,000	0.857	1,714
Year 3	2,000	0.794	1,588
Year 4	2,000	0.735	1,470
Year 5	2,000	0.681	1,362
Year 6	2,000	0.630	1,260
		Total	**9,246**

Answer 6

No, the company is not required to disclose the change in accounting policy in 20X6 because the inventory valuation method was changed in 20X5. So, disclosure of the same has to be done in 20X5 and not in 20X6.

Answer 7

The correct option is **A.**

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors states that the reasons for the change and the amount of the adjustments in the current period and in comparative information for prior periods must be disclosed. No further disclosures are required in future years.

Self Examination Questions

Question 1

ICC Plc purchased goods worth Tshs60 million. The transportation charges to deliver the material were Tshs5 million. The discount allowed by the supplier was Tshs2 million. Another supplier is willing to sell the same material for Tshs50 million. What is the historical cost?

Question 2

John purchased a building in 20X5 for Tshs60 million. Now a similar building may be acquired for Tshs90 million. However, John has a buyer for this building for Tshs110 million. What are the valuations of Tshs60 million, Tshs90 million and Tshs110 million called in accounting terminology?

Question 3

When the prices rise, the historical cost method will:

A Overstate the assets and understate the profits
B Understate the assets and overstate the profits
C Overstate the assets and profits
D Show correct profits

Question 4

High-tech Computers has changed an accounting policy during 20X6. During 20X6 it should:

A Disclose the reasons for the change, and the amount of adjustment in the current period and in comparative information for prior accounting periods
B Disclose an estimate of the effects of the new accounting policy on future accounting periods.
C Disclose the effects of the new policy and treat it as an extraordinary item in the current year.
D Do nothing.

Question 5

Banana Computers changed an accounting policy during 20X6. During 20X7 it should:

A Disclose the reasons for the change and the amount of adjustment in the current period and in comparative information for prior periods.
B Disclose an estimate of the effects of the new accounting policy on future accounting periods.
C Disclose the effects of the new policy as an extraordinary item in the current year.
D Do nothing.

Question 6

Which of the following is true with regard to a change in accounting policy?

A As a rule of thumb, all changes in accounting policies should be applied retrospectively.
B In the current year, the comparative figures of the previous year should be adjusted to reflect the change. If this is not possible, the opening balance of profit and loss should be adjusted as if the new policy had been applied since the beginning.
C As a rule of thumb, all changes in accounting policies should be applied going forward only, and no retrospective changes are required.
D None of the above.

Question 7

Which of the following is / are advantages of Historical Cost Accounting?

(i) Simple to apply.
(ii) There is no scope for different opinions.
(iii) Includes all effects of inflation.

A (i)
B (i) and (ii)
C (ii)
D All the above

Question 8

When might an entity change an accounting policy?

(i) An international accounting standard dictates new treatment.
(ii) To improve profit performance.
(iii) If it has difficulty in calculating figures under the current method.

A (i) and (ii)
B (ii) and (iii)
C (i) and (iii)
D (i)

Question 9

In 20X5 Jim purchased a new factory for Tshs100 million. He incurred additional legal costs of Tshs10 million at the time of purchase. A property developer has approached Jim, and wants to buy the factory for Tshs195 million. If Jim accepts this offer he will incur legal costs of Tshs10 million. What is the historical cost and the net realisable value of the factory?

	Historical cost	**Net Realisable Value**
A	110,000	195,000
B	110,000	185,000
C	100,000	185,000
D	100,000	195,000

Answers to Self-Examination Questions

Answer 1

The historical cost is Tshs63 million (Tshs60 million + Tshs5 million – Tshs2 million). Historical costs are costs incurred at the time of purchase. The fact that ICC Plc could have bought the goods from another supplier at a lower price is irrelevant.

Answer 2

Tshs60 million is the historical cost because it is the cost incurred to acquire the asset. Tshs90 million is the replacement cost because it is the value of a similar asset. Tshs110 million is the realisable value because it is the expected selling price of the asset.

Answer 3

The correct option is **B.**

When the price rises and the historical cost method is adopted, assets are understated and profits are overstated. This is explained in the following table:

Effects on HCA at the time of changing prices:

Items	Rising prices
Assets	Understated
Liabilities	Understated
Income	Understated
Expenses	Understated
Profit	**Overstated**

Answer 4

The correct option is **A.**

Disclose the reasons for change and the amount of adjustment in the current period and in comparative information for prior periods. There is no need to report the effect of change in accounting policy on future accounting periods, and also the effect of change in accounting policy need not be treated as an extraordinary item.

Answer 5

The correct option is **D.**

The change in accounting policy is made in 20X6, so there in no need to disclose the same in 20X7 because details about the change in accounting policy need not be given in subsequent years.

Answer 6

The correct option is **B.**

In the case of a change in accounting policy, in the current year, comparative figures of the previous year should be adjusted to reflect the change. If this is not possible, the opening balance of profit and loss should be adjusted as if the new policy had been applied since the beginning.

Answer 7

The correct option is **B.**

Historical cost accounting is simple to apply. It is the cost which was incurred to acquire the asset and the amount at which the asset is recorded in the financial statements i.e. there is no scope for differences of opinion.

Answer 8

The correct option is **D.**

An accounting policy can be changed if an accounting standard prescribes it or it results in greater accuracy of the financial statements.

Answer 9

The correct option is **B.**

Historical cost = Cost + Legal expenses
= Tshs100 million + Tshs10 million = Tshs110 million

Net realisable value = Expected sale price – Legal expenses
= Tshs195 million - Tshs10 million
= Tshs185 million

SECTION C

ACCOUNTING TREATMENT FOR PROPERTY, PLANT AND EQUIPMENT (IAS 16)

C1

STUDY GUIDE C1: TANGIBLE NON-CURRENT ASSETS

Get Through Intro

A 'tangible non-current asset' is an asset acquired by an entity for long-term use and which has physical presence i.e. it can be touched. A machine is a tangible non-current asset. Why do we say so?

A machine is used for a long period of time – for more than one accounting period. A machine produces goods which when sold will lead to an inflow of economic resources. Hence it is a non-current asset. A machine has physical presence – it can be touched. Therefore it is a tangible non-current asset.

An accountant has to be very careful when he classifies assets as either current or non-current. He also has to know which costs can be capitalised and the treatment to be given on revaluations and disposal of the non-current assets. Any mistakes in the interpretation and treatment given to these items can affect the reliability of the financial statements.

For example – Cheerleader Inc has had a bad year. Its profits have fallen from Tshs150 million in the last year to Tshs130 million in the current year. The accountant suggests that they should capitalise repairs to machinery by Tshs40 million in order to show more profits. The revised profits would be Tshs170 million (Tshs130 million + Tshs40 million).

What is capitalisation?
How can a mere change in an accounting entry help an entity to show more profits?
Would the directors accept the accountant's suggestion?
Would the auditors allow it?

These questions come to mind when one reads the example. This Study Guide will help you understand why Cheerleader Inc cannot act upon the accountant's suggestion and how important it is for an accountant to know the principles which help determine the classification of assets.

Learning Outcomes

a) Define and identify non-current assets.
b) Describe the difference between current and non-current assets.
c) Explain the difference between capital and revenue items.
d) Classify expenditure as capital or revenue expenditure.
e) Prepare ledger entries to record the acquisition and disposal of non-current assets.
f) Calculate and record profits or losses on disposal of non-current assets in the statement of income including part exchange transactions.
g) Record the revaluation of a non-current asset in ledger accounts, the statement of income and in the statement of financial position.
h) Calculate the profit or loss on disposal of a revalued asset.
i) Illustrate how non-current asset balances and movements are disclosed in notes to the financial statements.
j) Explain the purpose and operation of an asset register.

1. Define and identify non-current assets.
Describe the difference between current and non-current assets.
[Learning Outcomes a and b]

1.1 Current assets and non-current assets

IAS 1 defines a non-current asset as follows:

Definition

All **assets other than the current assets** shall be **classified as non-current assets**.

IAS 1

A non-current asset is defined in a negative manner as it is an asset which is not a current asset. Hence we first need to understand the meaning of current assets.

Definition

An asset should be classified as a current asset when it satisfies any of the following criteria:

It is expected to be **realised in**, or is **intended for sale or consumption in**, the entity's **normal operating cycle**;
It is held primarily for the purpose of **being traded**;
It is expected to be **realised within twelve months** after the end of the reporting period; or
It is **cash or a cash equivalent**

IAS 1

We shall now discuss this definition:

expected to be realised in, or is intended for sale or consumption in, the entity's normal operating cycle: a normal operating cycle refers to the duration within which the item is purchased, processed and cash been paid for it.

Example

Hi-tech Computers runs a business of manufacturing computers. The time period between buying the raw material, paying the suppliers, converting the raw material into computers, selling them to customers and recovering the amount from its sale is the normal operating cycle of Hi-tech Computers.

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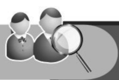
purpose of being traded: a current asset is an item which is purchased by an entity with the intention of selling it. These items are not retained for long term use.



Example

Michael is a sole trader who sells furniture. In this case furniture is his current asset because it is **purchased** for resale. However, the furniture which Michael purchases in order to use in his own office is not a current asset.

---

realised within twelve months: if an asset is expected to be sold within **twelve months** after the end of the reporting period, then such an asset is called a current asset. If an asset is expected to be held for more than one year then such an asset is called a non-current asset.

cash or cash equivalent: cash equivalents are highly liquid investments that can be easily converted into cash (usually within three months) and where there is little chance of its value being subject to change. You learn more about cash and cash equivalents in Study Guide I4.

Michael has a bank account with Heavenly Investments bank. The balance in the account is Tshs500,000. He also has cash in hand worth Tshs100,000 and Government securities (worth Tshs50,000) with a maturity period of 3 months.

Here, the bank balance of Tshs500,000, cash in hand of Tshs100,000 and Government securities worth Tshs50,000 are all his current assets.

Government securities are current assets because they are cash equivalent as they can be easily converted to cash within a year.

Classify the following items as current assets and non-current assets in the books of Smart Co – a manufacturer of television sets.

A Plant and Machinery
B Inventory
C Cash and bank balance
D Furniture and fixtures
E Raw material

Comparison of current and non-current assets

Current assets	Non-current assets
Expected to be realised within the normal operating cycle of the entity.	Expected to be used for many accounting periods.
Intended for sale or consumption.	Intended to be used over a longer period of time in the process of manufacturing or trading
Used for trading purposes.	Used for investment and to aid the manufacturing or trading process.
Realised within twelve months.	Held for more than twelve months.
Profitability is directly affected.	The effect on profitability is indirect.

Classification of an asset as current or non-current depends upon how the asset is being used. An asset which is a current asset for one entity can be a non-current asset for another entity.

John is a dealer of computers. He purchased five computers for Tshs20,000 each. The following month he sold them for Tshs40,000 each. As he is a dealer of computers and purchases computers for further sale, the computers are his current assets.

Jill runs a clothing business and purchases computers from John for her office. The computers Jill purchases are not for further sale but are retained in the business. For Jill, the computers are classified as non-current assets.

1.2 Tangible and Intangible non-current assets

The word ‘tangible’ means something that can be seen, touched or felt. On the contrary, the word ‘intangible’ means something that cannot be seen, touched or felt.

Hence**, a tangible non-current asset** is a non-current asset which physically exists. i.e. we can see, touch and feel this asset.

Example

Tangible non-current assets are plant and machinery, equipment, furniture and fixtures etc.

An intangible non-current asset is a non-current asset which does not exist physically i.e. we cannot see, touch and feel this asset.

Example

Intangible assets are goodwill, patents, copyrights etc.

Test Yourself 2

Classify the assets of Sun Inc. and Home Decorators into current and non-current:

Sun Inc is a manufacturer of steel

(a) Plant and Machinery
(b) Cash and bank balance
(c) Inventory of finished steel
(d) Computers
(e) Iron ore (a raw material in the manufacture of steel)
(f) Furniture and fixtures
(g) Vehicles

Home Decorators is a trader of furniture

(a) Vehicles
(b) Bank balance
(c) Computers
(d) Furniture and fixtures for resale

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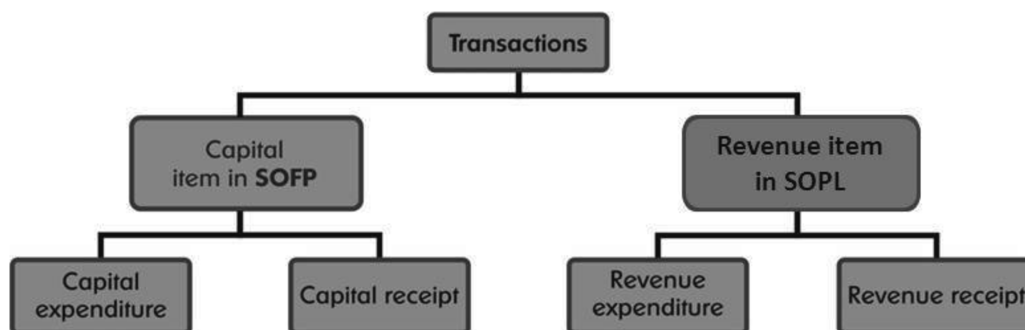
2. Explain the difference between capital and revenue items.
Classify expenditure as capital or revenue expenditure.

[Learning Outcomes c and d]

Diagram 1: Classification of items / transactions



2.1 Capital items: are those items which affect the statement of financial position.

Capital items are of two types: capital **expenditure** and capital **receipt.**

1. Capital expenditure

Capital expenditure is the expenditure which improves the **earning capacity** of an asset so that the asset works more efficiently or lasts longer. This benefit can be expected to last for more than one accounting period.

Nature of expense		Example
1.	Purchase of non-current assets	Computers, vehicles, building, land, plant and machinery
2.	Cost of bringing the non-current asset into the entity	carriage inward
3.	Legal and professional cost spent on purchasing non-current assets	Stamp duty, registration fees, solicitor's fees, architect's fees.
4.	Cost needed to make these non-current assets ready for use	Installation charges
5.	Improvement to existing non-current assets	Fitting of air conditioner in vehicles

Capital expenditure increases the value of a non-current asset. This means that the working capacity and the life of the asset are increased. This results in long lasting benefits to the entity.

Capitalisation of expenditure: When expenses are recorded in the books of accounts as an increase in the cost of a non-current asset, it is known as capitalisation of expenditure.

On 2 January 20X6, Diana purchased land worth Tshs900 million from Jack. She paid Tshs50 million stamp duty on the purchase price. This amount of Tshs50 million is included in the cost of the land bringing the total cost of the land purchased to Tshs950 million. In Diana's accounts, the cost of the land will be recorded as Tshs950 million.

(You will learn later on in this Study Guide why stamp duty of Tshs50 million is included in the purchase price.)

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2. Capital receipt

Capital receipt is income which is earned because not of the ordinary activities / regular operations of an entity i.e. not realised by the sale of the merchandise of the entity.

When an item of capital expenditure is sold, the receipt thus generated is called a capital receipt.

A capital receipt decreases the value of a non-current asset.

	Capital receipt
1.	Sale of non-current asset
2.	Receipt of share capital or capital
3.	Receipt of loans and debentures
4.	Premium received on issue of shares

Michael had a building worth Tshs700 million, which he purchased in 19W0 at a cost of Tshs50 million. On 15 November 20X6, he sold the building for Tshs950 million.

Here, Michael has received Tshs950 million as he sold the building, an asset. Hence, Tshs950 million is a capital receipt.

2.2 Revenue items: are those items which affect the statement of profit or loss.

Revenue items consist of two types: revenue **expenditure** and revenue receipt.

1. Revenue expenditure

Revenue expenditure is that expenditure which is incurred to **maintain the existing capacity** of an asset so that it can do its daily work. It is a regular expenditure incurred from time to time in the ordinary course of the business**.**

'Maintaining' the existing capacity of the asset means keeping the asset in a proper working condition so that the productivity of the asset is not reduced. Revenue expenditure provides benefit of a current nature i.e. the benefit arising out of revenue expenses expires in the same accounting period.

Example

Mack purchased computers for Tshs1,500,000 and computer stationery for Tshs50,000. These two expenditures will benefit Mack for different periods. The computers will give benefit of an enduring nature i.e. benefit for a longer duration whereas the expenditure on computer stationery will give benefit of a comparatively short duration. Hence:

purchase of computers Tshs1,500,000 will be treated as **capital** expenditure; and
purchase of computer stationery Tshs50,000 will be treated as **revenue** expenditure.

---

2. Revenue receipt

A revenue receipt is a **regular** receipt i.e. these transactions are regularly entered into in an entity in the ordinary course of the entity's activities

Revenue receipts are a result of sale of the merchandise of the entity and other revenue items like rent received or commission received.

Example

Michael gave his building on rent to Sam. The monthly rent received is Tshs5,000,000. Therefore, the amount received by Michael is Tshs5,000,000 is his revenue receipt.

Example

The chart given below shows why Better Plc. classified the expenses it incurred as capital or revenue expenses.

Nature of expense	Classification	Reason
Cost of machinery	Capital expenditure	Machinery will be used in business for long term.
Cost of installing the machinery	Capital expenditure	**Costs can be directly attributed** to bringing the asset to its intended location and condition. This allows the asset to be used as intended.
Consumables (spare parts) for machinery	Revenue expenditure	It is expenditure of a regular nature – it helps the machine do its daily work.
Repairs to machinery	Revenue expenditure	Expenditure incurred to maintain its existing capacity.
Electricity cost for machinery	Revenue expenditure	It is expenditure of a regular nature.

Disclosure of capital and revenue expenditure in the financial statements

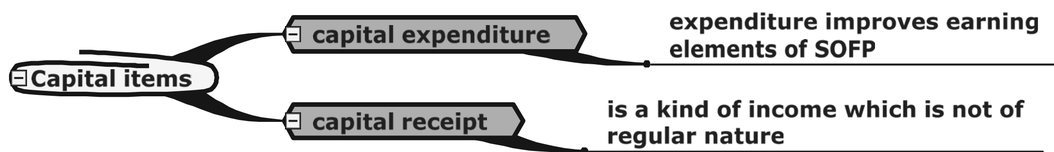
SOPL		
	Tshs	**Tshs**
Income	X	
Less: Expenses	(X)	

Revenue expenses will come here

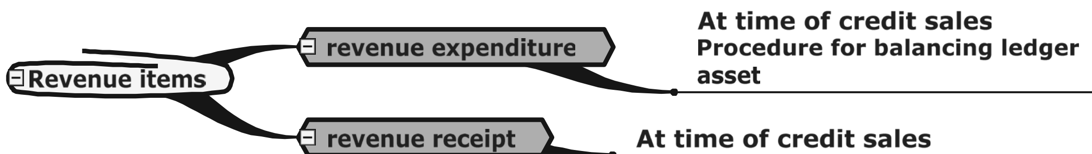
Capital expenses will come here

SOFP		
		Tshs
Non-current assets		X
	Total	
Capital and liability		
	Total	

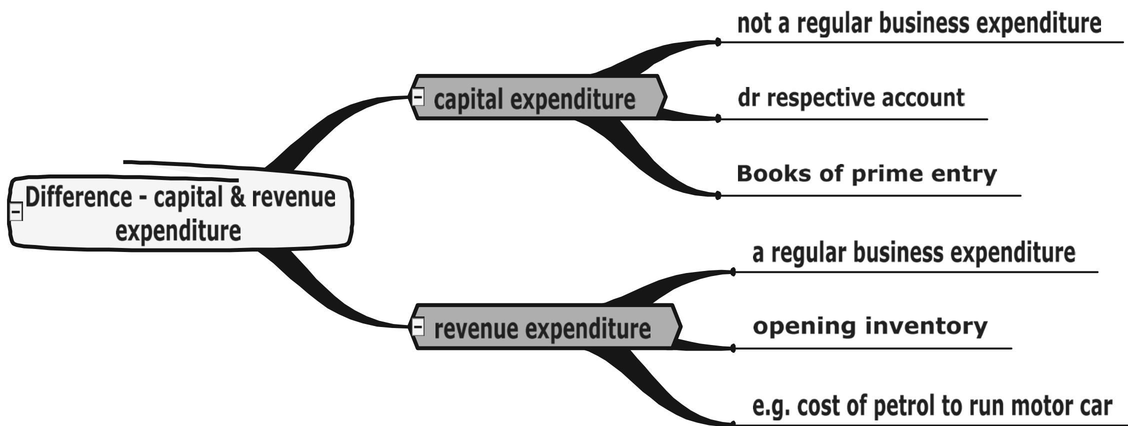
SUMMARY



SUMMARY



SUMMARY



Test Yourself 3

Fill in the blanks.

(a) Comp Plc is a manufacturer of computers. During 20X6, the company purchased machinery for Tshs100,000. This purchase price is a _______ expenditure.

Comp Plc. sold computers for Tshs200,000. This sale price received is a ____________ receipt because it is part of the regular income. The company sold one of its vehicles for Tshs50,000; this is a ____________ receipt because it is a sale of a non-current asset.

(b) Suzy is a sole trader dealing in furniture. A dressing table is sold for Tshs20,000; the amount received for this sale is a ____________ receipt. She also sold a computer used in her showroom for Tshs5,000. This is a __________ receipt because it is a sale of a non-current asset.

Test Yourself 4

Jack is a steel manufacturer. Classify the following expenses as revenue or capital expenditure.

(a) Purchase of computer
(b) Payment of electricity bill of the company
(c) Salaries to staff
(d) Installation cost of a computer server
(e) Extension of office building
(f) Interest on bank loan
(g) Rent on computers
(h) Purchase of vehicle
(i) Fees paid to directors
(j) Construction cost of new building

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3. Prepare ledger entries to record the acquisition and disposal of non-current assets. [Learning Outcome e]

3.1 Acquisition of non-current assets

The accounting entry for acquisition of non-current assets is as follows:

Dr	Non-current asset	X	
Cr	Cash / Payables / other asset		X

Being non-current asset acquired

Example

Sweet Home Inc is a manufacturer of furniture. It purchased machinery on 1 January 20X6 for Tshs50 million. The amount was paid in cash. On 1 February it purchased a drilling machine for Tshs60 million by cheque. It purchased a transit van on 30 June 20X6 for Tshs25 million on credit from Tony. On 30 September 20X6 it purchased plywood for Tshs10 million in cash.

All transactions of a capital nature are recorded in the ledger accounts in the following manner:

They are first recorded in the books of prime entry and then posted to ledger accounts.

The ledger accounts are shown below:

BBG Inc

Dr Machinery account Cr

Date		Tshs'000	Date	Details	Tshs'000
01/01/20X6	Cash	50,000			
01/02/20X6	Bank account	60,000	31/12/20X6	Balance c/f	110,000
	Total	**110,000**		**Total**	**110,000**

Acquisition of non-current asset is debited to that asset account.

Dr Vehicle account Cr

Date		Tshs'000	Date	Details	Tshs'000
30/06/20X6	Tony's account – Transit van purchased	25,000	31/12/20X6	Balance c/f	25,000
	Total	**25,000**		**Total**	**25,000**

Notes

1. The purchase of plywood is not a non-current asset, so it is not shown in the above ledger account. It will be debited to the purchase account.

2. The machinery purchased in January and the drilling machine purchased in February are recorded in the same ledger account as they are of the same class i.e. machinery whereas vehicle is recorded in a separate ledger account.

3.2 Cost of asset

The cost of an asset is not just made up of its purchase price, but also contains other elements. These elements are as follows:

Purchase price
Costs **directly attributable** to bringing the asset to its current location and condition, in order to make it available for its intended use.
Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located

These elements mentioned above should be capitalised as non-current assets. Let us discuss each of these elements in detail:

1. **Purchase price:** The purchase price is the price after deducting trade discounts and rebates, and adding duties and non-refundable taxes.

Example

Tom purchased machinery and paid Tshs120 million, the basic price being Tshs100 million plus value added tax (VAT) of Tshs20 million. While calculating the tax payable on the finished goods sold, he gets credit of VAT paid on machinery.

Therefore, Tshs20 million paid in tax will be treated as refundable, and hence will not be included in the cost of the machinery. Therefore, the machine will be capitalised for Tshs100 million.

(**Note:** VAT has been discussed in Study Guide D1).

---

2. **Costs directly attributable** to bringing the asset to its intended location and condition. These costs include:

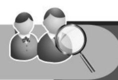
(a) Initial delivery and handling costs

Example

Jack purchased a machine on 5 January 20X6 for Tshs50 million. The supplier charged Tshs10 million as transportation costs. According to IAS 16, these delivery charges of Tshs10 million will be included in the purchase price of the machinery. The machine will be recognised in the statement of financial position as:

	Tshs'000
Cost of machine	50,000
Add: Transportation charges	10,000
To statement of financial position	**60,000**

(b) Installation costs



Example

Continuing the previous example of Jack,

The machinery purchased by Jack had to be installed in his factory. He paid Tshs5 million to the workers who installed the machinery. These installation charges will be included in the purchase price of the machinery. The machine will be recognised in the statement of financial position as:

	Tshs'000
Cost of machine	50,000
Add: Transport charges	10,000
Add: Installation charges	5,000
To statement of financial position	**65,000**

(c) Professional fees

Example

Mack decided to construct an office building. He appointed John, an architect to design the plan of the building and paid professional fees Tshs10 million to the architect.

Tshs10 million will be capitalised and added to the cost of the building.

---

3. Initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located

These costs are applicable when the entity has an obligation to return the assets to its original condition.

Test Yourself 5

Compute the amount to be capitalised in the Plant account in the books of ICC Inc from the following invoice.

Champion Equipments Inc			
Customers name: ICC Inc Address: Manchester, England		Date: 01/01/20X6 Invoice no-699	
	Qty	**Rate**	**Tshs'000**
Machinery	2	15,000	30,000
Add: Additional handling charges			2,000
Add: Transportation charges			8,320
			40,320
Less: Trade discount @1%			(320)
			40,000
Add: Import duty (set off not available)			6,000
Add: Sales tax (Set off available)			9,200
Add: Service charges for maintenance for next 2 years			3,000
			58,200
Less: Cash discount 5%			(2,910)
			55,290

A Tshs55,290,000
B Tshs58,200,000
C Tshs46,000,000
D Tshs55,200,000

3.3 Disposal of non-current assets

Disposal of a non-current asset can arise due to sale, exchange, loss, redundancy etc.

When a non-current asset is disposed of, the balance on that asset's account has to be reduced. For the purpose of disposal, an asset disposal account is created, to which the full cost of the disposed asset is transferred. The accounting entry to dispose of the asset is as follows:

Dr	Asset disposal account	X	
Cr	Asset account		X

Being the removal of the asset from the SOFP

Test Yourself 6

On 1 January 20X6, BBG Inc bought a plant for Tshs50 million. On 1 March 20X7 they disposed of the plant. What are the accounting entries for the disposal of the plant?

On **disposal of an asset, if money is received** (or receivable) then it is recorded in the asset disposal account.

The "Receivable" here refers to the amount receivable on the asset and is **not a part of the trade receivables** incurred in the normal course of business.

Dr	Cash (Asset Receivable) account	X	
Cr	Asset disposal account		X

Being cash received (asset disposed and amount receivable from asset debtor) on disposal of asset

Test Yourself 7

With reference to the information in Test Yourself 6, BBG received Tshs30 million in cash on selling the plant. What is the accounting entry for the receipt of cash on the sale of the asset?

Example

The books of Superb Co have the following balances on 1 January 20X7 - Plant A/c Tshs110 million and Vehicle A/c Tshs25 million. Superb Co sold the plant for a cash amount of Tshs30 million on 1 March 20X7. On 1 December 20X7 the vehicle met with an accident. It was not covered by insurance.

Prepare an asset and asset disposal account for all these events.

Superb Co
Plant Account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
1/01/20X7	Balance b/d	110,000	01/03/20X7	Asset disposal account (Note1)	110,000
	Total	**110,000**		**Total**	**110,000**

Vehicle account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
1/01/20X7	Balance b/d	25,000	01/12/20X7	Asset disposal account	25,000
	Total	**25,000**		**Total**	**25,000**

Asset disposal account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
1/03/20X7	Plant	110,000	01/03/20X7	Cash (Note2)	30,000
			31/12/20X7	Loss on disposal of asset (Note3)	105,000
01/12/20X7	Vehicle	25,000			
	Total	**135,000**		**Total**	**135,000**

Notes:

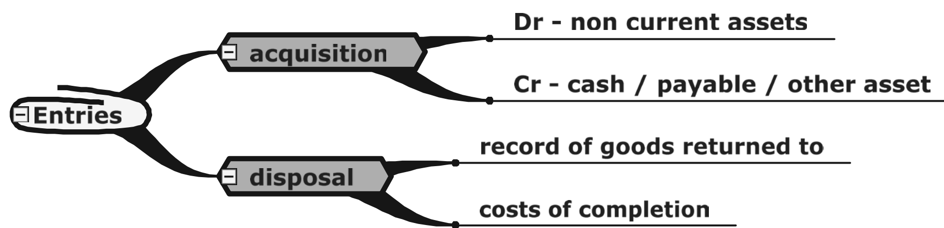
1. In the plant A/c, we credit the asset disposal a/c with the cost of plant, and not the disposal value.

2. When an asset is disposed of, we record the cash received in the asset disposal a/c.

3. For the plant, the cost is Tshs110 million and the cash received on disposal is Tshs30 million. So, the difference is Tshs80 million, which is a loss. The vehicle, however, met with an accident and there was no insurance cover so, the full Tshs25 million is a loss. Therefore, a total of Tshs105 million (Tshs25 million + Tshs80 million) is a loss on disposal of assets.

4. Profit or loss on disposal of an asset is transferred to the statement of profit or loss.

SUMMARY



Test Yourself 8

Zenith Inc purchased a press machine for Tshs20 million on 1 January 20X6. After six months, the company decided to make changes in its products, so modification to the machinery was required. On 1 July 20X6 the company made some modifications which amounted to Tshs5 million. Unfortunately on 27 November 20X6 a major earthquake occurred and destroyed the machinery.

What will be the amount of loss recognised in the statement of profit or loss?

A 20,000
B 25,000
C Nil
D None of the above

Test Yourself 9

Continuing the question of Zenith Inc, what will be the amount of loss if Zenith Inc receives Tshs18 million from the insurance company?

A Tshs20 million
B Tshs25 million
C Nil
D Tshs7 million

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4. Calculate and record profits or losses on disposal of non-current assets in the statement of profit or loss including part exchange transactions.

[Learning Outcome f]

The profit or loss on disposal of non-current assets is disclosed in the statement of profit or loss as follows:

	Tshs
Revenue	X
Cost of goods sold	(X)
Gross profit	**X**
Add (less): Profit (loss) on disposal of asset	**X**
Net profit	**X**

If there is a profit on disposal, it is shown as “other income”. Similarly, a loss is shown as “other expense”.

Important

Profit or loss on disposal of non-current assets is discussed in detail in Study Guide F2.

Example

Best Inc purchased machinery for Tshs50 million on 1 March 20X6 and a plant for Tshs75 million on 2 March 20X6. The company sold the machinery on 15 November 20X6 for Tshs70 million and the plant for Tshs60 million. The amount of profit or loss on the two non-current assets is determined in the following manner:

Best Inc
Plant and Machinery account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/03/20X6	Machinery	50,000	15/11/20X6	Asset disposal account (machinery)	50,000
02/03/20X6	Plant	75,000	15/11/20X6	Asset disposal account (plant)	75,000
	Total	**125,000**		**Total**	**125,000**

Asset disposal account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
15/11/20X6	Plant and Machinery	50,000	31/12/20X6	Cash received (for machinery)	70,000
15/11/20X6	Plant and Machinery	75,000	31/12/20X6	Cash received (for plant)	60,000
31/12/20X6	**Profit on disposal of machinery (reflected in SOPL)**	**20,000**	31/12/20X6	**Loss on disposal of plant (reflected in SOPL)**	**15,000**
	Total	**145,000**		**Total**	**145,000**

Notes:

1. In the plant and machinery account, we **credit the asset disposal a/c with the cost of machinery and not the disposal value.**
2. It is important to note that when two non-current assets are disposed of, one resulting in profit and the other resulting in loss, these two transactions have to be recorded **separately** in the financial statements.

In this section, we have explained the basic principles of calculating profit or loss on disposal of a non-current asset. The effect of depreciation has been ignored as depreciation is explained in detail in the Study Guide F2.

SUMMARY

Purchase price in exchange transactions

Sometimes an asset may not be acquired in exchange for money but in exchange for other monetary or non-monetary assets. If the asset given up is a monetary asset, then measurement is easier, since its amount can be determined easily. However, if the asset given up is a non-monetary asset, then it may be necessary to measure the value of the asset given up.

(a) Fair value: Very simply, the fair value of an asset refers to the market value of the asset. It is the amount at which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction. An arm's length transaction is a transaction between two related parties that is conducted as if they were unrelated so that there is no conflict of interest. The cost of the assets involved in the exchange is determined at fair value (of the asset received or the asset given up), unless:

the transaction lacks commercial substance; or
the fair value of the two assets cannot be reliably measured

Example

Machinery is acquired in exchange for plant. The fair value of the machinery is agreed at Tshs200 million and the fair value of the plant is Tshs250 million (its book value is Tshs225 million). The difference of Tshs50 million is settled by cash. The machinery acquired will be recorded at Tshs200million.

The accounting entry will be:

		Tshs'000	Tshs'000
Dr	Machinery	200,000	
Dr	Cash	50,000	
Cr	Plant		225,000
Cr	Profit on sale of Plant		25,000

Being sale of plant, partially in exchange for machinery, and partially for cash.
The resultant profit is accounted for

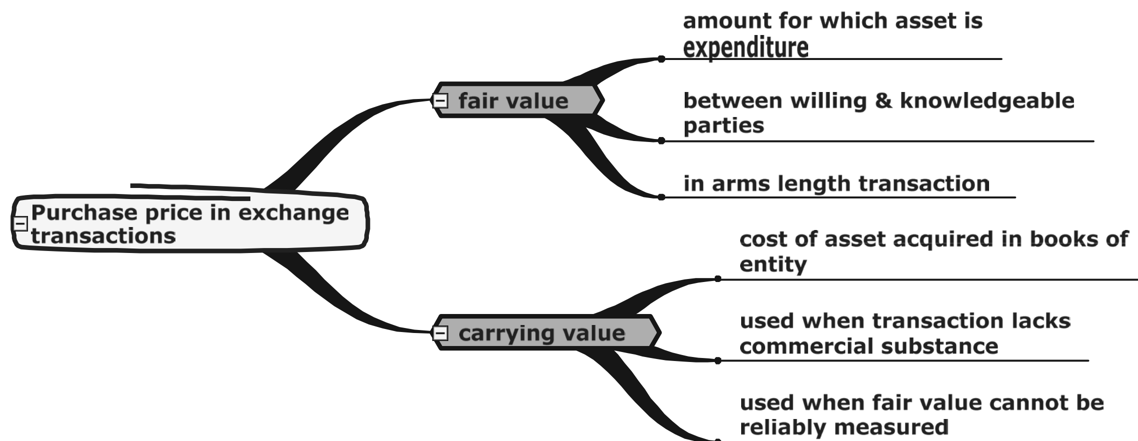
Carrying amount: if any of the above exceptions apply i.e. the transaction lacks commercial substance, or the fair value of both the assets cannot be reliably measured (and therefore the assets cannot be valued at fair value) then the cost of the asset acquired is measured at the carrying amount of the asset given up.

Example

Continuing the previous example

If there is only an exchange of the two assets (with no cash component), and the fair value of the two assets is not reliably measurable, then the book value of the plant, being the asset given up, i.e. Tshs225 million, should be recorded as the cost of the asset acquired i.e. the machinery.

SUMMARY



Test Yourself 10

Mark bought a machine for use in his business on 1 November 2008. He gave the supplier a cheque for Tshs23,140 and traded in an old machine. The supplier allowed him Tshs8,860 in part exchange for the old machine. Mark depreciates machinery on the reducing balance basis at a rate of 20% per annum. The old machine had cost Tshs24,000 and had been depreciated by Tshs11,712.

Calculate the profit or loss on the trade in of the old machine.

A a profit of Tshs2,852
B a profit of Tshs3,428
C a loss of Tshs2,852
D a loss of Tshs3,428

5. Record the revaluation of a non-current asset in ledger accounts, the statement of income and in the statement of financial position.

[Learning Outcome g]

5.1 Revaluation of assets

When assets are purchased, they are recorded at cost. As time passes, these assets can have a different value to what is recorded in the books.

Why do you think this is so?

The value of the asset e.g. a computer could decrease if the technology becomes out-dated.
The value of the asset could increase if there is a relative scarcity of such assets in the market, for example in the case of property.

'Revaluation' as the name suggests means to value the asset at its fair value. As seen earlier in the text, the fair value refers to the amount at which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction.

Test Yourself 11

Zodiac Enterprises purchased an office building in 20X0 for Tshs120 million. Will the value of that building be the same in 20X6? Give adequate reasons for your answer.

Accounting for revaluations

5.2 Upward revaluation

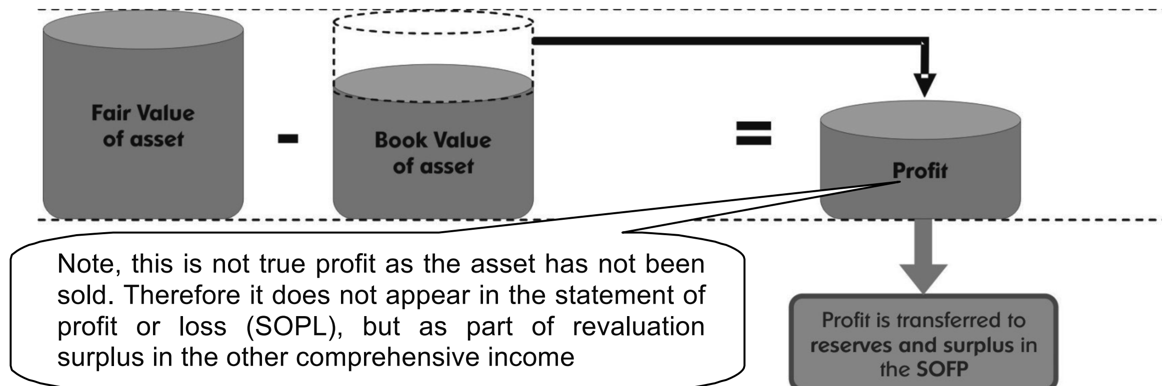
If the book value (known as the carrying cost) of an asset is **less than** the fair value:

the difference between the two is termed as **profit on revaluation**
this profit is transferred to the revaluation surplus account

Tip

The **revaluation surplus account** is recorded under reserves in the **statement of financial position**. However it is routed through the statement of other comprehensive income.

Diagram 2: Upward revaluation



The **entry** for recording revaluation of assets is as follows:

Dr	Asset account	X	
Cr	Revaluation surplus account		X

Being profit on revaluation of asset transferred to revaluation surplus account

Example

Zodiac Inc owns a plant, whose carrying amount (i.e. book value) is Tshs50 million on 31 December 20X6. Its fair value on 31 December 20X6 is Tshs60 million.

Here, Zodiac Inc has recorded the plant's book value as Tshs50 million.
The fair value of the asset is Tshs60 million.
When the book value of an asset is **less than** the fair value, it is known as **upward revaluation**

The **entry** for recording revaluation of an asset is as follows:

		Tshs'000	Tshs'000
Dr	Plant account	10,000	
Cr	Revaluation surplus account		10,000
Being plant brought up to face value			

Ledger accounts are as follows:

Zodiac Enterprises
Plant account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Balance b/d	50,000			
31/12/20X6	**Revaluation surplus**	**10,000**			
			31/12/20X6	Balance c/f	60,000
	Total	**60,000**		**Total**	**60,000**

Revaluation surplus account

Dr | Cr

Date		Tshs'000	Date		Tshs'000
			31/12/20X6	Balance b/d	0
			31/12/20X6	**Plant account**	10,000
31/12/20X6	Balance c/f	10,00			
	Total	**10,00**		**Total**	**10,000**

Notes:

1. We must increase the value of the plant by Tshs10 million to make it equal to the fair value. Hence we debit the plant account.

2. Revaluation surplus will be disclosed in the statement of financial position under the head "Reserves".

3. We cannot record the revaluation surplus in the statement of profit or loss because we apply the concept of prudence, which implies that we cannot recognise the profit in the statement of profit or loss until it is certain or realised. Here the asset has not been sold, so no profit has actually been made.

Extract of disclosure in the financial statements

Zodiac Enterprises – Statement of financial position (extract) for the year ended 31 December 20X6

	Tshs'000	Tshs'000
Assets		
Plant - Cost on 01/01/20X6	50,000	
Add: Revaluation	10,000	60,00
Net value on 31/12/20X6		0
Total		**X**
Capital and liabilities		
Share capital		
Reserves		
Revaluation surplus	10,000	
Total		**X**

Continued on the next page

Zodiac Enterprises - Statement of profit or loss and other comprehensive income (extracts) for the year to 31 December 20X6

	Tshs'000
Revenue	X (X)
Cost of sales	
Gross Profit	X X
Other Income	(X)
Expenses	
Profit for the year	**X**
Other comprehensive income	
Gains on property revaluation	10,000
Total comprehensive income for the year	**X**

Notes

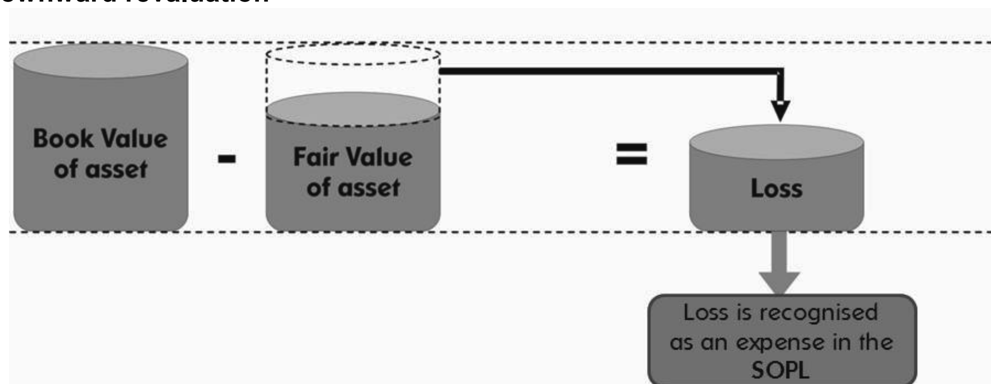
1. After revaluation, the plant is recorded at its fair value, which is Tshs60 million.
2. Revaluation surplus is Tshs10 million, recorded under reserves and routed through the other comprehensive income part of the statement of profit or loss and other comprehensive income.
3. Net value of non-current assets is calculated without giving the effect of depreciation, as depreciation is explained in the next Study Guide.

5.3 Downward revaluation

If the book value of an asset is **more than** its fair value:

the difference between the two is termed as **loss on revaluation**
this loss is charged to the statement of profit or loss

Diagram 3: Downward revaluation



Example

Zodiac Inc owns a plant whose carrying amount (book value) is Tshs50 million on 31 December 20X6. The company decided to revalue the plant at Tshs45 million on 31 December 20X6.

Answer

Here, the company recorded the plant at its book value of Tshs50 million.
It decided to revalue the plant at Tshs45 million. This is its fair value.
As the book value of the asset is **more than** its fair value, this is known as **downward revaluation** which results in **loss.**

The **entry** for recording revaluation of an asset is as follows:

		Tshs'000	Tshs'000
Dr	Loss on revaluation of asset	5,000	
Cr	Plant account		5,000

Being revaluation of plant

Continued on the next page

Ledger accounts are as follows:
Plant account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Balance b/d	50,000			
			31/12/20X6	Loss on revaluation	5,000
			31/12/20X6	Balance c/f	45,000
	Total	**50,000**		**Total**	**50,000**

Loss on revaluation account — Shown as an expense in the SOPL

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Plant account	5,000	31/12/20X6	SOPL	5,000
	Total	**5,000**		**Total**	**5,000**

Notes:

1 We must decrease the value of the plant by Tshs5 million to make it equal to the fair value. Hence we credited the plant account.

2 Loss on revaluation will be charged to the statement of profit or loss.

3 We record the loss on revaluation in the statement of profit or loss because we apply the concept of prudence, which implies that we have to recognise loss in the statement of profit or loss as soon as it is known, even if it is not yet realised.

Extract of disclosure in financial statements

Zodiac Enterprises - Statement of profit or loss and other comprehensive income (extract) for the year to 31 December 20X6

	Tshs'000
Revenue	-
Cost of goods sold	-
	-
Gross profit	**X**
Expenses:	-
	(5,000)
Loss on revaluation	-
Net profit	**(5,000)**

Zodiac Enterprises - Statement of financial position (extract) for the year ended 31 December 20X6

	Tshs'000	Tshs'000
Assets		
Plant - Cost on 01/01/20X6	50,000	
Add: Addition during the year	-	
Less: Loss on revaluation	(5,000)	
	45,000	
Net value on 31/12/20X6		45,000
Total		**X**
Capital and liabilities		
Share capital		
Reserves and surplus		(5,000)
Total		**X**

Continued on the next page

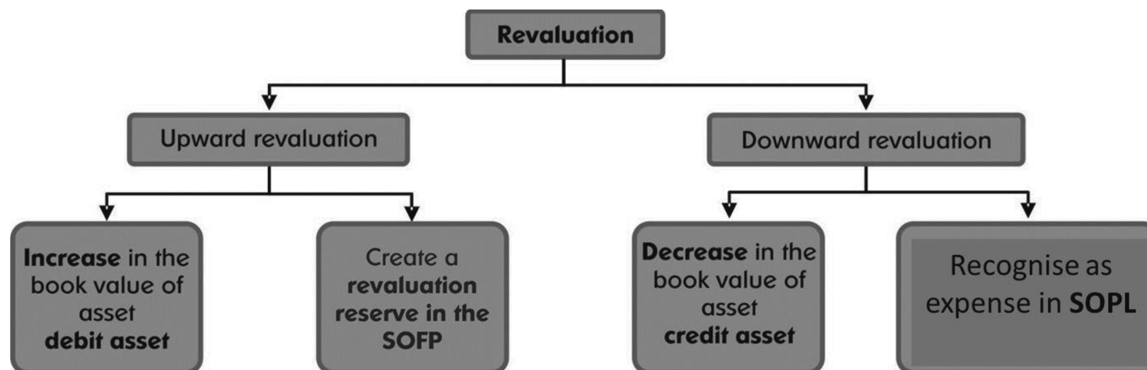
Notes:

1. After revaluation, the plant is recorded at its fair value, which is Tshs45 million.

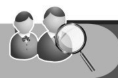
2. Loss on revaluation is charged to the statement of profit or loss and not to the statement of financial position.

3. Net value of the non-current asset is calculated without giving the effect of depreciation, as depreciation is explained in the next Study Guide.

Diagram 4: Revaluation



All assets belonging to the same class have to be revalued at the same time.



Example

Superb Inc wants to revalue its machinery. The company has 5 types of machinery in its possession. The company will have to revalue all five types of machinery.

Test Yourself 12

Superb Inc owns machinery, the carrying amount (book value) of which as on 31 December 20X6 was Tshs60 million. The company decided to revalue the plant at Tshs50 million on 31 December 20X6. What entry is to be made for recording the revaluation of machinery?

---

6. Calculate the profit or loss on disposal of a revalued asset.

[Learning Outcome h]

6.1 Nature of revaluation surplus account

The revaluation surplus account is created to record an increase in the value of a non-current asset due to a revaluation. As discussed in the previous Learning Outcome, this is an unrealised gain because the increase in the value of the non-current asset does not bring cash into the entity. Hence there cannot be a distribution of profits out of the revaluation surplus.

You should understand that in the above case the revaluation surplus has not brought any realised gains or cash inflows. It is just an accounting adjustment. **If an entity declares dividend out of revaluation surplus, it will result in a declaration of dividend out of future potential profits which is not allowed. The revaluation surplus is therefore a non-distributable reserve.**

6.2 Realisation of revaluation surplus account

Revaluation surplus falls under the category of unrealised gains. But this **unrealised gain becomes realised gain on disposal of the asset.**

Example

Zodiac Enterprises purchased a building on 1 January 20X6 for Tshs150 million.
On 31 December 20X7 it revalued the building at Tshs200 million.
On 31 December 20X8 it sold the building for Tshs280 million in cash.

What is the final gain on disposal of the asset? Draft the ledger accounts to support this.

Answer

Zodiac Enterprises
Building account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/01/20X6	Bank account	150,000			
			31/12/20X6	Balance c/f	150,000
	Total	**150,000**		**Total**	**150,000**
01/01/20X7	Balance b/d	150,000			
31/12/20X7	Revaluation surplus (Note1)	50,000			
			31/12/20X7	Balance c/f	200,000
	Total	**200,000**		**Total**	**200,000**
01/01/20X8	Balance b/d	200,000			
			31/12/20X8	Asset disposal account (Note2)	200,000
	Total	**200,000**		**Total**	**200,000**

Revaluation surplus account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
			31/12/20X7	Building	50,000
31/12/20X7	Balance c/d	50,000			
	Total	**50,000**		**Total**	**50,000**
			01/01/20X8	Balance b/d	50,000
31/12/20X8	General reserve (note 5)	50,000			
	Total	**50,000**		**Total**	**50,000**

Asset disposal account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X8	Building	200,000	31/12/20X8	Cash (Note 3)	280,000
31/12/20X8	Profit on disposal of asset (Note4)	80,000			
	Total	**280,000**		**Total**	**280,000**

As you can see the final gain of Tshs80 million is realised in the year of disposal.

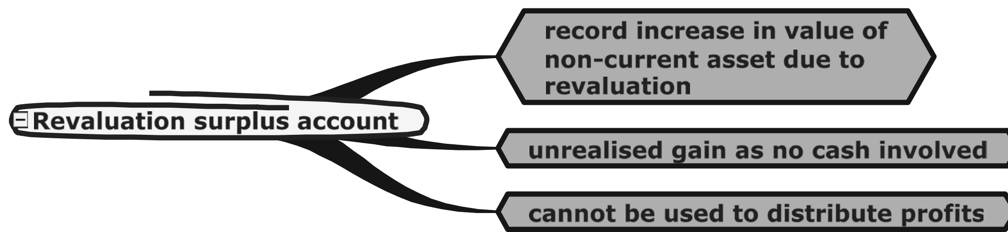
Notes

1. Building has to be **revalued upwards**, so, we debit the asset account and credit the revaluation surplus account.
2. On disposal of asset, the entire **book value** of the asset is transferred to the asset disposal account.
3. On disposal of asset, any **amount received** is transferred to the asset disposal account.
4. The **profit or loss on disposal** of the asset is recognised in the statement of profit or loss. Here, it is profit.
5. On disposal of asset, the **revaluation surplus** of that asset becomes a realised gain, and hence it is transferred to retained earnings. The following journal entry is passed:

		Tshs'000	Tshs'000
Dr	Revaluation surplus	50,000	
Cr	Retained earnings		50,000

Being revaluation surplus recorded

SUMMARY



Test Yourself 13

Half Moon Inc purchased a plant on 5 January 20X6 for Tshs200 million.

On 31 December 20X7 it revalued the plant at Tshs260 million.
On 31 December 20X8 it sold the plant for Tshs320 million in cash.

Prepare the ledger accounts to calculate the profit or loss on disposal of plant.

---

7. Illustrate how non-current asset balances and movements are disclosed in notes to the financial statements.
[Learning Outcome i]

Non-current asset balances and movements are disclosed in the financial statements in the following format:

Details of non-current assets as on 31 December 20X6						
		Land	**Building**	**Plant**	**Equipment**	**Total**
A	**Cost**					
	Balance on 1 January 20X6					
	(+) Additions					
	(+/ -) Revaluations					
	(-) Transfer to assets held for sale					
	(-) Disposals					
	Balance on 31 December 20X6					

Example

Sun Inc had a building where the opening balance on 1/01/20X6 was Tshs20 million. It purchased land on 5 January 20X6 for Tshs50 million.

The company decided to revalue its building on 31/12/20X6 at Tshs30 million.
The price of land appreciated very quickly, so, the company decided to dispose of its land for Tshs75 million.

The movements of non-current assets are disclosed on the financial statements as follows:

		Land	**Building**
		Tshs'000	**Tshs'000**
A	**Cost**		
	Balance on 1 January 20X6		20,000
	(+) Additions	50,00	
	(+/ -) Revaluations	0	10,000
	(-) Transfer to assets held for sale		-
	(-) Disposals	-	-
	Balance on 31 December 20X6	0	30,000

Since this example only refers to land and building, only the land and building columns are shown. One can show as many columns for as many non-current assets that are owned by the entity.

Continued on the next page

Notes

1. The above disclosure is made without giving the effects of depreciation because depreciation is explained in detail in the next Study Guide.

2. Here, we have shown the disposal of land at its book value. The profit or loss on disposal is not shown here.

The **statement of financial position** will **contain** a **single figure showing the total carrying amount** of all the non-current assets. All the requirements and **details discussed earlier are disclosed by way of notes** to accounts.

Classes of asset

Each class of property, plant and equipment is disclosed separately in accordance with IAS 16 Property, Plant and Equipment. Therefore it is important to understand what the meaning of a 'class of assets' is. This is a subjective issue, so there may be a difference of opinion.

Properties, plant or equipment can be classified by an entity according to the following criteria:

Geographical location of asset: When an entity has two assets, each in a different place, then the assets are classified on the basis of their location. E.g. plant in the UK, plant in Australia etc.

Nature of asset: Classification can be done on the basis of the type of asset. E.g.: plant, vehicle, tools, furniture etc.

Use of asset: Classification of an asset also depends on the purpose for which it is used. E.g. computers at lab, computers at office etc.

This classification has to be **consistent every year** in order to ensure that annual financial statements are comparable and easily understood by the user.

Test Yourself 14

Which ONE of the following options is not a criteria for asset classification?

A Geographical location
B Nature of assets
C Use of asset
D Size of assets

---

8. Explain the purpose and operation of an asset register.

[Learning Outcome j]

A company invests a huge amount of capital in non-current assets. Therefore they must maintain proper and systematic records to avoid any loss to the assets. Also for the day to day management of the business it is important to know what assets the company owns and where they are located.

An asset register includes the following details about an asset:

Name of the asset
Description
Date of purchase
Purchase cost
Supplier's details
Additions to assets
Revaluation (if any)
Depreciation
Disposal details
Unique asset code
Location

We will discuss this in the next Study Guide

Proforma Asset register

(Amounts in Tshs)

Asset No.	Date of purchase	Description	Location	Depre-ciation rate	Cost	Accumulated depreciation b/f	Depreciation charge in the year	Accumulated depreciation c/f	Net book value
Land and Building									
10015	15/05/19W9	35 High Street	Sheffed USA	Nil	2,500,000				2,500,000
10015A	12/10/20X2	35 High Street extension	Sheffed USA	Nil	100,000				100,000
10016	12/06/20X6	15 Long lane	Bernsley USA	Nil	250,000				250,000
					2,850,00	**0**	**0**	**0**	**2,850,00**
Plant and Machinery									
20013	05/10/20X4	Milling Machine	Workshop 1	10%	20,000	4,000	2,000	6,000	14,000
20014	01/01/20X5	Pressing Machine	Workshop 1	10%	32,000	3,200	3,200	6,400	25,600
20015	31/12/20X5	Rolling Machine	Workshop 2	10%	50,000		5,000	5,000	45,000
					102,000	**7,200**	**10,200**	**17,400**	**84,600**
Fixtures and Fittings									
3045	4/02/20X4	Office chairs	Office-1	20%	15,000	6,000	3,000	9,000	6,000
3046	5/05/20X5	Shelving Unit	Office-1	20%	10,000	2,000	2,000	4,000	6,000
3047	2/05/20X6	Tall Storage unit	Office-2	20%	20,000		4,000	4,000	16,000
					45,000	**8,000**	**9,000**	**17,000**	**28,000**
Total					**2,997,000**	**15,200**	**19,200**	**34,400**	**2,962,600**

Maintaining an asset register is compulsory for limited liability companies.

The carrying amount in the asset register should **be equal to** the amount shown in the statement of financial position.

Non-current assets are also physically verified at the year end.

In a computerised system a more complex report could be printed that shows supplier details, improvements made etc.

Purpose of an asset register:

A well maintained asset register could help in the following:

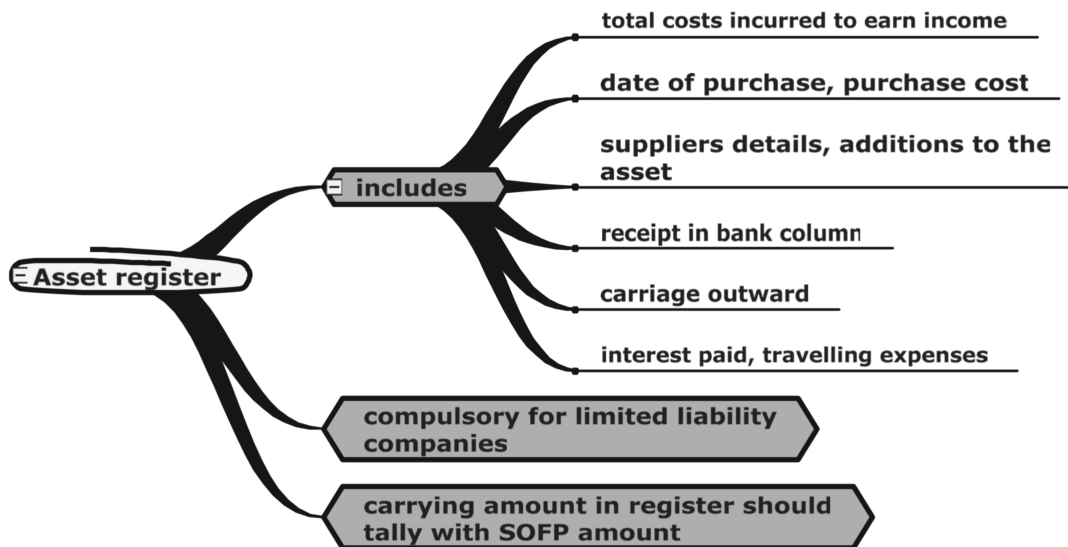
(i) Insurance: when the correct value or description of assets is not known, the company may face a problem of determining the adequate insurance cover. If the assets are over insured, it would entail excess cost in the form of premium charges, and under insuring would imply that the company may not be able to recover adequate amount of claims from the insurance company in the case of any unfortunate event.

(ii) Impairment of assets: a well-maintained asset register would be the basic requirement for complying with the requirements of revaluation and impairment.

(iii) Costing records: proper maintenance of assets assists the company in deriving information regarding output and efficiency of machines and other assets. This may be useful in the allocation of overheads and cost control.

(iv) Assist statutory investigations: systematic maintenance of asset registers can make the audit proceedings less cumbersome.

(v) Monitoring assets: a well-maintained asset register helps in monitoring and maintenance of assets. This also helps in locating the assets easily.



Test Yourself 15

Which ONE of the following is not a purpose of maintaining fixed asset register?

A It helps in monitoring the assets.
B It helps in statutory investigations
C It helps in deriving information regarding output and efficiency of machines and other assets for costing purpose
D It is mandatory under IFRS to keep an asset register

Answers to Test Yourself

Answer to TY 1

A **Plant and Machinery:** Non-current asset because it is held for long term use and is used for production of goods.
B **Inventory:** Current asset because it is held with an intention to sell within 12 months in the ordinary course of business.
C **Cash and bank balance:** Current asset because it is specifically included in the definition of current asset according to IAS 1.
D **Furniture and fixtures:** Non-current asset because it is not held with an intention to sell in the ordinary course of business, and expected to be used for more than one year.
E **Raw material:** Current asset because it is consumed for the production of goods in the normal operating cycle.

Answer to TY 2

Sun Inc

Assets	Type of asset	Reasons
Plant and Machinery	Non-current asset	Held for long-term use and used for production of goods.
Cash and bank balance	Current asset	Included in the definition
Inventory of finished steel	Current asset	Held with an intention to sell in the ordinary course of business.
Computers	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Iron ore	Current asset	Consumed for the production of goods in the normal operating cycle.
Furniture and fixture	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Vehicles	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.

Home decorators

Assets	Type of asset	Reasons
Vehicles	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Bank balance	Current asset	Specifically included in definition.
Computers	Non-current asset	Not held with an intention to sell in the ordinary course of business and expected to be used for more than one year.
Furniture and fixtures for resale	Current asset	Held with an intention to sell in the ordinary course of business.

Answer to TY 3

(a) capital, revenue, capital

(b) revenue, capital

Answer to TY 4

Classification of expenditure:

A	Purchase of computer	Capital expenditure	Computer will be used in the business for a long term.
B	Payment of the company's electricity bill	Revenue expenditure	It is expenditure of a regular nature.
C	Salaries to staff	Revenue expenditure	It is expenditure of regular nature.
D	Installation cost of a computer server	Capital expenditure.	Without incurring these expenses the computer cannot be used.
E	Extension of office building	Capital expenditure	It increases the value of non-current assets and provides benefits of an enduring nature i.e. for more than one accounting period.
F	Interest on bank loan	Revenue expenditure	It is expenditure of a regular nature.
G	Rent on computers	Revenue expenditure	It is expenditure of a regular nature.
H	Purchase of vehicle	Capital expenditure	Purchase of non-current assets is a capital expenditure.
I	Fees paid to directors	Revenue expenditure	It is expenditure of a regular nature.
J	Construction cost of new building	Capital expenditure	It increases the value of non-current assets and includes expenditures that provide benefits of an enduring nature i.e. for more than one accounting period.

Answer to TY 5

The correct option is **C**.

The amount to be capitalised is Tshs46 million because cost of a non-current asset includes transportation charges and import duty but it excludes trade discount, refundable taxes i.e. tax on which set off is available, service charges for maintenance and cash discount. Therefore, the amount to be capitalised is calculated as follows:

	Tshs'000
Machinery	30,000
Add: Additional handling charges	2,000
Less: Trade Discount	(320)
Add: Transportation charges	8,32
Add: Import duty	0
	46,00

Notes

1. Tshs9.2 million is sales tax amount, on which set-off is available which will not be included in the cost of purchase.
2. Tshs3 million is service charges paid for maintenance for the next two years which will not be included in the cost of purchase.
3. Tshs2.91 million is cash discount available, which will not be deducted from cost of machinery.

Hence, the amount to be capitalised is Tshs46 million.

Answer to TY 6

The journal entry is as follows:

		Tshs'000	Tshs'000
Dr	Plant disposal account	50,000	
Cr	Plant account		50,000
Being plant disposed of			

Answer to TY 7

The journal entry is as follows:

		Tshs'000	Tshs'000
Dr	Cash account	30,000	
Cr	Plant disposal account		30,000
Being cash received on disposal of plant			

Answer to TY 8

The correct option is **B**.

Calculation of loss to be recognised in the statement of profit or loss:

Zenith Inc

Dr — Machinery account — Cr

Date		Tshs'000	Date		Tshs'000
01/01/20X6	Press machine	20,000			
01/07/20X6	Press modifications	5,000			
			27/11/20X6	Asset disposal account	25,000
	Total	**25,000**		**Total**	**25,000**

Dr — Asset disposal account — Cr

Date		Tshs'000	Date		Tshs'000
27/11/20X6	Plant	25,000			
			31/12/20X6	**Loss on disposal of asset**	**25,000**
	Total	**25,000**		**Total**	**25,000**

Answer to TY 9

The correct option is **D**.

If Zenith receives cash from the insurance company, we have to record the entry for this amount in the asset disposal account. Therefore, the asset disposal account will change.

Calculation of revised loss to be recognised in the statement of profit or loss:

Dr — Asset disposal account — Cr

Date		Tshs'000	Date		Tshs'000
27/11/20X6	Plant	25,00 0	31/12/20X6	Cash received	18,000
			31/12/20X6	**Loss on disposal of asset**	**7,000**
	Total	**25,00**		**Total**	**25,000**

Answer to TY 10

The correct option is **D.**

NBV of old machine = Tshs12,288 (Cost Tshs24,000 less accumulated depreciation Tshs11,712)

Proceeds Tshs8,860

Loss as proceeds less than NBV = Tshs3,428

Answer to TY 11

The value of the office building in 20X6 will not be same. It can either be more or less than Tshs120 million. The value will depend on local property prices and the condition of the building, i.e. the value of the office building will depend upon its market value on that date.

Answer to TY 12

Here, the company recorded the machinery at its book value of Tshs60 million.

It decided to revalue the machinery at Tshs50 million. This is its fair value.

As the book value of the asset is **more than** its fair value, this is known as **downward revaluation** which results in **loss**

The **entry** for recording revaluation of an asset is as follows:

		Tshs'000	
Dr	Loss on revaluation of asset	10,000	
Cr	Machinery account		10,000

Being decrease in value of machinery due to revaluation

Answer to TY 13

Moon Inc

Dr **Plant account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
05/01/20X6	Purchase	200,000			
			31/12/20X6	Balance c/d	200,000
	Total	**200,000**		**Total**	**200,000**
01/01/20X7	Balance b/d	200,000			
31/12/20X7	Revaluation surplus (note1)	60,000			
			31/12/20X7	Balance c/d	260,000
	Total	**260,000**		**Total**	**260,000**
01/01/20X8	Balance b/d	260,000	31/12/20X8	Asset disposal account (Note 2)	260,000
	Total	**260,000**		**Total**	**260,000**

Dr **Revaluation surplus account** **Cr**

Date		**Tshs'000**	**Date**		**Tshs'000**
			31/12/20X7	Plant	60,000
31/12/20X7	Balance c/f	60,000			
	Total	**60,000**		**Total**	**60,000**
			01/01/20X8	Balance b/d	60,000
31/12/20X8	General reserve (Note5)	60,000			
	Total	**60,000**		**Total**	**60,000**

Dr — **Asset disposal account** — Cr

Date		Tshs'000	Date		Tshs'000
31/12/20X8 31/12/20X8	Plant Profit on disposal of asset (Note4)	260,000 60,000	31/12/20X8	Cash (Note3)	320,000
	Total	**320,000**		**Total**	**320,000**

The final gain of Tshs60 million is realised in the year of disposal.

Notes

1. As we have to increase the value of plant, it has to be **revalued upwards**, so, we debit the asset account and credit the revaluation surplus account.

2. On disposal of asset, the entire **book value** of the asset is transferred to the asset disposal account.

3. On disposal of asset, any **amount received** is transferred to the asset disposal account.

4. The **profit or loss on disposal** of the asset is recognised in the statement of profit or loss. Here, it is profit.

5. On disposal of asset, the **revaluation surplus** of that asset becomes a realised gain, and hence it is transferred to retained earnings.

Answer to TY 14

The correct option is **D.**

Except size of the asset, all other options are criteria to classify an asset.

Answer to TY 15

The correct option is **D.**

IFRS does not mandate entities to maintain asset register. The local laws may require entities to maintain asset register.

Self Examination Questions

Question 1

The accountant of Simplex Cosmetics LLC informs the board that profits of the company for 20X6 are much lower than expected due to heavy repairs and maintenance expenses. An analysis of the repairs and maintenance account shows that it included:

(a) Upgrade of machinery, increasing its production capacity by 10% to Tshs175 million.

(b) Tshs62.5 million for the replacement of major worn-out components in an old piece of machinery. (You receive additional information that the carrying value of the old parts was Tshs7 million. It was sold as scrap and the proceeds of Tshs4 million were credited to the sales account.)

(c) Servicing costs: Sundry materials of Tshs8 million and wages of Tshs1 million.

Required:

Pass Journal entries to record the above transactions

A big machine which costs Tshs1 million is always a non-current asset. **State whether true or false?**

Question 2

Capital expenditure can be used to:

A Improve the quality of a non-current asset
B Increase the quantity of a non-current asset
C Both of the above
D None of the above

Question 3

A non-current asset is_______________

A Always recorded at cost
B Always recorded at fair value
C Initially recorded at cost but must be revalued later
D Initially recorded at cost but can be revalued later

Question 4

A revenue receipt is recorded in [ ]

Revenue expenditure is recorded in [ ]

Question 5

In times of rising prices, **what effect does the use of the historical cost concept have on a company's asset values and profit?**

A Asset values and profit both understated
B Asset values and profit both overstated
C Asset values understated and profit overstated
D Asset values overstated and profit understated.

Question 6

Gareth, a sales tax registered trader purchased a computer for use in his business. The invoice for the computer showed the following costs related to the purchase:

	Tshs'000
Computer	890
Additional memory	95
Delivery	10
Installation	20
Maintenance (1 year)	25
	1,040
Sales tax (17.5%)	182
Total	**1,222**

How much should Gareth capitalise as a non-current asset in relation to the purchase?

A Tshs1,222,000
B Tshs1,040,000
C Tshs890,000
D Tshs1,015,000

Question 7

On disposal of an asset, the following is credited to the asset disposal account:

A Amount received on disposal
B Cost of the asset
C Fair value of the asset
D None of the above

Question 8

When an asset is revalued upward:

A The deficit is charged to the statement of profit or loss and reduced from the value of the asset.
B The deficit is treated as income and added to the value of the asset.
C The surplus is disclosed in reserves and added to the value of the asset.
D The surplus is treated as income and added to the value of the asset.

Question 9

How frequently should an asset be revalued?

A Yearly
B Monthly
C Once in five years
D None of the above

Answers to Self Examination Questions

Answer to SEQ 1

(a) The cost of upgrading machines is capital expenditure as it improves their earning capacity. It should be debited to the machinery account. Assuming that there is no replacement of any parts, no derecognition is required. The entry for correction is:

Dr	Machinery account	Tshs175 million	
	Cr Repairs and maintenance		Tshs175 million

Being the cost of upgrading the machines

Depreciation will be charged on Tshs175 million.

(b) The cost of the new part for Tshs62,500 will be capitalised, and depreciation charged thereon, along with the other assets.

The entry for correction is

Dr	Machinery account	Tshs62.5 million	
	Cr Repairs and maintenance		Tshs62.5 million

Being the cost of new plant wrongly debited to repairs and maintenance, now transferred to machinery account

The old part should be derecognised from machinery and transferred to a disposal account, as:

Dr	Disposal of machinery account	Tshs7 million	
	Cr Machinery account		Tshs7 million

Being machinery disposed and machinery account nullified

Sale proceeds have been wrongly credited to sales. The following rectification entry is needed:

Dr	Sales account (Since wrongly credited)	Tshs4 million	
Dr	Loss on disposal of machinery parts	Tshs3 million	
	Cr Disposal of machinery account		Tshs7 million

Being amount wrongly credited to sales now corrected and the loss on sale of machinery accounted for

(c) Servicing costs are correctly debited to repairs and maintenance account. No correction is required.

The correct answer is false.

Classification of assets into non-current assets and current asset depends on the nature of the asset and not the amount. If the machinery purchased is used for a long period of time, then it is a non-current asset. If the machinery is purchased with the intention to sell it in the near future, then it is a current asset.

Answer to SEQ 2

The correct option is **C**.

Capital expenditure incurred can be either for addition of a new asset or for improvement / modification to an existing non-current asset.

Answer to SEQ 3

The correct option is **D**.

A non-current asset is initially recorded at cost. However, an entity can revalue it at a later date, as revaluation is not compulsory.

Answer to SEQ 4

All revenue receipts are recorded as income in the statement of profit or loss.

All revenue expenditures are recorded as expenses in the statement of profit or loss.

Answer to SEQ 5

The correct option is **C**.

In times of rising prices, the value of assets would remain the same as their cost. However, the fair value of the assets would be at a price higher than the historical cost of the asset. As a result, the assets would be understated, which would result in the profits being overstated.

Answer to SEQ 6

The correct option is **D**.

(Tshs890 million + Tshs95 million + Tshs10 million + Tshs20 million) = Tshs1,015 million. Maintenance will not be included in the cost of the asset, as it does not fall into the category of those costs which are necessary to bring the asset into its present location and condition.

Answer to SEQ 7

The correct option is **A**.

The asset disposal account is credited with the amount received on disposal.

The account is as follows:

Asset disposal account

Dr **Cr**

	Tshs		**Tshs**
Cost or value in the asset account	X	Cash	X
Profit on disposal	X	Loss on disposal	X
Total	**X**	**Total**	**X**

Answer to SEQ 8

The correct option is **C**.

When an asset is upwardly revalued, the surplus is disclosed in reserves, is added to the value of the asset.

Answer to SEQ 9

The correct option is **D**.

An accounting standard does not prescribe any time limit for revaluation. It is for the correct disclosure of the financial statements of an entity that revaluation should be made regularly.

SECTION C

ACCOUNTING TREATMENT FOR PROPERTY, PLANT AND EQUIPMENT (IAS 16)

C2

STUDY GUIDE C2: DEPRECIATION

Get Through Intro

A substantial part of the assets owned by an entity is in the form of non-current assets. Most of these have a finite useful life and need to be depreciated over their useful life. Why is this so?

An entity can expect non-current assets to generate income over their estimated useful life. Hence it follows that the entity should charge the cost of the non-current assets over the period of estimated returns – i.e. costs should match revenue.

For example if a machine costs Tshs30,000 and is expected to produce goods for three years – then this means that the entity can expect the machine to generate revenue for 3 years. Hence the cost of the machine should be spread over 3 years – so that costs match revenue.

A systematic allocation of the cost of a non-current asset over its estimated useful life is called depreciation. An error in the calculation of depreciation leads to an unfair depreciation charge in the statement of profit or loss and as a result the carrying value of non-current asset in the statement of financial position is incorrect.

Misrepresentation of these figures misleads the users of financial statements and may harm the interests of the entity itself. For example banks rely on the financial statements of an entity when approving loans. Misleading figures means that banks may authorise incorrect loans or refuse to authorise loans when they should.

Revaluations of non-current assets also have repercussions on depreciation – the answers are in this Study Guide. This whole Study Guide is very important as the accountant is responsible for deciding and implementing the depreciation policy of an entity.

Learning Outcomes

a) State and explain the meaning of depreciation.
b) Calculate depreciation using straight-line and reducing balance methods.
c) Identify the circumstances where different methods of depreciation would be appropriate.
d) Illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts.
e) Calculate depreciation on a revalued non-current asset including the transfer of excess depreciation between the revaluation surplus and retained earnings.
f) Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and/or residual value of a non-current asset.
g) Record depreciation in the statement of profit or loss and statement of financial position.

1. State and explain the meaning of depreciation.
[Learning Outcome a]

1.1 What is depreciation?

Definition

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life.

IAS 16 Property, plant and equipment

1.2 Why charge depreciation on non-current assets?

Non-current assets are acquired at a cost. However, it would be incorrect to charge the entire cost in the first year itself. The asset is going to help generate income for many years.

The matching principle requires that the expenses be recognised in the year in which the revenue is recognised (cost is matched with the relevant revenue). If the revenue from an asset is going to be earned over a number of years then its cost should also be allocated over the same number of years. Hence, it is logical to charge the cost of an asset to revenue over the useful life of the asset.

Physical wear and tear and obsolescence also result in the depreciating value of an asset.

Example

Sales revenue in a year was Tshs100 million. Cost of material for the goods produced and sold was Tshs60 million (For simplicity, assume that there was no opening or closing inventory.)

Cost of machine used in the manufacture of these goods is Tshs80 million. The machinery has 10 years' working life.

Since the life of the machine is 10 years, 1/10 of the life and cost of the machine are consumed in producing these goods. Therefore, 1/10 of the cost i.e. Tshs80 million x 1/10 = Tshs8 million is charged as a depreciation. (This calculation is according to the straight line method of depreciation – you will study about this in more detail later in this Study Guide.)

Like material costs, the depreciation on non-current assets is matched with the sales revenue.

The purpose of charging depreciation is not to record the decrease in the **value of an asset**. If and when this adjustment is made to the value, it is called a revaluation adjustment.

Unlike what many accounting students feel, the purpose of depreciation is not setting aside some funds to replace the asset at a later stage. However, it is a fact that indirectly, the profits are reduced by the depreciation amount. If this depreciation amount is invested in outside securities, it can actually provide an amount for replacement of the asset.

1.3 Other important terms used in depreciation

1. **Residual value** is the value which the entity expects to realise from disposal of the asset at the end of its useful life. Residual value is likely to be immaterial and is therefore ignored. However, for exam purposes, if it is given in the question, it must be considered.

2. **Useful life** is the **period** over which the asset is expected to be available for an entity's use.

While useful life is denoted in number of years, it may also be denoted in terms of **number of units** expected to be produced by the asset.

Example

Equipment that is purchased today is expected to last for another 5 years. The useful life of the equipment is 5 years. Alternatively, it can also be said that the useful life of the equipment is 1,000,000 units of the equipment it is expected to produce / last for the production of 1,000,000 units.

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3. An **asset held for sale** is an asset available for immediate sale in its present condition.

Tip

Asset held for sale is not examined in Paper T05.

4. **Derecognising** an asset is to stop recognising the asset in the books.

'**Derecognition**' is the opposite of recognition. By '**recognition**' of an asset, we mean recognising the item as an asset in the accounting records and statement of financial position. Derecognition means **removing it from property, plant and equipment in the statement of financial position**. It may be converted into either other assets (e.g. from non-current asset to cash) or a loss / gain on derecognition, or both.

Example

Equipment which is in working condition and is held for sale on 2 March 20X9 is known as, equipment **held for sale,** and is not recognised in the books. This is known as derecognising the asset.

1.4 Depreciable amount

Definition

Depreciable amount is the **cost** of an asset, or any other amount substituted for cost, **less its residual value.**

According to IAS 16 Property, Plant and Equipment, the depreciable amount of an asset should be allocated on a systematic basis over its **useful life**

The depreciable amount is determined after deducting the residual value from the cost.

Example

The cost of a machine is Tshs600 million and its residual value is Tshs20 million. Its depreciable amount will be Tshs580 million (Tshs600 million - Tshs20 million)

Depreciation is charged even if the fair value (F.V.) of the asset exceeds its carrying amount (C.A.). What is required is for the carrying amount to exceed the residual value (R.V).

Tip

Even if F.V. > C.A. depreciation is charged; as long as C.A. > R.V.

Example

The carrying value of the machine is Tshs40 million and its residual value is Tshs20 million. Its fair value is Tshs50 million. Depreciation is charged even if the fair value Tshs50 million exceeds the carrying value Tshs40 million; as long as carrying value exceeds the residual value i.e. Tshs40 million > Tshs20 million.

Depreciation is charged until the residual value of an asset becomes equal to or greater than the asset's carrying amount. Depreciation is not charged once the asset reaches its realisable amount. This is because the entity knows that it will be able to recover the entire residual amount from the sale of the asset. Hence, there is no need to charge depreciation.

Example

The carrying value of the machine is Tshs20 million and its residual value Tshs21 million.

The depreciation charge in this case will be zero because the residual value Tshs21 million > the carrying value Tshs20 million.

1.5 When does the charge of depreciation begin and when does it end?

The depreciation charge **begins** when an asset is available for use at the location, and in a condition intended by the management.

Depreciation **does not end** when the asset becomes idle or is retired from active use unless the asset is fully depreciated. The depreciation charge of an asset **ends** at the **earlier** of the two following events:

the date the asset is classified as held for sale (or included in a disposal group that is classified as held for sale) in accordance with IFRS 5 and/ or
the date that the asset is derecognised (sold)

When depreciation is charged at a given percentage per annum, it is said that it is charged on a time basis. However, **under usage-linked methods of depreciation** if there is no production, the depreciation charge can be zero.

Example

Optimistic Ltd has two factories. At factory 1, depreciation is charged on a time basis and in factory 2 it is charged on a usage basis. There are two items of machinery that each cost Tshs50 million at both the factories. During 20X5 / 20X6, both the items remained idle. For factory 1, depreciation will be charged, whereas for factory 2, it will not be charged. This is because, in factory 1, whether the machine is used or not, its life is decreasing and therefore depreciation should be charged. However, in factory 2, only when the machine starts to produce goods will depreciation be charged on the basis of units produced

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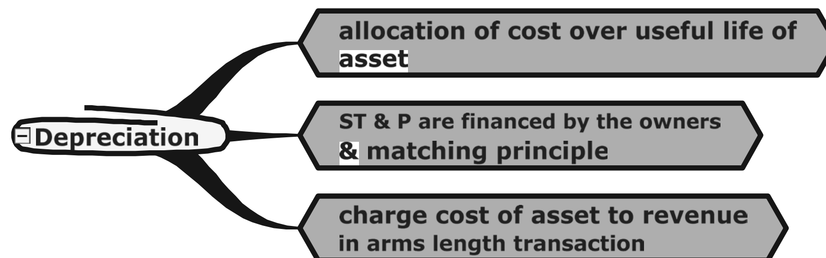
SUMMARY



Test Yourself 1

Which of the following is the most appropriate purpose for charging depreciation?

A To record the decrease in the value of an asset.
B To provide an amount for the replacement of an asset.
C To comply with accrual and the matching principle.
D None of the above.

Test Yourself 2

Depreciation ends:

(i) On the date when the asset is classified as held for sale.
(ii) On the date when the asset is derecognised.
(iii) When the asset becomes idle or is retired from active use no matter whether it is fully depreciated or not.

A (i)
B (i) and (ii)
C (ii) and (iii)
D (i) and (iii)

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2. Calculate depreciation using straight-line and reducing balance methods. Identify the circumstances where different methods of depreciation would be appropriate. [Learning Outcomes b and c]

2.1 Depreciation methods

Definition

"The depreciation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity"

IAS 16

The method of charging depreciation selected is to be **applied consistently** from period to period unless there is a change in the expected pattern of consumption of those future economic benefits.

The method decided is to be **reviewed at the end of each financial year**. If there is a change in the consumption pattern, the method may be changed. The impact of such a change shall be accounted for as a change in accounting estimates in accordance with IAS 8.

An entity selects the method that **most closely reflects the expected pattern of consumption** of the future economic benefits embodied in the asset.

There are a **variety of depreciation methods** including the **following most widely used methods of depreciation:**

1. Straight-line Method

This method results in a constant charge over the useful life of the asset. The asset's residual value does not change and depreciation is calculated as a fixed amount every year or a fixed percentage of the original cost.

$$\text{Depreciation} = \frac{\text{Cost of the asset - Estimated residual value}}{\text{Estimated rate of the Asset}}$$

Example

Tapra Ltd bought machinery on 01 January 20X4 for Tshs260 million. It incurred transportation and installation expenses of Tshs20 million in connection with the machinery. Tapra Ltd expects the useful life of the asset to be 6 years. The estimated realisable value after 6 years is expected to be Tshs10 million.

Calculate the depreciation for six years.
Answer
(Amounts in Tshs'000)

$$\text{Depreciation} = \frac{\text{Cost of the asset - Estimated residual value}}{\text{Estimated rate of the Asset}}$$

$$= \frac{\text{(Tshs260,000+Tshs.20,000)-Tshs.10,000}}{\text{6yrs}}$$

$= \text{Tshs}45{,}000$

The carrying values at the end of each year will be as follows:

	Tshs'000	Tshs'000
1st year	280,000 - 45,000	235,000
2nd year	235,000 - 45,000	190,000
3rd year	190,000 - 45,000	145,000
4th year	145,000 - 45,000	100,000
5th year	100,000 - 45,000	55,000
6th year	55,000 - 45,000	10,000

The carrying value at the end of the asset's useful life is equal to the **disposal or realisable value**.

If the depreciation rate is applied as a percentage, it will be **applied to the original cost,** and not to the carried down value net of depreciation.

E.g. it may be stated that depreciation is to be charged at 16.07% of the original cost, on a straight line basis.

The amount of depreciation each year would be calculated as 280,000 x 16.07% = 45,000

The amount of depreciation remains constant in this method.

2. Diminishing or reducing balance method

Under this method, depreciation is charged as a percentage of the written down or book value of the asset i.e. cost minus accumulated depreciation. This is also known as the **reducing balance method.** This method results in a decreasing charge over the useful life of the asset.

Depreciation = (Cost – Accumulated depreciation) x Depreciation rate

Example

KPL Inc purchased machinery for Tshs10,000 on 1 January 20X4. Its expected life is 4 years and the residual disposal value is Tshs1,296. KPL charges depreciation at 40% using the reducing balance method. Calculate the depreciation amount for 4 years.

Answer

Calculation of the depreciation amount:

Year	Particulars	Calculation	Depreciation	Carrying value
1st year	Depreciation	= 10,000 x 40%	= Tshs4,000	
	Carrying value	= 10,000 - 4,000		= Tshs6,000
2nd year	Depreciation	= 6,000 x 40%	= Tshs2,400	
	Carrying value	= 6,000 - 2,400		= Tshs3,600
3rd year	Depreciation	= 3,600 x 40%	= Tshs1,440	
	Carrying value	= 3,600 - 1,440		= Tshs2,160
4th year	Depreciation	= 2,160 x 40%	= Tshs864	
	Carrying value	= 2,160 – 864		= Tshs1,296

The depreciation charged in this method keeps reducing every year. In this case it was Tshs4,000 in the first year, which gradually reduced to Tshs864.

Under the diminishing balance method of depreciation, the carrying value at the end of the useful life is equal to the disposal or realisable value.

Comparison between straight-line method and reducing balance method

Straight-line method	Reducing balance method
It charges a **fixed amount each year** to the statement of profit or loss	It charges a **higher amount during the initial years** when the machine is new and efficient and a lower amount in later years
It is suitable for assets which give the **same efficiency year after year** e.g. a building is used equally over the years	It is suitable for assets which give a **higher efficiency in earlier years and a lower efficiency in later years** e.g. machinery used in various manufacturing processes
If repairs increase in later years, the charge of depreciation plus repairs increases each year (since the depreciation is constant).	The charge of depreciation plus repairs is expected to be the same over the years. In the initial years when repairs are low, depreciation is high, and in later years when repairs are high, depreciation is low.
It is **simple** to understand and operate.	It is **relatively difficult** to understand and operate.

3. The units of production method

This method would be appropriate where the economic benefits derived from the assets are in proportion to the units produced and in cases where the pattern of production is not uniform. This method results in a charge based on the expected use or output of the asset. Under this method of depreciation, the cost of the non-current asset is allocated in proportion to the production achieved.

$$\text{Depreciation rate} = \frac{\text{Cost of the asset - Estimated residual value}}{\text{Total estimated units of output}}$$

Example

On 1 January 20X2 LPN Ltd bought a new asset for Tshs100 million that was estimated to have a working life of 5 years. Its realisable value after that was estimated at Tshs20 million. It is expected to produce 800,000 units of output during its useful life. The actual production for the five years was as follows:
20X2: 150,000; 20X3: 200,000; 20X4: 190,000; 20X5: 150,000; 20X6: 110,000

(a) Calculate the depreciation provision under the units of production method.
(b) Show the depreciation schedule.

Answer

(a)

$$\text{Depreciation rate} = \frac{\text{Cost of the asset - Estimated residual value}}{\text{Total estimated units of output}}$$

$$= \frac{\text{Tshs100 million - Tshs20 million}}{\text{800,000 units}}$$

$$= \text{Tshs100 per unit}$$

We now multiply the value of Tshs100 per unit by the number of units of output per year.

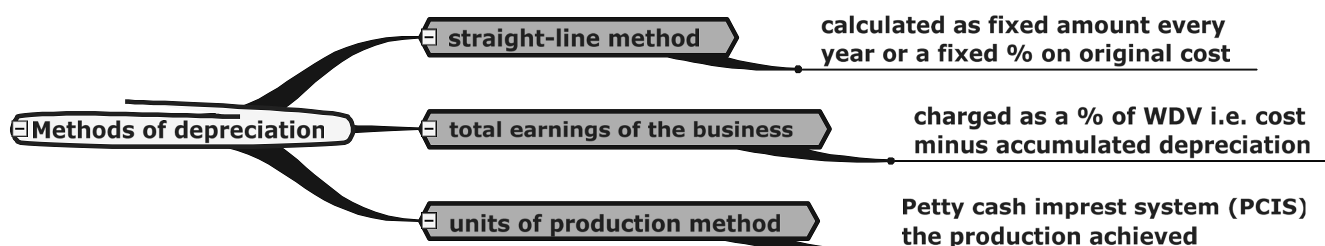
(b) Depreciation Schedule

Year ended	Production (units)	Annual Depreciation	Carrying Value
		Tshs'000	Tshs'000
01/01/20X2		-	100,000
31/12/20X2	150,000	15,000	85,000
31/12/20X3	200,000	20,000	65,000
31/12/20X4	190,000	19,000	46,000
31/12/20X5	150,000	15,000	31,000
31/12/20X6	110,000	11,000	20,000

Note

The carrying value on 31 December 20X6 is exactly Tshs20 million which is the selling value it is expected to achieve.

SUMMARY



2.2 Depreciation on assets acquired or disposed of in the middle of an accounting year

Depreciation is charged pro-rata over the period of use i.e. depreciation is charged for that part of the accounting period during which the asset is used. However, there are two other methods of calculating the depreciation provisions for assets acquired and disposed of during the accounting year which are sometimes followed for the purpose of approximation.

1. **In the year of acquisition,** calculate the depreciation for the whole year irrespective of the date of acquisition. **In the year of sale,** ignore depreciation for the full year irrespective of the date of sale of an asset.

2. Provide for depreciation on the asset on the basis of the number of months the asset is used in the year of sale or purchase.

Tip

In years other than the years of sale and purchase (i.e. the years when the entity owns and uses the asset), depreciation is provided for the whole year irrespective of the number of months the asset is used.

Example

Smart Enterprises runs a computer software business. The proprietor purchases a car for himself, and later for his chief assistant, Peter. The relevant data is as follows:

	Date of purchase	Cost	Estimated life	Estimated residual value
Proprietor's car	1 June 20X6	Tshs20 million	3 years	Tshs2 million
Peter's car	1 January 20X7	Tshs8 million	3 years	Tshs2 million

The straight-line method of depreciation is to be used.

Prepare the motor vehicles account and the accumulated depreciation of the motor vehicles account for the years to 31 December 20X7. (You should allow for the proportionate monthly use of the car while computing the annual charge of depreciation.)

Calculate the net book value of the motor vehicles as at 31 December 20X7.

Answer

Motor vehicles account

Dr / **Cr**

Date		Tshs'000	Date		Tshs'000
01/06/20X6	Asset payables (or cash)	20,000	31/12/20X6	Balance c/f	20,000
		20,000			**20,000**
01/01/20X7	Balance b/f	20,000			
01/01/20X7	Asset payables (or cash)	8,000	31/12/20X7	Balance c/f	28,000
		28,000			**28,000**
01/01/20X8	Balance b/f	**28,000**	01/01/20X8		28,000

Continued on the next page

Accumulated depreciation of motor vehicles

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X6	Balance c/f	3,500	31/12/20X6	Statement of profit or loss	3,500
		3,500			**3,500**
			01/01/20X7	Balance b/f	**3,500**
			31/12/20X7	Statement of profit or loss (Tshs6,000 + Tshs2,000)	8,000
31/12/20X7	Balance c/f	11,500			
		11,500			**11,500**
			01/01/20X8	Balance b/f	11,500

Statement of financial position (extracts) for the year ended 31 December 20X7

	Proprietor's car	**Peter's car**	**Total**
	Tshs'000	**Tshs'000**	**Tshs'000**
Asset at cost	20,000	8,000	28,000
Less: Accumulated depreciation:			
Year to: 31/12/20X7	9,500	2,000	11,500
	10,500	**6,000**	**16,500**

Workings

1. Proprietor's car

$$\text{Annual depreciation} = \frac{(\text{Tshs20 million} - \text{Tshs2million})}{3\text{ years}} = \text{Tshs6million p.a.}$$

		Tshs'000
	Monthly depreciation Tshs0.5 million	
Depreciation	1 June 20X6- 31 December 20X6 (7 months)	3,500
	1 January 20X7- 31 December 20X7	6,000
		9,500

2. Peter's car

$$\text{Annual depreciation} = \frac{(\text{Tshs8 million} - \text{Tshs2 million})}{3\text{ years}} = \text{Tshs2million p.a.}$$

Depreciation	1 January 20X7-31 December 20X7	Tshs2 million

2.3 Change in the depreciation method

The depreciation method is expected to be followed consistently. However, if the pattern of expected consumption of economic benefits has changed, then the method of depreciation may be changed.

If the method of charging depreciation has been changed, then the change is prospective and not retrospective.

This means:

The net book value on the date of change is depreciated over the remaining period according to the new method.

Only the depreciation for the current period and the future periods will change.

The calculations for the past periods are not restated.

Example

Jack and Rose Co purchased machinery for Tshs60 million on 1 April 20X2. The transportation and installation charges incurred are Tshs5 million. The machinery was estimated to have a useful life of 6 years. It was decided to depreciate the machinery using the reducing value method. The rate of depreciation was 25%.

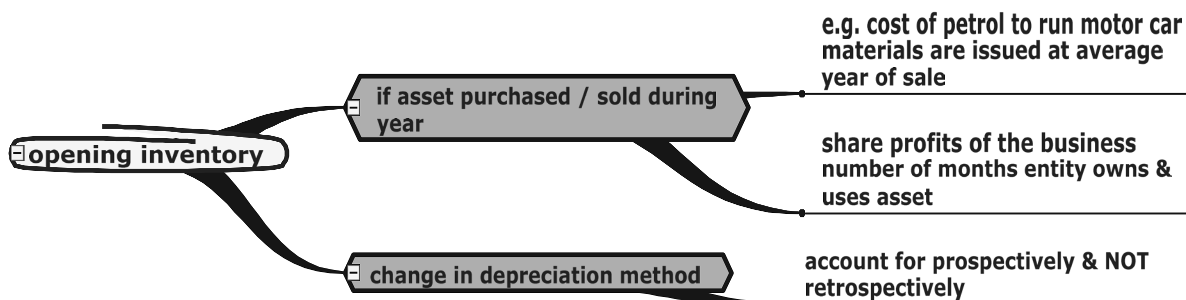
On 01 April 20X5 it is found that the reducing value method is no more appropriate and therefore the method is changed to the straight-line method. The depreciation on the machine over its life will be as follows:

Tshs60 million + Tshs5 million = Tshs65 million

Year	Carrying value at the beginning of the period	Rate of depreciation	Depreciation charge	Written down value at the end of the period	Aggregate depreciation
	Tshs'000		Tshs'00	Tshs'000	Tshs'000
20X2	65,000		16,250	48,750	16,250
20X3	48,750	25%	12,187	36,563	28,437
20X4	36,563	25%	9,141	27,422	37,578
20X5	**27,422	25%	9,141	18,281	46,719
20X6	18,281		9,141	9,140	55,860
20X7	9,140		9,140	0	65,000

** In 20X5, when the written down value was Tshs27,422,000, it was decided to change the method to the straight-line method. Therefore, the depreciation will be = depreciable amount / number of years of remaining useful life i.e. Tshs27,422,000 / 3 years = Tshs9,141,000.

SUMMARY



Example

Jon Bros. acquired a machine on 1 July 20X6 at a cost of Tshs14 million and spent Tshs1 million on its installation. The firm writes off depreciation at 10%. The books are closed on 31 December every year. Show the machinery account and depreciation account for 20X6-20X7 using the straight-line method and reducing balance method.

Machinery account (straight-line method)

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/07/20X6	Asset payables (or cash)	14,000	31/12/20X6	Depreciation (6 months)	750
	Bank (installation)	1,000			
				Balance c/d	14,250
		15,000			**15,000**
01/01/20X7	Balance b/f	14,250	31/12/20X7	Depreciation (Tshs15,000 / 10 years)	1,500
			31/12/20X7	Balance c/f	12,750
		14,250			**14,250**

Continued on the next page

Depreciation account

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X6	Machinery account	750	31/12/20X6	Statement of profit or loss	750
		750			**750**
31/12/20X7	Machinery account	1,500	31/12/20X7	Statement of profit or loss	1,500
		1,500			**1,500**

Machinery account (reducing balance method)

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
01/07/20X6	Payables (or cash)	14,000	31/12/20X6	Depreciation (6 months)	750
	Bank (installation)	1,000		Balance c/d	14,250
		15,000			**15,000**
01/01/20X7	Balance b/d	14,250	31/12/20X7	Depreciation	1,425
			31/12/20X7	Balance c/d	12,825
		14,250			**14,250**

Depreciation account

Dr					Cr
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X6	Machinery account	750	31/12/20X6	Statement of profit or loss	750
		750			**750**
31/12/20X7	Machinery account	1,425	31/12/20X7	Statement of profit or loss	1,425
		1,425			**1,425**

Test Yourself 3

Which of the following is not a method of charging depreciation?

A The straight-line method
B The reducing value method
C The units of production method
D The residual value method

3. Illustrate how depreciation expense and accumulated depreciation are recorded in ledger accounts.
Record depreciation in the statement of profit or loss and statement of financial position.
[Learning Outcomes d and g]

Accumulated depreciation refers to the cumulation of depreciation expenses of each year. It reflects the loss of the value of the asset, due to wear and tear, usage of asset, obsolesce, etc. It is reflected in the statement of financial position as a reduction from the gross value of the asset.
The accounting entries for recording depreciation expenses are as follows:

1. When the asset is purchased

Dr Asset account	X	
Cr Cash / Bank account for the amount paid		X
Cr Liability account for the amount unpaid		X
Being asset purchased		

2. When depreciation is charged

Dr Depreciation account	X	
Cr Accumulated depreciation account		X
Being depreciation charged		

3. To transfer depreciation to statement of profit or loss

Dr Statement of profit or loss X
Cr Depreciation account X
Being depreciation transferred to the statement of profit or loss

Accumulated depreciation has been explained through the following comprehensive example:

Example

On 1 January 20X4 Kalbros Ltd purchased a second-hand plant for Tshs72 million and immediately spent Tshs48 million on getting the plant into working condition. On 1 July 20X4, an additional plant that cost Tshs48 million was purchased. On 1 July 20X6 the plant purchased on 1 January 20X4 became obsolete and was sold for Tshs60 million. On 1 July 20X6 another new plant was purchased at a cost of Tshs144 million. The firm calculated depreciation under the reducing balance method at 15% per annum. Show the machinery account and the accumulated depreciation account for the calendar years 20X4 to 20X6.

Answer

To identify the plants, let us give them nos. I, II and III

The plant-wise break up is given in the account itself. This can also be given in a separate working.

Machinery account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/01/20X4	Bank account (purchased plant I)	72,000			
01/01/20X4	Bank (or cash) account (expenses to get the plant into working condition)	48,000			
01/07/20X4	Bank account (purchased plant II)	48,000	31/12/20X4	Balance c/f	
				Plant I	120,000
				Plant II	48,000
		168,000			**168,000**
Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X5	Balance b/f				
	Plant I	120,000			
	Plant II	48,000			
			31/12/20X5	Balance c/f	
				Plant I	120,000
				Plant II	48,000
		168,000			**168,000**
Date		**Tshs'000**	**Date**		**Tshs'000**
01/01/20X6	Balance b/f		01/01/20X6	Accumulated depreciation	39,803
	Plant I	120,000			
	Plant II	48,000			
01/07/20X6	Bank (bought plant III)	144,000	01/07/20X6	Bank (sale proceeds: plant I)	60,000
				Statement of profit or loss (Loss on sale Tshs120,000 – Tshs39,803 - Tshs60,000)	20,197
			31/12/20X6	Balance c/f	
				Plant II	48,000
				Plant III	144,000
		312,000			**312,000**

Continued on the next page

Accumulated depreciation account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X4	Balance c/f		31/12/20X4	Depreciation	
	Plant I	18,000		**On plant I** (for full year)	18,000
	Plant II	3,600		(Tshs72,000 + Tshs48,000) x 15%	
				On plant II	3,600
				(for 6 months)	
				Tshs48,000 x 15% x 6/12	
		21,600			**21,600**
Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X5	Balance b/f	18,000
				Plant I	3,600
				Plant II	
31/12/20X5	Balance c/f		31/12/20X5	**Depreciation provision**	
	Plant I	33,300		**On plant I** (for full year)	15,300
	Plant II	10,260		Tshs102,000 x 15%	
				On plant II (for full year)	6,660
				Tshs44,400 x 15%	
		43,560			**43,560**
Date		**Tshs'000**	**Date**		**Tshs'000**
			01/01/20X6	Balance b/f	
				Plant I	33,300
				Plant II	10,260
31/07/20X6	Machinery account	39,803	01/07/20X6	**Depreciation provision**	
	(Accumulated depreciation on plant I transferred)			(**Plant I** - 6 months) Tshs86,700 x 15% x 6/12)	6,503
			31/12/20X6	**Depreciation provision:**	
				On plant II (for full year	5,661
				Tshs37,740 x 15%)	
				On plant III	10,800
				(for 6 months Tshs144,000 x 15 % x 6/12)	
31/12/20X6	Balance c/f				
	Plant II	15,921			
	Plant III	10,800			
		66,524			**66,524**

Continued on the next page

Depreciation Account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X4	Accumulated depreciation On plant I (for full year) (Tshs72,000 + Tshs48,000) x 15% On plant II (for 6 m) Tshs48,000 x 15% x 6/12	18,000 3,600	31/12/20X4	Statement of profit or loss - transfer	21,600
		21,600			**21,600**
Date		**Tshs'000**	**Date**		**Tshs'000**
31/12/20X5	Accumulated depreciation on plant I (for full yr) Tshs102,000 x 15% On plant I (for full yr) Tshs44,400 x 15%	15,300 6,660	31/12/20X5	Statement of profit or loss - transfer	21,960
		21,960			**21,960**
Date		**Tshs'000**	**Date**		**Tshs'000**
31/07/20X6	Accumulated depreciation (Plant I - 6 months) Tshs86,700 x 15% x 6/12)	6,503	31/07/20X6		
31/12/20X6	Depreciation provision: On plant II (for full year Tshs37,740 x 15%) On plant III (for 6 months Tshs144,000 x 15% x 6/12)	5,661 10,800	31/12/20X6	Statement of profit or loss - transfer	22,964
		22,964			**22,964**

Presentation in the statement of profit or loss and statement of financial position

1. **If the statement of profit or loss is presented using the 'nature of expenses' method,** then depreciation and amortisation expenses are disclosed on the face of the statement of profit or loss as an expense.

In the above example the presentation of non-current assets and depreciation in the financial statements is as follows:

Example

Extract from statement of profit or loss for the year ended 31 December 20X6
(Nature of expenses method)

Revenue	X
Other income	X
Changes in inventories of finished goods and work in progress	X
Raw materials and consumables used	X
Employee benefits expense	X
Depreciation and amortisation expense	22,964
Other expenses	X
Total expenses	X
Profit	**X**

Tip

Remember statement of profit or loss includes only the depreciation for the current year.

2. **Under the 'function of expenses' method of presentation of the statement of profit or loss**, depreciation does not appear on the face of the statement of profit or loss. The information is given in the notes.

Function of expense method presents expenses according to their function e.g. distribution expenses, administration expenses and finance expenses.

Example

Presentation in the statement of financial position

In the statement of financial position, property, plant and equipment is shown at the carrying value in the following manner:

Assets

Non-current assets	**Tshs'000**
Property plant and equipment	192,000 (48,000 + 144,000)
Less: Accumulated depreciation	(26,721) (15,921 + 10,800)
	165,279

(**Note:** this calculation may be given on the face of the statement of financial position or in a schedule. The net amount of Tshs165,279,000 must always appear on the face of the statement of financial position).

Example

Diana & Co purchased a non-current asset on 1 January 20X1 for Tshs20 million. It had an estimated life of six years and an estimated residual value of Tshs8 million. The asset was sold after three years on 1 January 20X4 to another trader who purchased it for Tshs17.5 million.

What was the profit or loss on disposal, assuming that the business uses the straight-line method for depreciation?

Answer

$$\text{Annual depreciation} = \frac{(\text{Ths20 million - Tshs8 million})}{\text{6 years}} = \text{Tshs2 million p.a.}$$

	Tshs'000
Cost of asset	20,000
Less: Accumulated depreciation (for 3 years)	(6,000)
Net book value at date of disposal	14,000
Sale price	17,500
Profit on disposal of asset	**3,500**

Example

On 1 July 20X1 Bill Inc purchased a machine for Tshs35 million. The machine had an estimated residual value of Tshs3 million and a life of eight years. The machine was sold for Tshs18.6 million on 31 December 20X4, the last day of the accounting year of the business. To sell the machine, the business had to incur dismantling costs and the costs of transporting the machine to the buyer's premises. These costs amounted to Tshs1.2 million.

Required:

Assuming that the business uses the straight-line method of depreciation, what was the profit or loss on disposal of the machine?

`Continued on the next page

Answer

$$\text{Annual depreciation} = \frac{(\text{Tshs35 million - Tshs3 million})}{\text{8 years}} = \text{Tshs4 million p.a.}$$

	Tshs'000	Tshs'000
Non-current asset at cost		35,000
Less: Accumulated depreciation		
Depreciation in 20X1 (6 months)	2,000	
20X2, 20X3 and 20X4 (3 years)	12,000	14,000
Net book value at date of disposal		21,000
Sale price	18,600	
Less: Costs incurred in making the sale	(1,200)	
Net sale price		17,400
Loss on disposal		**(3,600)**

Tip

Disposal gains and losses (like most calculations) can also be calculated by preparing a required ledger accounts. However, in order to answer multiple choice questions quickly, it is easier to solve questions using the tabular format.

Test Yourself 4

In the statement of profit or loss the amount of depreciation recorded is for the:

A Remaining life of the asset
B Number of years the asset is used i.e. accumulated depreciation since the purchase of the asset
C Current period
D None of the above

4. Calculate depreciation on a revalued non-current asset including the transfer of excess depreciation between the revaluation surplus and retained earnings.
[Learning Outcome e]

Depreciation on revalued non-current asset

When non-current assets are revalued, the depreciation is calculated on the revalued amount of the asset, not on the book value or cost.

Example

The cost of a machine on 1 January 20X6 is Tshs5 million. At the end of three years, its book value is Tshs3.5 million. On 1 January 20X9, the machine is revalued at Tshs4 million.

Here, depreciation will be calculated on its revalued amount Tshs4 million.

4.1 Depreciation calculation and accounting treatment after revaluation

After revaluation, the depreciation calculations will be based on the revalued amount. The full depreciation amount is charged as an expense to the statement of profit or loss. An amount equal to the difference between the depreciation on the revalued amount and that on the original cost may be transferred from revaluation surplus to retained earnings.

Example

JM Products Plc purchased machinery for Tshs24 million on 1 January 20X4. Its expected life was 6 years. JM Products depreciated it under SLM for 20X4 to 20X6. On 01 January 20X7 the asset was revalued at Tshs21 million.

Show the accounting entries for 20X7.

Answer

	Tshs'000
Cost on 01/01/20X7	24,000
Less: Accumulated depreciation on 01/01/20X7	12,000
Carrying value on 01/01/20X7	12,000
Revalued at	21,000
Difference between the two is a gain	**9,000**

As **carrying value < revalued amount**

The accounting entry will be:

		Tshs'000	**Tshs'000**
Dr	Machinery account	9,000	
Cr	Revaluation Surplus Account		9,000

Being increased amount of machine on revaluation is recorded

Recognised in OCI part of the SOPL and OCI and accumulated in equity under the heading of revaluation surplus.

Depreciation for the remaining life (3 years) of the asset will be Tshs21 million/3 years= Tshs7 million

Depreciation on the original cost was Tshs24 million / 6 years = Tshs4 million

Each year (from 20X7 to 20X9), depreciation will be charged at Tshs7 million on the revalued amount of the machinery and the difference (between depreciation on revalued amount and original cost) of Tshs3 million (Tshs7 million – Tshs4 million) will be transferred to retained earnings. This is because the additional amount of depreciation is treated as revaluation surplus which is realised.

The entry will be:

		Tshs'000	**Tshs'000**
Dr	Depreciation on machinery	7,000	
Cr	Accumulated depreciation		7,000

Being depreciation on the revalued asset

Dr	Revaluation Surplus Account	3,000	
Cr	Retained Earnings		3,000

Being additional depreciation on the revalued asset is transferred to the retained earnings

Continued on the next page

Machinery account

Dr | | | | | Cr

		Tshs'000			Tshs'000
01/01/20X4	Cash	24,000	31/12/20X4	Balance c/d	24,000
		24,000			**24,000**
01/01/20X5	Balance b/d	24,000	31/12/20X5	Balance c/d	24,000
		24,000			**24,000**
01/01/20X6	Balance b/d	24,000	31/12/20X6	Balance c/d	24,000
		24,000			**24,000**
01/01/20X7	Balance b/d	24,000			
01/01/20X7	Revaluation surplus	9,000	31/12/20X7	Balance c/d	33,000
		33,000			**33,000**
01/01/20X8	Balance b/d	33,000	31/12/20X8	Balance c/d	33,000
		33,000			**33,000**
01/01/20X9	Balance b/d	33,000	31/12/20X9	Balance c/d	33,000
		33,000			**33,000**

Depreciation on machinery account

Dr | | | | | Cr

		Tshs'000			Tshs'000
31/12/20X4	Balance c/d	4,000	31/12/20X4	SOPL	4,000
		4,000			**4,000**
			01/01/20X5	Balance b/d	4,000
31/12/20X5	Balance c/d	8,000	31/12/20X5	SOPL	4,000
		8,000			**8,000**
			01/01/20X6	Balance b/d	8,000
31/12/20X6	Balance c/d	12,000	31/12/20X6	SOPL	4,000
		12,000			**12,000**
			01/01/20X7	Balance b/d	12,000
31/12/20X7	Balance c/d	19,000	31/12/20X7	SOPL	7,000
		19,000			**19,000**
			01/01/20X7	Balance b/d	19,000
31/12/20X8	Balance c/d	19,000	31/12/20X7	SOPL	7,000
		26,000			**26,000**
			01/01/20X7	Balance b/d	26,000
31/12/20X9	Balance c/d	33,000	31/12/20X7	SOPL	7,000
		33,000			**33,000**

Revaluation surplus account

Dr | | | | | Cr

		Tshs'000			Tshs'000
31/12/20X7	Retained earnings	3,000	01/01/20X7	Machinery	9,000
31/12/20X7	Balance c/d	6,000			
		9,000			**9,000**
31/12/20X8	Retained earnings	3,000	01/01/20X8	Balance b/d	6,000
31/12/20X8	Balance c/d	3,000			
		6,000			**6,000**
31/12/20X9	Retained earnings	3,000		Balance b/d	3,000
31/12/20X9	Balance c/d				
		3,000			**3,000**

4.2 Treatment of accumulated depreciation after revaluation

When an item is revalued we arrive at its present fair value that is **comparable to** its carrying value, i.e. **gross value less depreciation**. This raises the issue of how the accumulated depreciation should be treated.
IAS 16 gives two options:

1. The accumulated depreciation may be either **restated proportionately** so that the carrying amount of the asset after revaluation equals its revalued amount. This method is normally used when an asset is revalued by applying an index to its depreciated replacement cost.

Example

An entity adopts a revaluation model. Its building has a carrying value of Tshs500 million (arrived at after deducting accumulated depreciation of Tshs100 million from the gross value of Tshs600 million). The fair value of the building is Tshs700 million.

Tshs700 million - Tshs500 million

There is a 40% increase in the net value (Tshs200 million/Tshs500 million x 100) of the building.

The gross value as well as the accumulated depreciation shall be increased by 40%, to Tshs840 million (Tshs600 million + 40% of Tshs600 million) and Tshs140 million (Tshs100 million + 40% of Tshs100 million) respectively.

This will give a carrying amount of Tshs700 million (i.e. Tshs840 million - Tshs140 million), which is equal to the revalued amount.

Building account

Dr **Cr**

	Tshs'000		**Tshs'000**
Balance b/d	600,000		
Revaluation surplus (gain) (40% of Tshs600,000)	240,000	Balance c/d	840,000
	840,000		**840,000**

Accumulated depreciation account

Dr **Cr**

	Tshs'000		**Tshs'000**
		Balance b/d	100,000
Balance c/d	140,000	SOPL (40% of Tshs100,000)	40,000
	140,000		**140,000**

Revaluation surplus account

Dr **Cr**

	Tshs'000		**Tshs'000**
Retained earnings	40,000	Balance b/d	-
Balance c/d	200,000	Building account	240,000
	240,000		**240,000**

2. Or the accumulated depreciation may be **deducted from** the original gross carrying amount of the asset in order to determine the original net carrying amount of the asset. This net amount is then increased or decreased to make it equal to the revalued amount of the asset. **This is the more common method.**

Example

(i) At present there are two ledger accounts: a building account with a debit balance of Tshs600 million and an accumulated depreciation account with a credit balance of Tshs100 million.

(ii) The balance in the accumulated depreciation account will be transferred to the building account. Therefore the balance of the building account will be reduced from Tshs600 million to Tshs500 million (its net carrying amount). This net amount is then increased by Tshs200 million to make it equal to the revalued amount of Tshs700 million. Tshs100 million accumulated depreciation is transferred to the revaluation surplus account.

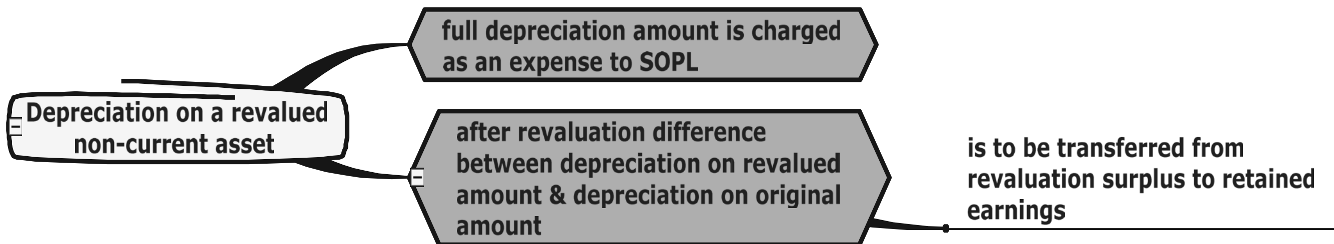
Building account

		Tshs			Tshs
	Balance b/d	600,000		Accumulated depreciation (transfer)	100,000
	Revaluation surplus (gain)	200,000		Balance c/d	700,000
		800,000			**800,000**

Accumulated depreciation account

		Tshs			Tshs
	Building account (transfer)	100,000		Balance b/d	100,000

SUMMARY



Test Yourself 5

Plasto Plc purchased machinery for Tshs120 million on 1 January 20X2. Its expected life was 10 years. Plasto Plc depreciated it by SLM from 20X2 to 20X6. On 1 January 20X7 the asset was revalued at Tshs90 million.

Calculate the amount to be transferred from the revaluation surplus to the retained earnings.

A Tshs3,000,000
B Tshs6,000,000
C Tshs12,000,000
D Tshs9,000,000

5. Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and / or residual value of a non-current asset.

[Learning Outcome f]

We learnt earlier that;

The depreciable amount is the cost of an asset, or other amount substituted for cost (i.e. revalued amount), less its residual value, and
The depreciable amount of an asset shall be allocated on a systematic basis over its **useful life**.

It is obvious that if the residual value changes, the depreciable amount will change and therefore depreciation will change. Similarly, if the estimated useful life changes, then the depreciation charged over the useful life of asset is bound to change. If any of these changes happen, depreciation has to be recalculated.

IAS 16 requires that the residual value and the useful life of an asset are **reviewed** at least at each financial year-end. If expectations differ from previous estimates, the change(s) should be accounted for as follows:

Step 1 Calculate the depreciation until the date of change
Step 2 Calculate the book value until the date of change (Cost – accumulated depreciation)
Step 3 Calculate the new depreciable amount (Book value – residual value)
Step 4 Calculate the remaining useful life
Step 5 Calculate the new amount of depreciation. For a straight line method calculation, it is = new depreciable amount / remaining useful life.

Example

A company purchased a non-current asset for Tshs17 million. It was expected to have a residual value of Tshs1 million, and its useful life was estimated at 8 years. The company charges depreciation under the straight-line method. After two years, it was discovered that the original estimate of useful life was wrong and that the actual total useful life would be only 6 years. Calculate the revised depreciation.

Answer

The initial depreciation under the straight-line method is calculated as:

$$\text{Depreciation (p.a)} = \frac{\text{Depreciable amount}}{\text{Estimated useful life of the Asset}}$$

$$= \frac{\text{Tshs.17million-1million}}{\text{8yearst}} = \text{Tshs.2million p.a.}$$

Depreciation charged for two years = Tshs2 million x 2 years = Tshs4 million
Book value after two years = Tshs17 million - Tshs4 million = Tshs13 million
Residual value: remains at = Tshs1 million
New depreciable amount = Tshs13 million - Tshs1 million = Tshs12 million
Revised remaining useful life = 6 years - 2 years
= 4 years
Revised depreciation = Tshs12 million / 4 years
= Tshs3 million

The same procedure is followed if the residual value of the asset changes.

Test Yourself 6

A company purchased a machine for Tshs70 million. It was expected to have a residual value of Tshs2.4 million and its useful life was estimated at 8 years. The company charges depreciation under the straight-line method. After three years, it was discovered that the original estimate of residual value was wrong and that the actual residual value would be only Tshs1.5 million.

The revised depreciation will be:

A Tshs8,562,500
B Tshs5,393,750
C Tshs7,450,750
D Tshs8,630,000

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

The most appropriate purpose for charging depreciation is to comply with accrual and the matching principle.

Answer to TY 2

The correct option is **B**.

Charging depreciation ceases when an asset is classified as held for sale or when it is derecognised. Depreciation does not end when the asset becomes idle or is retired from active use.

Answer to TY 3

The correct option is **D**.

The residual value is the value which the entity expects to realise from disposal of the asset at the end of its useful life. It is not a method of depreciation. All the others are methods of depreciation.

Answer to TY 4

The correct option is **C**.

The statement of profit or loss includes only the depreciation for the current year. Accumulated depreciation is considered in the statement of financial position in order to calculate the carrying amount.

Answer to TY 5

The correct option is **B**.

Depreciation for the remaining life (5 years) will be Tshs90 million / 5 years = Tshs18 million

Depreciation on the original cost Tshs120 million/ 10 years = Tshs12 million

Difference Tshs6 million

Amount to be transferred to the retained earnings = Tshs6 million

Answer to TY 6

The correct option is **D**.

Initial depreciation under the straight-line method is:

$$\text{Depreciation (p.a)} = \frac{\text{Depreciable amount}}{\text{Estimated useful life of the Asset}}$$

$$= \frac{\text{Tshs.70million-2.4million}}{\text{8years}} = \text{Tshs.8.45million p.a.}$$

Depreciation charged for three years	= Tshs8.45 million x 3 years = Tshs25.35 million
Carrying value after three years	= Tshs70 million – Tshs25.35 million = Tshs44.65 million
New depreciable amount	= Tshs44.65 million – Tshs1.5 million= Tshs43.15 million
Remaining useful life	= 8 years- 3 years
	= 5 years
Revised depreciation	= Tshs43.150 million / 5 years
	= Tshs8.63 million

Self Examination Questions

Question 1

State any five important points one should keep in mind when charging depreciation.

Question 2

Which of the following statements is incorrect?

A The depreciation method should be followed consistently.
B Under the straight-line method, a fixed amount is charged each year.
C The depreciation charge begins when an asset is available for use at the location and in the condition intended by the management.
D When the fair value of an asset exceeds its carrying amount, the depreciation of the asset ends.

Question 3

An entity adopts the revaluation model. Its building has a carrying value of Tshs900 million i.e. gross value Tshs1,050 million – accumulated depreciation Tshs150 million. The building is revalued at Tshs1,260 million.

Required:

Calculate the revised accumulated depreciation.

Question 4

Which of the following statements is correct?

A Under the straight-line method, depreciation plus repairs remains constant each year.
B Under the reducing value method depreciation remains constant each year.
C Under the reducing value method depreciation plus repairs remains relatively stable over the useful life of the asset.
D The depreciation charge should not be zero under any method for any year, unless the asset is derecognised or classified as held-for–sale.

Question 5

KKAC Inc purchased machinery for Tshs25 million on 1 January 20X4. Installation charges are Tshs2 million. Its expected life is 4 years and the residual disposal value is Tshs3.5 million.

Required:

Calculate the amount of depreciation under the reducing balance method for the first and second year. Rate of depreciation is given as 40% p.a.

Question 6

On 1 October 20X7 James Inc acquired a machine for Tshs29 million. The company spent Tshs1 million for installation, which was paid by cheque. The rate of depreciation is 10%. The end of the reporting period is 31 December 20X8.

Required:

Show the machinery and depreciation account using the straight line method and also the diminishing balance method.

Question 7

At 31 December 20X4 Q, a limited liability company, owned a building which was purchased on 1 January 1995 for Tshs800 million. It was being depreciated at two per cent per year.

On 1 January 20X5 a revaluation to Tshs1,000 million was recognised. At this date the building had a remaining useful life of 40 years.

What is the depreciation charge for the year ended 31 December 20X5 and the revaluation surplus balance as at 1 January 20X5?

	Depreciation charge for year ended 31 December 20X5	Revaluation surplus as at 1 January 20X5
A	25,000	200,000
B	25,000	360,000
C	25,000	200,000
D	25,000	360,000

Question 8

On 1 April 20X3 Pluto Ltd had a motor vehicles account had a balance of Tshs126 million and accumulated depreciation of Tshs55.5 million on 1 April 20X3. One of the vehicles which was purchased on 1 May 20X2 at a cost of Tshs54 million was sold on 1 January 20X5 for Tshs28.5 million. Full year's depreciation is provided in the year of purchase but no depreciation in the year of sale. Depreciation is to be made at 20% on book value for financial years ending 31 March each year.

Required:

Prepare the following ledger accounts, in the books of Pluto Ltd.

(a) Motor vehicles account for the years ended March 20X4 and March 20X5.

(b) Accumulated depreciation on motor vehicles for the years ended March 20X4 and March 20X5.

(c) Motor vehicle disposal account

Answers to Self Examination Questions

Answer to SEQ 1

Important points for charging depreciation

(a) The method of depreciation should be reviewed at the end of each financial year
(b) The method of depreciation should be one that most closely reflects the expected pattern of consumption.
(c) For any change in the method of depreciation, the impact of the change should be accounted for as a change in accounting estimates (i.e. prospectively).
(d) Under usage methods of depreciation if there is no production, the depreciation charge can be zero.
(e) Depreciation is charged pro-rata to the period of use.

Answer to SEQ 2

The correct option is **D**.

The depreciation charge should not cease unless the asset has been classified as held-for-sale or has been disposed of.

Answer to SEQ 3

Calculate percentage of increase in the net value.

Percentage increase in net value = Increase in net value/carrying value x 100
= Tshs360 million/ Tshs900 million x 100
= 40%

Therefore, accumulated depreciation should be increased by 40%

Revised accumulated depreciation = Tshs150 million + 40% of Tshs150 million
= Tshs210 million

Answer to SEQ 4

The correct option is **C**.

The amount of depreciation plus repairs remains relatively stable throughout the life of the asset under the reducing balance method. This is because in the initial years when the depreciation charge is high, the amount of repairs is low. In the later years of the asset's useful life, the amount of repairs rises while the depreciation charge reduces.

Under the straight line method, while the depreciation charge remains constant each year, the amount spent on the repairs each year would increase as the asset approaches the end of its useful life.

Under the reducing balance method, the depreciation charge is a percentage of the written down value of the asset. Hence the amount of depreciation changes each year.

Under usage linked methods of charging depreciation, the depreciation charge can be zero in accounting periods where there is no production.

Answer to SEQ 5

Cost of the assets = Tshs25 million + Tshs2 million = Tshs27 million

Calculation of the depreciation amount

Depreciation = (Cost – Accumulated depreciation) x Depreciation rate
= Carrying value x Depreciation rate

1st year: Depreciation = Tshs27 million x 40% = Tshs10.8 million
Carrying value = Tshs27 million - Tshs10.8 million = Tshs16.2 million

2nd year: Depreciation = Tshs16.2 million x 40% = Tshs6.48 million

Answer to SEQ 6

Machinery account (straight-line method)

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/10/20X7	Bank	29,000	31/12/20X7	Depreciation (3 months)	750
	Bank (installation)	1,000		Balance c/d	29,250
		30,000			**30,000**
01/01/20X8	Balance b/f	29,250	31/12/20X8	Depreciation	3,000
			31/12/20X8	Balance c/f	26,250
		29,250			**29,250**

Depreciation account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X7	Machinery account	750	31/12/20X7	SOPL	750
		750			**750**
31/12/20X8	Machinery account	3,000	31/12/20X8	SOPL	3,000
		3,000			**3,000**

Machinery account (reducing balance method)

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
01/10/20X7	Bank	29,000	31/12/20X7	Depreciation (3 months)	750
	Bank (installation)	1,000		Balance c/d	29,250
		30,000			**30,000**
01/01/20X8	Balance b/f	29,250	31/12/20X8	Depreciation	2,925
			31/12/20X8	Balance c/f	26,325
		29,250			**29,250**

Depreciation account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X7	Machinery account	750	31/12/20X7	SOPL	750
		750			**750**
31/12/20X8	Machinery account	2,925	31/12/20X8	SOPL	2,925
		2,925			**2,925**

Answer to SEQ 7

The correct option is **B.**

Depreciable amount = Revalued asset / Useful life = Tshs1,000 million / 40 years = Tshs25 million

Depreciation adjustment = Tshs1,000 million – (Tshs800 million – (Tshs800 million x 2% x 10 years)) = Tshs360 million.

Answer to SEQ 8

(a)

Motor Vehicle A/C

Date	Particulars	Tshs	Date	Particulars	Tshs
01/04/20X3	Balance b/d	126,000,000	31/03/20X4	Balance c/d	126,000,000
		126,000,000			**126,000,000**
01/04/20X4	Balance b/d	126,000,000	01/01/20X5	Disposal A/c	54,000,000
				Balance c/d	72,000,000
		126,000,000			**126,000,000**

(b)

Accumulated Depreciation on Motor Vehicles A/C

Date	Particulars	Tshs	Date	Particulars	Tshs
31/03/20X4	Balance c/d	69,600,000	01/04/20X3	Balance b/d	55,500,000
			31/03/20X4	P & L A/c	14,100,000
		69,600,000			**69,600,000**
01/04/20X5	Disposal A/C (Note ii)	26,352,000	01/04/20X4	Balance b/d	69,600,000
31/03/20X5	Balance c/d	48,998,400	31/03/20X5	SOPL(Note i)	*5,750,400
		75,350,400			**75,350,400**

(i) Depreciation for the year:

*(Tshs72,000,000 – (Tshs69,600,000 – Tshs26,352,000) x 20% = Tshs5,750,400

(ii) Accumulated depreciation on disposed vehicle:

	Tshs
Cost of disposed vehicle	54,000,000
Less: Depreciation	(10,800,000)
	43,200,000
Less: Depreciation	(8,640,000)
	34,560,000
Less: Depreciation	(6,912,000)
	27,648,000

Accumulated depreciation = Tshs10,800,000 + Tshs8,640,000 + Tshs6,912,000 = Tshs26,352,000

(c)

Disposal A/c (Motor Vehicles)

Date	Particulars	Tshs	Date	Particulars	Tshs
01/01/20X5	Motor Vehicle A/c	54,000,000	01/01/20X5	Bank	28,500,000
	Profit on disposal	852,000		Accumulated depreciation	26,352,000
		54,852,000			**54,852,000**

SECTION D

THE ADJUSTMENTS TO PREPARATION OF FINANCIAL REPORT

D1

STUDY GUIDE D1: ACCRUALS AND PREPAYMENTS

Get Through Intro

Agreements, contracts and transactions of a business are guided by the needs of the business and not according to the convenience of the accountant.

For example, if an insurance cover expires on 1 December 20X6, the manager will renew it without a moment's hesitation. The accountant would ideally like him to renew it on 1 January 20X7 if his financial year end is 31 December 20X6. This saves him the trouble of making adjustments for prepaid expenses.

The matching concept requires expenses and incomes to be recorded in the year in which they accrue. This results in adjustments which have to be made for:

- Outstanding and prepaid expenses
- Outstanding income and income received in advance

The general principles that guide all these adjustments are discussed in this Study Guide. Every accountant has to be familiar with these principles; if these adjustments are not done then the financial statements based on these accounts will be misleading.

Learning Outcomes

a) Explain the meaning of accruals and matching.
b) Identify and calculate the adjustments needed for accruals and pre-payments in preparing financial statements.
c) Illustrate the process of adjusting for accruals and pre-payments in preparing financial statements.
d) Prepare the journal entries and ledger entries for the creation of an accrual or pre-payment.
e) Identify and describe the impact on profit and net assets of accruals and pre-payments.

1. Explain the meaning of accruals and matching.

[Learning Outcome a]

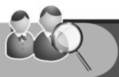
In Section C of this Study Text, we understood the principles of double entry and primary books of account. We were also introduced to accounting the various accounting concepts under Section B. An accountant is required to deal with adjustments for pre-payments and accruals while preparing the financial statements.

What is matching?

Definition

Under matching, expenses are recognised in the statement of profit or loss on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events.

Framework



Example

Johnson runs a transport business. On 24 December 20X6 since his own trucks were unavailable, he hired a truck from Larry to deliver goods to his customer Mason. Johnson charged Tshs1,000,000 for the goods sold to Mason and recorded it as revenue in the accounts for the year to 31 December 20X6.

However until the year end i.e. 31 December 20X6, Johnson did not receive an invoice nor did he pay Larry the agreed sum of Tshs80,000.

According to the matching concept, since Johnson has (in his accounts for the year to 31 December 20X6) recognised the revenue for the trip, he must also recognise the costs incurred for earning this revenue.

Adjustments made to match expenses with revenue invariably create assets or liabilities. In the above example the accounting entry is:

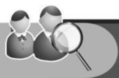
		Gives a matching effect	Creates a liability
Dr	Transport charges (expense)	Tshs80,000	
Cr	Accrued transport charges payable		Tshs80,000

Being transport charges payable to Jack, accrued for (ref. Trip dated 30/12/20X6 to Stanburg)

Being transport charges payable to Jack, accrued for (ref. Trip dated 30/12/20X6 to Stanburg).

The debit effect in this entry is the matching effect. It simultaneously creates a liability.

Consider the following example to understand the concept of accrual:



Example

On 16 December 20X9, Jim decides to go for a film with his friends on 25 December 20X9. Accordingly he books tickets for the film in advance i.e. on 16 December 20X9.

When will the cinema's accountant account for the money? On 16 December 20X9 or on 25 December 20X9?

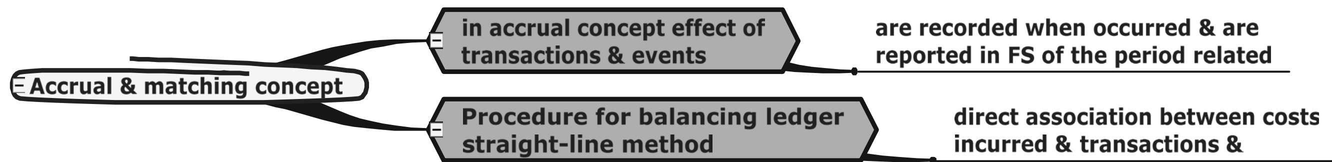
Let's evaluate:

Can Jim go and watch the film on 16 December 20X9? No, because he booked tickets for 25 December 20X9.

When will the expenses be incurred to show the film related to this revenue? On 25 December 20X9.

Therefore the revenue will not accrue until 25 December 20X9. The advance payment received will be treated as an advance received by the accountant of the cinema owing to the matching concept. Hence, according to the matching concept, the accountant will recognise the revenue on 25 December 20X9.

SUMMARY



For construction of office premises, Sanya has taken a loan from DCHF bank on 1 January 20X7. The construction was completed on 31 July 20X7 and the office is rented out for Tshs2,000,000 per month. Interest on the loan is incurred at Tshs400,000 per month since 1 January 20X7.

What amount should be recorded as an expense in the statement of profit or loss prepared at the year ended 31 December 20X7?

A Tshs2,800,000
B Tshs4,800,000
C Tshs2,000,000
D None of the above

---

2. Identify and calculate the adjustments needed for accruals and pre-payments in preparing financial statements.
Prepare the journal entries and ledger entries for the creation of an accrual or pre-payment.
Illustrate the process of adjusting for accruals and pre-payments in preparing financial statements.
Identify and describe the impact on profit and net assets of accruals and pre-payments.
[Learning Outcomes b, c, d and e]

Expenses and incomes which do not pertain to a particular year need adjustments for accruals and pre-payments in order to comply with the requirements of the matching principle. Remember, when an invoice is received, it is automatically routed to the statement of profit or loss as an expense for the year. Hence, adjustments need to take place if not all the expenses incurred during the year do not belong to the same year.

2.1 Accrued expenses (Outstanding expenses)

Meaning

In the practical business world, invoices are received / payment is made after the financial year has ended. In certain cases, organisations may prefer to pay a supplier in a lump sum, rather than pay them for weekly / monthly orders. In order cases, certain customers may prefer making bulk payment for a contract in the middle of the year that even covers a few months of the following year.

At times expenses accrue but are not due for payment at the end of the reporting period. However, since the relevant expenses are accrued, (i.e. incurred for earning the revenue recognised in a financial year) we need to record them in the same financial year.

Pallore Co obtained a loan of Tshs1 million from a bank on 1 January 20X7 at an agreed interest rate of 9%. The dates of interest payment are 30 June and 31 December every year. The financial year ending is on 31 March 20X7. Payment of interest is made every 6 months at the end of June and December.

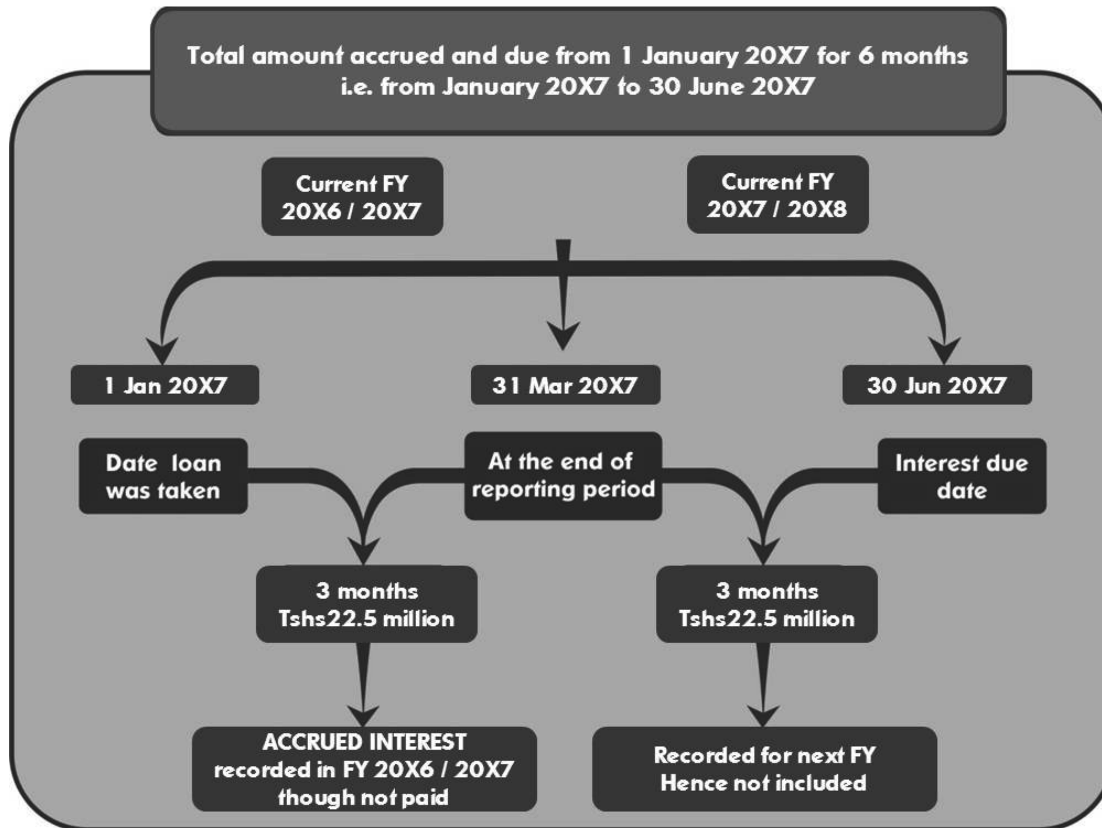
Calculate the accrual adjustments.

Whether the interest is due or not, the accrual continues every day.

Interest for the period 1 January 20X7 to 30 June 20X7 is due on 30 June 20X7. The reporting date for Pallore Co is 31 March 20X7 and it falls in between the interest repayment period.

Continued on the next page

Interest for the period 1 January 20X7 to 31 March 20X7 is not due for payment on reporting date, but still it has accrued. Therefore the amount of interest outstanding which needs to be recognised is Tshs1,000,000 x 9% x 3/12 = Tshs22,500.



The journal entry made is

Dr Interest on loan (Expense) Tshs22,500
Cr Interest accrued on term loan (Liability) Tshs22,500
Being recording of interest accrued on loan

Interest expense account
(Year 20X6-X7)

Dr Cr

	Tshs		Tshs
Interest accrued on term loan	22,500	Transferred to SOPL	22,500
	22,500		**22,500**

Outstanding expense is added to expenses here

Note: the interest accrued during 20X6-X7 is transferred to the statement of profit or loss even if there is no payment of interest. This is achieved by the accrual adjustment.

Interest accrued on term loan (liability) account (extract)
(Year 20X6-X7)

Dr Cr

	Tshs		Tshs
		Interest expense	22,500

Outstanding expense recorded as a liability

Continued on the next page

1. Presentation in the financial statements

The interest expense will be added to the interest cost under finance costs in the statement of profit or loss. The interest accrued on the loan is shown in the statement of financial position under current liabilities.

SOPL (extract) For the year ended 31 March 20X7		
	Tshs	Tshs
Income		X
Less: Expenses		
Interest accrued	22,500	
Other expenses	X	
Net profit		**X**

SOFP (extract) as at 31 March 20X7		
		Tshs
Assets		
Non-current assets		X X
Current assets		
Total		XX
Capital		X X
Non-current liabilities		
Current liabilities		
Interest accrued on term loan		22,500
Total		**X**

2. Impact on profit and net assets

As you have now learnt, accrued interest has two effects:

increase in expense = reduction in profit for the current period
creation / increase in liability = reduction in net assets

Reversal of accrual

At the beginning of the next year, the journal entry is reversed. This is known as reversal of accrual. In the example considered above, the entry to be made in the next year is:

Dr	Interest accrued on term loan (Liability)	Tshs22,500	
Cr	Cash (payments)		Tshs22,500

Being the reversal of entry taken for accrued interest in the last year

Interest expense account (extract)
(Year 20X7-X8)

Dr					**Cr**
		Tshs			**Tshs**
30/06/20X7	Cash (payments)	22,500	01/04/20X7	Transferred to SOPL	90,000
31/12/20X7	Cash (payments)	45,000			
31/03/20X8	Interest accrued on term loan	22,500			
		90,000			**90,000**

Interest accrued on term loan (liability) account (extract)
(Year 20X7-X8)

Dr					**Cr**
		Tshs			**Tshs**
30/06/20X7	Cash (payments)	22,500	01/04/20X7	Balance b/f	22,500
31/03/20X8	Balance c/d	22,500	31/03/20X8	Interest expense (Jan 20X8 to March 20X8)	22,500
		45,000			**45,000**

Impact on profit and net assets

The reversal of last year's provision amount ensures that out of Tshs45,000 paid on 30 June 20X7 only half (the part related to the period from 1 April 20X7 to 30 June 20X7) is transferred to the statement of profit or loss (income and expense).

Test Yourself 2

Selection Ltd has taken a loan from Chartered Bank on 1 October 20X2. Interest is due on a six monthly timeline i.e. on 31 March, and 30 September. Each interest instalment is Tshs6,000,000. According to the local laws, Selection prepares its financial statements to the year ended 30 June.

What is the amount of accrued interest that Selection would show in its financial statement for the year ended 30 June 20X3?

A Tshs4,000,000
B Tshs12,000,000
C Tshs6,000,000
D Tshs3,000,000

2.2 Prepaid expenses

Certain suppliers may require payment upfront. In other cases, certain organisations may make payments at a certain date, which may not coincide with their accounting year. Hence, these expenses would be paid in advance. As an accountant you, have to ensure of the total expenses, only the part which relates to the current financial year is presented as an expense. The part which relates to the next financial year is carried forward as an asset under the heading 'Prepaid expenses'.

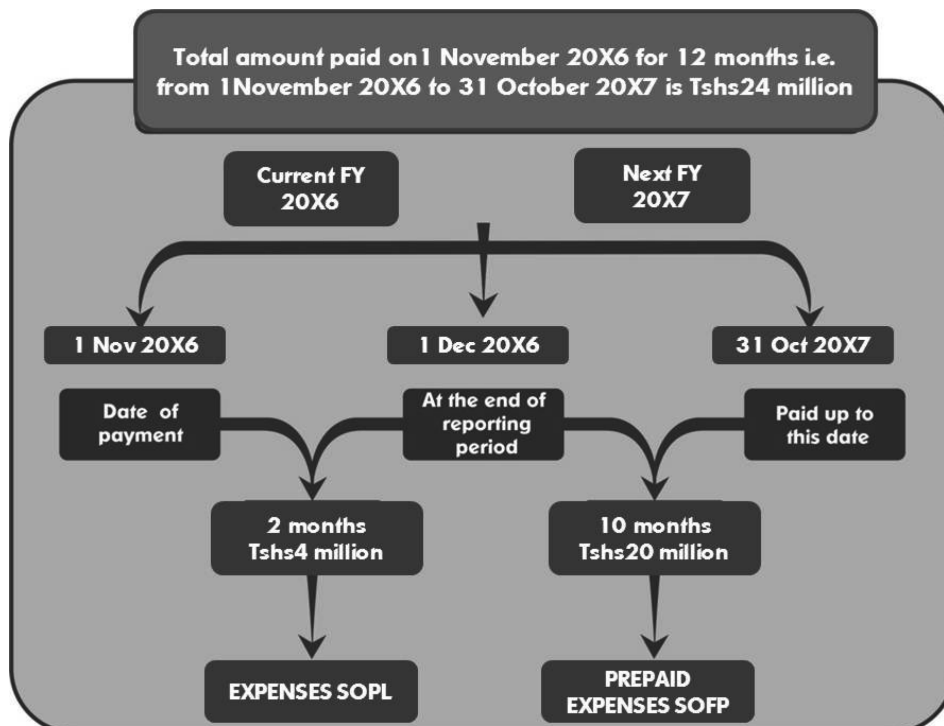
Example

An insurance policy for fire and similar risks is obtained for the year from 1 November 20X6 by paying a premium of Tshs24,000,000 for the full year in advance. The reporting period is 31 December 20X6.

Of the total premium paid of Tshs24,000,000, the premium accrued up to the end of the reporting period is: Tshs24,000,000 x (2/12) months = Tshs4,000,000.

The part which relates to the current financial year is added to the insurance expense account (in this case, two months: November and December 20X6) and the part which relates to the next financial year is carried forward as an asset – 'prepaid expenses'. (in this case 10 months from January to October 20X7).

The premium for the remaining 10 months, i.e., Tshs24,000,000/12 x 10 = Tshs20,000,0000 accrues in the next financial year i.e. it is paid in order to cover the fire and other risks for the period 1 January 20X7 to 31 October 20X7.



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1. The journal entry made is:

When the payment was made, the accountant would have recorded the following entry:

Dr	Insurance expense (expense)	Tshs24,000,000	
Cr	Cash (asset)		Tshs24,000,000

Being payment of insurance premium recorded

Now, at the end of the year, having determined that Tshs20,000,000 is a pre-payment, the following entry is made:

Dr	Prepaid insurance (asset)	Tshs20,000,000	
Cr	Insurance expense (expense)		Tshs20,000,000

Being prepaid insurance recorded

Prepaid expense is shown here as a reduction from expense

Insurance expense account
(Year 20X6)

Dr			Cr
	Tshs'000		**Tshs'000**
	X	Transferred to SOPL (balancing figure)	4,000
Cash (payments)	24,000		
		Prepaid insurance	20,000
	24,00		**24,000**

The adjustment for prepaid insurance leads to an amount of Tshs4,000,000 i.e. the amount of expense accrued. This amount is transferred to the statement of profit or loss.

Prepaid expense is recorded here as an asset

Pre-paid insurance (asset) account
(Year 20X6)

Dr			Cr
	Tshs'000		**Tshs'000**
Insurance expense	20,000		

2. Presentation in the financial statements

The insurance expense in the statement of profit or loss will be reduced by Tshs20,000,000.

The prepaid insurance of Tshs20,000,000 is recognised as a current asset in the statement of financial position.

SOPL for the year ended 31 December 20X7		
	Tshs'000	**Tshs'000**
Income		X
Less: Expenses		
Insurance expenses	24,000	
Less: Pre-paid	(20,000)	4000
Net profit		X
		X

SOFP as at 31 December 20X7	
	Tshs'000
Assets	
Non-current assets	X
Current assets	X
Pre-paid expenses	20,000
Total	**X**
Capital and liabilities	X
Total	**X**

3. Impact on profit and net assets

Expenses prepaid for the year would have two effects:

Decrease in expense = Increase in profit for the current period
Creation / Increase in asset = Increase in net assets

The impact on the next year's profit and net assets is the opposite of this.

Continued on the next page

4. At the beginning of the next year, the journal entry is reversed.

In the example considered above, the entry would be:

Dr Insurance expense	Tshs20,000,000	
Cr Prepaid insurance (asset)		Tshs20,000,000

Being the entry to transfer prepaid insurance to insurance expense, i.e. the reversal of last year's entry

The ledger accounts would appear as:

This indicates addition to insurance expense

Insurance expense account
(Year 20X7)

Dr	Tshs'000		Tshs'000 Cr
Prepaid insurance (last year's prepaid expense transferred to expense account)	20,000	Transferred to SOPL (including 20,000)	X
Cash (payments)	X		
	X		**X**

This reversal of prepaid adjustment enables us to correctly show Tshs20,000,000 as an expense of 20X7, since the expense has actually accrued during this period, even though it was paid in 20X6.

Prepaid insurance (asset) account
(Year 20X7)

Dr	Tshs'000		Tshs'000 Cr
Balance b/f	20,000	Insurance expense (last year's prepaid expense transferred to insurance expense account)	20,000
		Closing balance	-
	20,000		**20,000**

Test Yourself 3

Milltone paid Tshs24 million as insurance on 1 January 20X7. The insurance for a year is Tshs16 million. Therefore, in its statement of financial position on 31 December 20X7, the company adjusted Tshs8 million as prepaid insurance. In 20X8,

A Tshs8 million will be debited to prepaid insurance account and credited to insurance expense account
B Tshs8 million will be credited to prepaid insurance account and debited to insurance expense account
C Tshs8 million will be treated as an asset
D Tshs8 million will be treated as a liability

2.3 Accrued income (outstanding income)

Income can also accrue continuously. It needs **to be recognised in the financial year** in which it has accrued, whether the actual cash is received or not (i.e. the date of actual receipt of the income is not important).

Example

Mozart had business premises that were lying vacant. He rented it out for an agreed rent of Tshs400,000 per month with effect from 1 April 20X6.

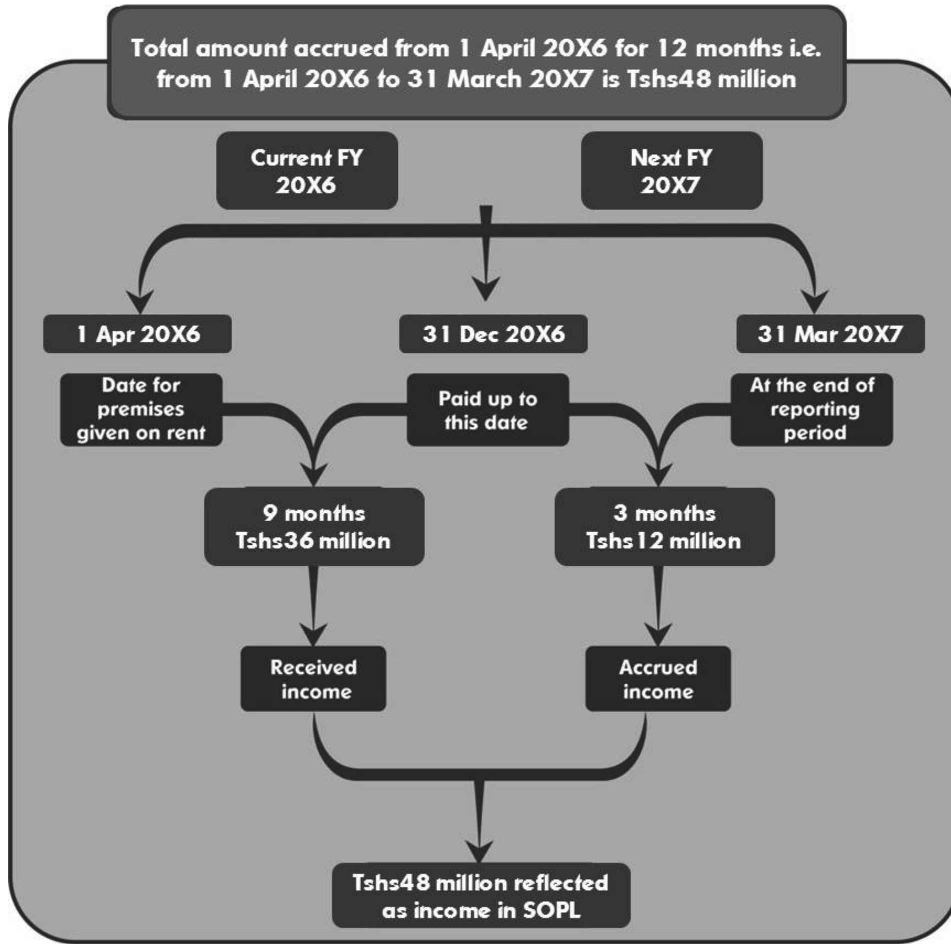
The following rents were received by Mozart

Period	Rent received on	Amount
1 April 20X6 to 31 December 20X6 (9 months)	1 January 20X7	Tshs3,600,000
1 January 20X7 to March 20X8 (15 months)	1 April 20X8	Tshs6,000,000

Continued on the next page

The reporting period of Mozart is 31 March each year.

The rent for the 9 month's period from 1 April 20X7 to 31 December 20X7 must be accounted as an expense. Rent for the 3 months from January 20X7 to March 20X7 had accrued even though it had not actually been received by Mozart. Mozart needs to record an amount of Tshs1,200,000 (Tshs400,000 x 3) in his accounts as rent receivable for the year 20X6-20X7.



1. The journal entry

		Tshs'000	Tshs'000
Dr	Cash	3,600	
Cr	Rent income		3,600
Being rent received			
Dr	Rent receivable (SOFP)	1,200	
Cr	Rent income (SOPL)		1,200
Being rent receivable recorded			

Accrued income is added to income

A proforma expense account

Rent (income) account
(Year 20X6-X7)

Dr	Tshs'000		Cr Tshs'000
Transferred to SOPL (balancing figure)	4,800	Cash (receipts)	3,600
		Income accrued (outstanding)	1,200
	4,800		**4,800**

Continued on the next page

Accrued income is recorded as an asset

Rent receivable (asset) account
(Year 20X6-X7)

Dr | | | **Cr**

	Tshs'000		**Tshs'000**
Rent income	1,200		

2. Presentation in the financial statements

The rent receivable is shown as a current asset in the statement of financial position.
The rent income of Tshs1,200,000 is added to the figure of rent income appearing in the statement of profit or loss.

3. Impact on profit and net assets

Accrued income would lead to an increase in income. Hence the following two effects are noticed:

1. increase in income = increase in profit for the current period
2. creation / increase in asset = increase in net assets

The **effect on the profit** and the net assets in the next year, when the entries are reversed, is the opposite of this.

3. At the beginning of next year, the journal entry is reversed.

		Tshs'000	**Tshs'000**
Dr	Rent income (SOPL)	1,200	
Cr	Rent receivable (SOFP)		1,200

Being the entry to transfer rent receivable account to rent income account, i.e. the reversal of last year's entry no.____.

The ledger accounts would appear as:

Rent (income) account
(Year 20X7-X8)

Dr | | | **Cr**

	Tshs'000		**Tshs'000**
Income accrued (outstanding)	1,200	Cash (receipts)	6,000
Transferred to SOPL (balancing figure)	4,800		
	6,000		**6,000**

Opening balance of accrued income is reduced from income received

Reversal of accrual adjustment ensures that Tshs1,200,000 received during 20X7-X8 but relating to 20X6-X7 is not shown as an income of 20X7-X8.

Accrued income is transferred to rent (income) account

Rent receivable (asset) account
(Year 20X7-X8)

Dr | | | **Cr**

	Tshs'000		**Tshs'00**
Balance b/f	1,200	Rent income account	1,200
		Closing balance	-
	1,200		**1,200**

Test Yourself 4

Brilliant Brains Ltd, made a deposit of Tshs500,000 on 1 April 20X7. Interest on the fixed deposit is accrued quarterly (31 March, 30 June, 30 September and 31 December) but only paid at maturity. The end of the reporting period is 31 August 20X7. Monthly interest is Tshs3,000. The amount to be shown in the statement of financial position is_____________.

2.4 Income received in advance

Income is occasionally received before it accrues – it is sometimes given in advance. The income related to the current year is to be recorded as income for the current year. The excess income received needs to be recorded in the same financial year by reducing the income which is received in advance, and shown in the statement of financial position as a liability.

Example

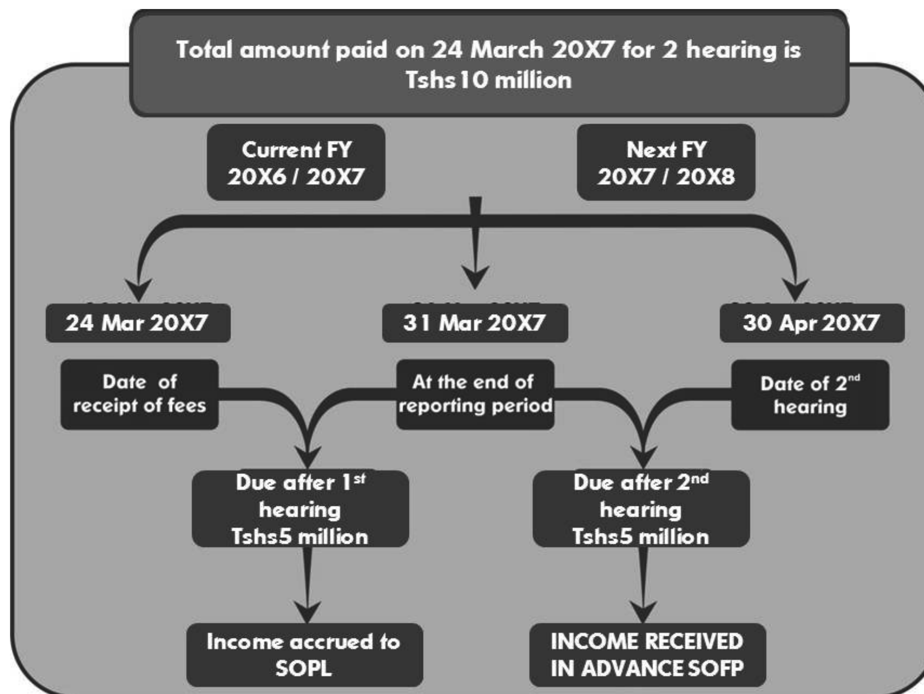
A firm of lawyers received Tshs10 million on 24 March 20X7 as fees for a case that it was handling and booked the same as revenue for the period. This amount covered 2 court hearings requiring approximately similar time and effort. Up to the end of the reporting period on 31 March 20X7, only 1 hearing was complete. The second hearing took place on 30 April 20X7.

At the reporting date only half of the work was complete and therefore only half of the fees must to be accounted.

Since, the fees for both the hearings was received in advance, it must be accounted in the following manner:

half of the fees i.e. Tshs10 million /2 = Tshs5 million is treated as a revenue in 20X7 and

the remaining amount is treated as income received in advance



1. The journal entry

		Tshs'000	Tshs'000
Dr	Cash	10,000	
Cr	Professional fees		10,000
Being cash received			
Dr	Professional fees (SOPL)	5,000	
Cr	Professional fees received in advance (SOFP)		5,000
Being adjustment for fees received in advance recorded			

Continued on the next page

Professional fees (income) account
(Year 20X6-X7)

Dr			Cr
	Tshs'000		**Tshs'000**
Transferred to SOPL (balancing figure) Fees received in advance	5,000 5,000	Cash (receipts)	10,000
	10,000		**10,000**

Fees received in advance shown here as a reduction from income

Fees received in advance recorded here as a liability

Professional fees received in advance (liability) account
(Year 20X6-X7)

Dr			Cr
	Tshs000		**Tshs000**
		Professional fees	5,000
	X		

2. Presentation in the financial statements

The income from professional fees in the statement of profit or loss is reduced by Tshs5,000.
The fees received in advance are shown as a current liability in the statement of financial position.

3. Impact on profit and net assets

Income received in advance would lead to an increase in income. Hence the following two effects are noticed:

1. increase in expenses = decrease in profit for the current period
2. creation / increase in liability = decrease in net assets

The effect on the profit and the net assets in the next year, when the entries are reversed, is the opposite of this.

4. At the beginning of next year, the journal entry is reversed.

In the example considered above, the entry would be:

		Tshs'000	**Tshs'000**
Dr	Professional fees received in advance (SOFP)	5,000	
Cr	Professional fees (SOPL)		5,000

Being reversal of fees received in current year, in order to record income in the current year

The ledger accounts would appear as:

Transferred from professional fees received in advance account

Professional fees (income) account
(Year 20X7-X8)

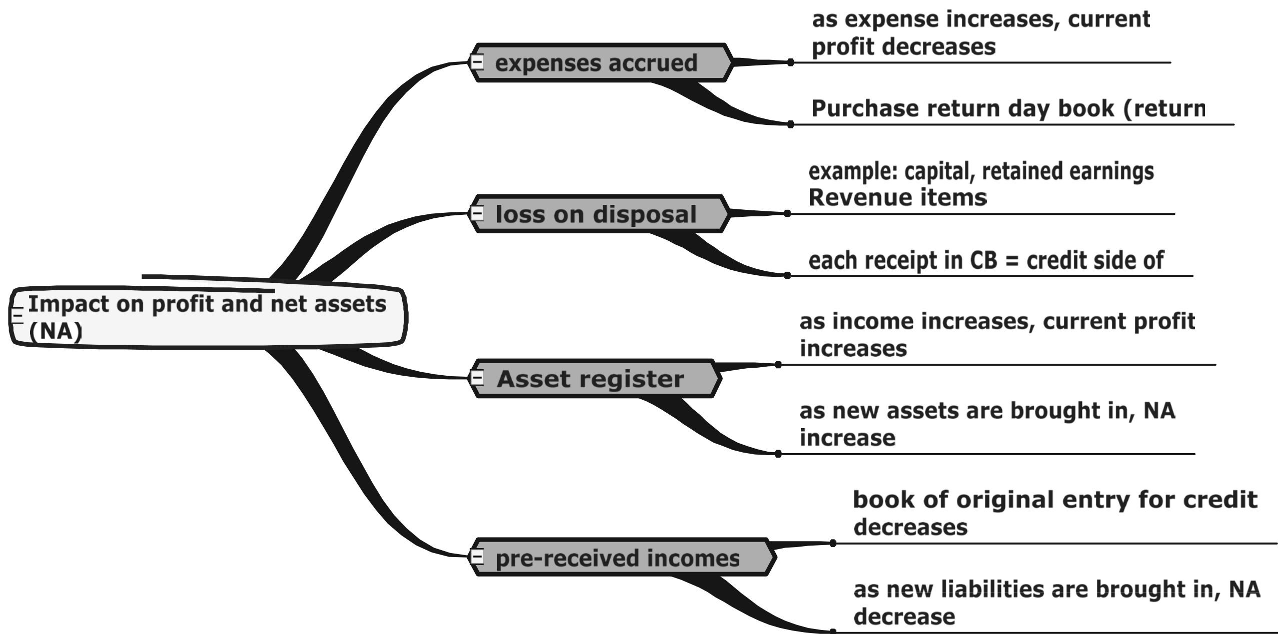
Dr			Cr
	Tshs'000		**Tshs'000**
SOPL (balancing figure)	5,000	Professional fees received in advance	5,000
	5,000		**5,000**

Transfer of the amount received last year but pertaining to the current year (20X7 - 20X8) to this account enables us to show the income earned in the current year (Tshs5,000) as current year's income.

Professional fees received in advance (liability) account
(Year 20X7-X8)

Dr			Cr
	Tshs000		**Tshs00**
Professional fees (opening balance transferred to professional fees account)	5,000	Balance b/f	5,000
		Closing balance	-
	5,000		**5,00**

SUMMARY



Test Yourself 5

Saligo Traders earns sales commission on the orders he obtains for Shoe Makers Inc. On 30 December 20X6 Shoe Makers Inc paid commission of Tshs55,000 for the year 20X6. Saligo records the commission income only when the related sales orders are executed by Shoe Makers. Later, it was found out that an order, on which a commission of Tshs8,000 was due, was executed only on 7 January 20X7. Therefore, this commission amount was due in 20X7, but was erroneously included in the amount of Tshs55,000 paid for 20X6.

Required:

Give accounting entries for 20X6 and 20X7 and the relevant extracts from the financial statements for 20X6.

Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

The office is put to use on 1 August 20X7, after which only revenue is generated by the office. According to the matching principle, expenditure should be matched with revenues. Therefore interest should be recognised from 1 August 20X7 to 31 December 20X7 i.e. only for 5 months. The interest to be recorded in the statement of profit or loss should be Tshs400,000 x 5 = Tshs2,000,000.

Answer to TY 2

The correct option is **D**.

Two instalments of Tshs6,000,000 in a year amounts to the yearly interest expense of Tshs12,000,000. Hence, the monthly interest charge would be Tshs1,000,000.

The last instalment of Tshs6,000,000 made on 31 March 20X3 would include the period from 1 October 20X2 to 31 March 20X3. The next instalment of Tshs6,000,000 to be made on 30 September 20X3 would include the period from 1 April 20X3 to 30 September 20X3. This instalment would be made in the next accounting period. Hence, the amount of interest accrued would be equal to 3 months interest charge (from 1 April 20X3 to 30 June 20X3) Tshs3,000,000. This is the amount of interest that has accrued, but has not been paid.

Answer to TY 3

The correct option is **B**.

At the beginning of the accounting year, on 1 January 20X8, Tshs8 million will be credited to the prepaid insurance account and debited to the insurance expense account. This is to reverse the adjustment for prepaid insurance, made at the end of 20X7.

Answer to TY 4

Interest for 5 months will accrue i.e. from 1 April 20X7 to 31 August 20X7. Therefore the amount to be shown in the statement of financial position is Tshs15,000.

Answer to TY 5

When the amount of commission is received, the following entry would be made:

		Tshs'000	Tshs'000
Dr	Cash account	55,000	
Cr	Commission (income)		55,000

Being receipt of commission from Shoe Makers Inc recorded

Unless an adjustment is made, this entire amount will be reflected as an income in the statement of profit or loss for the year ended 31 December 20X6. This is wrong. We need to remove the part related to 20X7 and show it in the statement of financial position as income received in advance. The commission of Tshs8 million was accrued only on 7 January 20X7, and hence relates to 20X7.

The following entry is made at the end of the financial year:

		Tshs'000	Tshs'000
Dr	Commission (Income)	8,000	
Cr	Commission received in advance (Liability)		8,000

Being commission received in advance transferred to commission received in advance account

Extracts from financial statements (Amounts in Tshs'000)
Statement of profit or loss

Other income
Commission (Tshs55,000 - Tshs8,000) Tshs47,000

Statement of financial position

Current liabilities

Commission received in advance Tshs8,000

Year 20X7

The entry given above is reversed at the beginning of 20X7

Dr	Commission received in advance (Liability)	Tshs8,000	
Cr	Commission (Income)		Tshs8,000

Being reversal of commission received in the current year, in order to record income in the current year

Self Examination Questions

Question 1

State which of the following is an asset?

(i) Expense accrued
(ii) Expense prepaid
(iii) Income accrued
(iv) Income prepaid

A (i)
B (iii)
C (i) and (iv)
D (ii) and (iii)

Question 2

Miliguri Co had made use of the services of a security agency for the month of December 20X6.

However, by the time the financial statements for the year ended 31 December 20X6 were prepared, the invoice for this amount had not been received. The value of the services of the security agency was estimated at Tshs25 million. Show the accounting adjustments for the years 20X6 and 20X7.

Also show the extracts of the financial statements, assuming that the security expenses appearing in the trial balance before this adjustment are Tshs200 million.

Question 3

Solotel Inc rented new premises for its office on 1 October 20X6 and paid four months' rent, amounting to Tshs20 million on the same date. Show the accounting entries for the year ended 31 December 20X6 and 31 December 20X7 and the extracts from the financial statements for the year ended 31 December 20X6.

Question 4

Mallone Inc invested Tshs100 million in 8% debentures on 1 November 20X6. The next due date for receiving the interest is 31 March 20X7. Show the accounting adjustments related to accrued interest for 20X6 and 20X7, and the extracts from the financial statements for 31 December 20X6.

Question 5

At Choice Ltd, a financial services company, salaries are paid on the seventh day of the following month. Monthly salary expenses are Tshs5 million. For preparation of the statement of financial position on 31 December 20X7 state the amount to be recorded in the statement of profit or loss and its effect on profit and net assets. Also show the treatment in the statement of financial position.

Question 6

Khosala Co rented out one of its vehicles for an agreed price of Tshs200,000 per month to Tosala Co. It was decided that Tosala Co would pay the rent quarterly. On the end of the reporting period, rent for 3 months was outstanding.

How would this amount of Tshs600,000 be reflected in Khosala's statement of financial position?

A Tshs600,000 as an asset
B Tshs600,000 as a liability
C No recording in the SOFP, as it is not actually paid.
D No recording, as it is not a business income.

Question 7

A company receives rent from a large number of properties. The total received in the year ended 30 April 20X6 was Tshs481,200,000.

The following were the amounts of rent in advance and in arrears at 30 April 20X5 and 20X6:

	30 April 20X5	30 April 20X6
	Tshs'000	Tshs'000
Rent received in advance	28,700	31,200
Rent in arrears (all subsequently received)	21,200	18,400

What amount of rental income should appear in the company's statement of profit or loss for the year ended 30 April 20X6?

A Tshs486,500,000
B Tshs460,900,000
C Tshs501,500,000
D Tshs475,900,000

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **D**.

Prepaid expenses and accrued income.

Answer to SEQ 2

Year 20X6

The accounting entry for recording accrued expenses is:

		Tshs'000	Tshs'000
Dr	Security expenses (reflected as expense in SOPL	25,000	
Cr	Provision for expenses (reflected as liability in SOFP)		25,000

Being security expenses for December 20X6 recorded

Extracts from financial statements:

Statement of profit or loss	**Tshs'000**
Administration expenses:	
Security expenses (Tshs200,000 + Tshs25,000)	225,000

Statement of financial position	**Tshs'000**
Current liabilities	
Provision for expenses	25,000

Year 20X7

The entry made above is reversed

		Tshs'000	Tshs'000
Dr	Provision for expenses	25,000	
Cr	Security expenses		25,000

Being the reversal provision for security expenses for December 20X6

Answer to SEQ 3

When rent was paid, the entry would have been:

		Tshs'000	Tshs'000
Dr	Rent (Expense)	20,000	
Cr	Cash		20,000

Being the payment of rent for four months from 1 October 20X6

At the year end, we need to adjust prepaid expenses.]

The total amount paid is Tshs20 million for the period from 1 October 20X6 to 31 January 20X7.

The period from 1 October 20X6 to 31 December 20X6 relates to 20X6, and the rent expense for this period has accrued.

Rent for January 20X7 needs to be carried forward as prepaid rent, since it relates to the next financial year.

The amount of rent for January 20X7 is Tshs20 million/4 years = Tshs5 million

The accounting entry is;

		Tshs'000	Tshs'000
Dr	Prepaid rent (reflected as an asset in the SOFP	5,000	
Cr	Rent (reflected as an expense in the SOPL)		5,000

Being prepaid rent for January 20X7 adjusted

Extracts from financial statements:	**Tshs'000**	**Tshs'000**
Statement of profit or loss		
Administration expenses:		
Rent (Tshs20,000 - Tshs5,000)	15,000	
SOFP		
Current assets		5,000
Prepaid rent		

It can be seen that the adjustment of prepaid rent of Tshs5 million ensures that only the rent for 20X6 is shown as an expense in the statement of profit or loss, and that the prepaid amount is shown as an asset. If this adjustment was not made, the full amount of Tshs20 million would have been shown as an expense.

Year 20X7

The entry made above will be reversed as follows:

		Tshs'000	Tshs'000
Dr	Rent	5,000	
Cr	Prepaid rent		5,000

Being the reversal of the adjustment of prepaid rent for January 20X7

Answer to SEQ 4

Interest from 1 November 20X6 to 31 December 20X6 has accrued until the end of the financial year 20X6. The amount is: Tshs100 million x 8/100 x 2/12 = Tshs1,333,333

The accounting entry is:

		Tshs	Tshs
Dr	Interest accrued on 8% debentures (asset)	1,333,333	
Cr	Interest on debentures (income)		1,333,333

Being interest accrued until 31 December 20X6 on 8% debentures recorded

Extracts from financial statements:

Statement of profit or loss

Other Income:
Interest on 8% debentures Tshs1,333,333

Statement of financial position

Current Assets
Interest accrued on 8% debentures Tshs1,333,333

Year 20X7

The accrual entry made at the end of 20X6 is reversed as follows:

Dr	Interest on debentures (income)	Tshs1,333,000	
Cr	Interest accrued on 8% debentures (asset)		Tshs1,333,000

Being entry for interest accrued until 31 December 20X6 on 8% debentures reversed

Answer to SEQ 5

As salary is paid on the seventh day of the following month. The salary for one month will be outstanding i.e. Tshs5 million at the end of the accounting period. The amount to be recorded as expenses in the statement of profit or loss is Tshs5 million x 12 = Tshs60 million i.e. salary paid + outstanding salary. When the expense is recorded, profit will decrease and so will the net assets. This outstanding salary of Tshs5 million is shown as a liability of the company.

Answer to SEQ 6

The correct option is **A**.

This amount of Tshs600,000 (i.e. 3 months rent) is income yet to be received, but has already accrued with Khosala. As a result this amount would be shown as an asset in Khosala's statement of financial position.

Answer to SEQ 7

The correct option is **D**.

The correct answer is arrived at as follows:

Rent Receivable account

Dr			Cr
	Tshs'000		**Tshs'000**
Balance b/d	21,200	Opening balance	28,700
Transfer to SOPL (balancing figure)	475,900	Disposal	481,200
Closing balance	31,200	Balance c/d	18,400
	528,300		**528,300**

SECTION D

THE ADJUSTMENTS TO PREPARATION OF FINANCIAL REPORTS

D2

STUDY GUIDE D2: RECEIVABLES AND PAYABLES

Get Through Intro

Efficient management of receivables and payables is important for finance as well as accounting functions:

For finance - because they directly affect the cash flows as no other component does.
For accounts - because they contain numerous transactions that are to be recorded and presented so as to give a fair presentation in the financial statements.

In view of the large volume of transactions and their direct impact on the liquidity of the company, regular system checks are needed, e.g. age wise debt analysis for the receivables so as to identify debts which have been outstanding for a long time and may turn bad (i.e. no payment will be made for those debts). Similarly we can obtain suppliers' statements and reconcile the transactions they have with our records.

Bad debts are a risk that a business accepts when they make credit sales (sales where payment for the goods is not made immediately, but after a period of time e.g. 1 month). However, this risk is not to be undertaken recklessly. There has to be a systematic check of credit appraisals and credit limits so as to minimise this risk. Otherwise, not only is the profitability of a business affected, but its very existence is endangered!

This Study Guide discusses the accounting of receivables and payables, which is an important function of all accountants.

Learning Outcomes

a) Identify and describe different examples of receivables and payables.
b) Identify the benefits and costs of offering credit facilities to customers and taking credit from suppliers.
c) Explain the purpose of an aged receivables analysis in credit control and accounting.
d) Explain the purpose of credit limits.
e) Record the ledger accounting entries to write off a bad (irrecoverable) debt.
f) Record the ledger accounting entries, for a bad (irrecoverable) debt recovered.
g) Identify the impact of bad (irrecoverable) debts on the statement of profit or loss and on the statement of financial position.
h) Record the ledger accounting entries to create and subsequently adjust an allowance for receivables.
i) Illustrate how allowance for receivables and their subsequent adjustments appear in the main financial statements.
j) Account for contras between trade receivables and payables in personal and general ledger accounts.
k) Prepare, reconcile and understand the purpose of supplier statements.
l) Classify items as current or non-current liabilities in the statement of financial position.

1. Identify and describe different examples of receivables and payables.

[Learning Outcome a]

1.1 Trade receivables

Sales to customers may be either for cash or credit. If goods are sold on credit then the amount receivable for goods sold is shown as trade receivables in the records of the seller. This will be shown on the assets side of statement of financial position in the seller's financial statements. When the buyer eventually pays, the cash paid is set off against the receivables account.

Example

Johnson sold goods to Thomson worth Tshs5 million on 30 November 20X6. They agreed on a credit period of two months. Thomson paid for the goods on 31 January 20X7 according to the agreed credit terms. Therefore, in Johnson's financial statements, an amount of Tshs5 million receivable from Thomson is shown as a trade receivable. This is because as on 31 December 20X6 Thomson owes Johnson Tshs5 million.

The journal entries to record this amount of receivables in Johnson's accounts are as follows:

Journal entry to record the credit sale			Journal entry to record the collection of receivables		
Dr Trade receivables (Thomson)	Tshs5m		Dr Cash	Tshs5m	
Cr Sales		Tshs5m	Cr Trade Receivables (Thomson)		Tshs5m
Being credit sales recorded			Being collections made		

1.2 Trade payables

If goods are purchased on credit, the amount payable for goods purchased is shown as trade payables in the records of the purchaser.

Example

In the previous example of Thomson and Johnson, Thomson will show Tshs5 million as a trade payable under liabilities in Thomson's financial statements.

The journal entries to record this amount of payables in Thomson's accounts are as follows:

Journal entry to record credit purchases			Journal entry to record payment of dues		
Dr Purchases	Tshs5m		Dr Trade payables (Johnson)	Tshs5m	
Cr Trade payables (Johnson)		Tshs5m	Cr Cash		Tshs5m
Being credit purchases recorded			Being cash paid for the outstanding payables		

Other receivables and payables

There may be other receivables and payables that are included in the overall figure of receivables and payables. Examples of other receivables are:

Loans and advances to employees
Receivables on assets sold
Interest receivable on loans given out
Claims not paid

These receivables do not result from the normal operations of the business i.e. out of the usual sales of the business. They are present separately from the entity's trade receivables in the entity's financial statements.

Example

An insurance claim of Tshs25 million was authorised on 1 November 20X6 but the amount was not received at the end of the reporting date, i.e. 31 December 20X6. The amount is shown as other receivables apart from the company's trade receivables. These receivables would be classified under non-current assets.

The same rules apply to trade payables and other payables.

Example

Uno Ltd sold a machine to Dos Co for Tshs40 million on 26 July 20X6. Of this amount, Tshs18 million was paid upfront while Tshs22 million was to be paid by Dos co on 1 April 20X7. Therefore the outstanding amount of Tshs22 million was shown as a receivable on 31 December 20X6, when Uno prepared its financial statements. This receivable would be classified under non-current assets and not under current assets since it is not a part of its regular trade receivables.

Test Yourself 1

Ambition Ltd sold goods worth Tshs56 million to Dream Ltd on 26 July 20X6. The statement of financial position of Ambition Ltd is prepared on 31 March 20X7. During that period Dream Ltd paid Tshs43 million. State the amount to be shown in the statement of financial position as on 31 March 20X7 as receivables from Dream Ltd. Assume that there is no opening balance of Dreams Ltd as on 1 April 20X6.

A Tshs56,000,000
B Tshs13,000,000
C Tshs43,000,000
D Nil

---

2. Identify the benefits and costs of offering credit facilities to customers and taking credit from suppliers.
Explain the purpose of an aged receivables analysis in credit control and accounting.
Explain the purpose of credit limits.

[Learning Outcomes b, c and d]

2.1 Benefits of offering credit facilities to customers

Quite often, businesses will extend credit facilities to their customers as a strategy for increasing sales. Customers are allowed a certain amount of credit for goods and services and are allowed a certain period within which payment must be made.

Everyone wants their money to go the furthest. In this manner, customers would prefer those suppliers that offer them the most beneficial credit terms.

Offering credit can result in increased sales. If you are allowing them a credit period to pay, then automatically the customers would have a higher buying power. In the marketplace, an entity can eat into its competitors' market share by offering its customers a longer credit period.

Example

Thomson and Johnson are competitors. Thomson sells goods for cash, with a 15 day credit period. A year later, Johnson offered a 30 day credit period. As a result, a major chunk of Thomson's customers moved to Johnson.

Another benefit of offering credit facility to customers is that it can give the organisation a competitive advantage over other organisations that don't offer credit. By offering credit, a relationship of trust can be built with the customers. Another aspect of offering credit is the fact that the entity believes in the product being sold and is confident about customer satisfaction. It shows that the entity is ready to take risk since it is confident that the goods and services being supplied will meet the customers' expectations.

2.2 Costs of offering credit facilities to customers

On the flipside, offering customers credit facilities has its own costs and limitations. According to an old school of thought, an entity should delay all payment to be made to external parties, but recover all amounts due as soon as possible. This is to keep as much liquid cash as possible with the entity to meet its own transactionary, precautionary and speculative motives.

(a) **Working capital is tied up in receivables**. Due to this the entity has to incur finance costs.

Example

Two lots of goods worth Tshs10 million are sold on 1 January 20X7. The first lot is sold to Dosh for cash and the second lot is sold to Kred on 60 days credit. With the first lot, the entity receives cash immediately. With the second lot, the amount is received after 60 days. This means that working capital of Tshs10 million is tied up in receivables. The company has an overdraft account on which it pays interest at 10%. Since the receipt of the amount of Tshs10 million from the customer is delayed by 60 days (due to credit being given), the overdraft remains higher by Tshs10 million for 60 days. The company pays interest at 10% on this. The interest paid will be called as finance cost.

The finance cost is = Tshs10 million x 10% x 60/365 = Tshs164,384

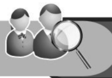
(b) When credit is allowed, there is always a **risk of bad debts**, i.e. the customer failing to pay. This may increase the bad debt expenses.

(c) The managing of accounts receivables requires an **administrative set up for record-keeping**, **follow-up and collection** of amounts from customers. This set up can come only with certain costs such as salaries, rent, stationery etc.

2.3 The purpose of an aged receivables analysis

The amount reflected as trade receivable in the statement of financial position consists of the total of all outstanding amounts receivable from customers. The number of customers who are included in receivables can vary from one to any number. E.g. Bee Co could have amounts receivable from one customer while Dee Co could have amounts due from seven customers.

In addition to this, the amount receivable from every customer could be against one invoice or many.



Example

The amount receivable from Nelson Co is Tshs75 million. This amount relates to invoice No. 66 dated 1 September 20X6. As on 31 December 20X6, this entire balance is four months old.

The amount due from Gelson (Tshs25 million) is towards invoice No. 87 dated 25 December 20X6.

The total receivables from Polson as on 31 December 20X6 are Tshs100 million. The invoices which make up this balance are:

Invoice No.	Date	Tshs'000
51	1 June 20X6	20,000
105	1 November 20X6	45,000
110	30 December 20X6	35,000
		100,000

The company offers a credit period of 90 days to its customers.

In an aged receivable analysis, receivables are analysed according to the period of time for which the debts remain outstanding. This gives information about the exact age of each debt. The aged receivable analysis as at 31 December 20X6 is as follows:

Continued on the next page

Outstanding for							
Name of customer	**0 - 3 months (i.e. from 1/10/20X6 to 31/12/20X6)**		**3 - 6 months (i.e. from 1/07/20X6 to 30/09/20X6)**		**6 - 9 months (i.e. from 1/04/20X6 to 30/06/20X6)**		**Total amount**
	Invoice no	**Amount**	**Invoice no**	**Amount**	**Invoice no**	**Amount**	
		Tshs'000		Tshs'000		**Tshs'000**	**Tshs'00**
Polson		45,000				20,00	
	105	35,000				0	
	110	**80,000**			51	**20,00**	100,000
Gelson	**Sub total**	25,000					25,000
Nelson	87		66	75,000			75,000
Total		**1,05,000**		**75,000**		**20,00**	**200,000**

More urgency and efforts are needed in collecting old receivables. Experience suggests that the older the debts become, the lower the chances of recovering them either fully or partly.

The credit period agreed with Polson is 90 days i.e. 3 months. The aged receivable analysis shows that there is a problem with invoice no 51 and some strict action is required to recover it immediately. This will include calling Polson up, and discussing the payment with him.

2.4 Purpose of credit limits

Once a customer is considered to be credit worthy i.e. goods can be sold to him on credit, the company has to decide the credit limit for the customer. Credit limit means the maximum**:**

- amount up to which the customer is allowed to buy on credit, and
- period of credit that can be allowed to him.

The credit limit can be determined:

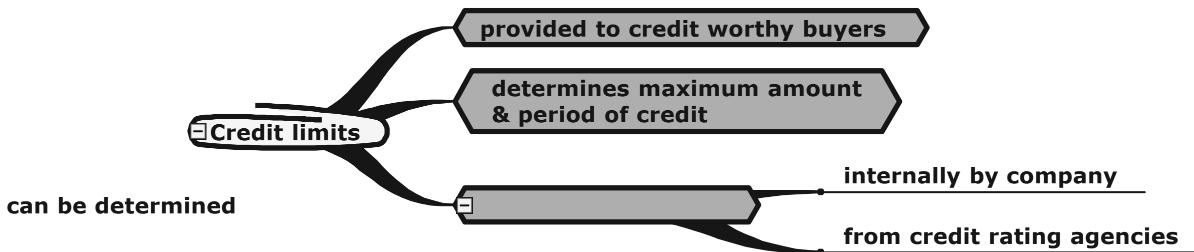
- internally by a company or
- based on data / analysis received from credit rating agencies

The credit limit for each customer is regularly reviewed. Orders are not accepted if they may result in:

- the customer paying after the authorised credit period or
- there were problems while recovering of dues from this customer in the past
- the customer's total authorised credit amount being exceeded

The fixing of a credit limit assumes that the creditworthiness of the customer is assessed. There is no question of authorising any credit limits unless the customer is creditworthy.

SUMMARY



2.5 Assessing creditworthiness

Creditworthiness refers to the **ability of the customers** to meet their commitments regarding payment of their debts.

If the creditworthiness of a **new customer** is checked before credit is granted, the risk of bad debts and slow payment is minimised. Similarly, it is essential to monitor the payment history of existing customers on a regular basis since those who were paying promptly may not necessarily continue to do so. The following methods are used:

1. Bank references

Bank references provided by new customers give information about their financial standing but, because they tend to be quite general and vague, are not really relied on.

2. Trade references

Trade references provide information about the satisfactory conduct of business dealings between potential customers' and their suppliers. The problem with these, however, is that the customer is free to choose the supplier providing the trade reference. As such, it is unlikely that they will select a supplier with whom they have a poor trade relationship.

3. Analysis of financial information

The financial statements of a customer provide some useful information about his creditworthiness. The number of days receivable and payable as well as inventory holding periods will give an indication of the length of their cash operating cycle. Profitability and liquidity can also be assessed as these will provide some indication of the customer's ability to pay.

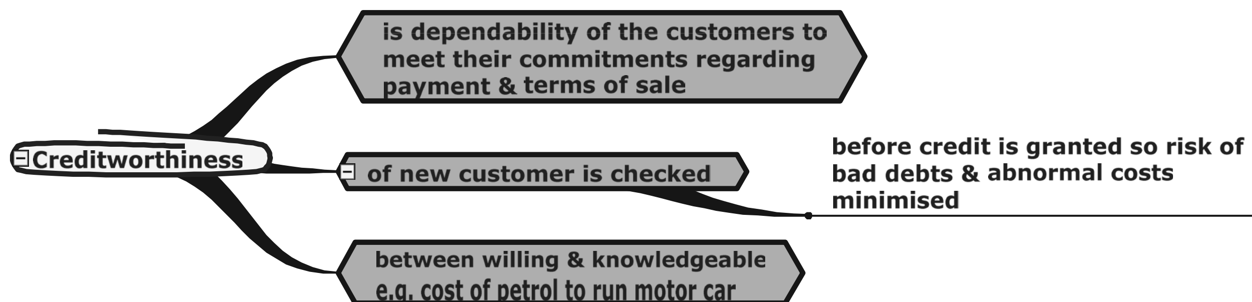
4. Credit rating

Professional credit rating agencies such as Dunn and Bradstreet, Moody's and Standard and Poor's provide credit reports on certain entities and individuals such as their credit history, payment trends, financial problems, and other relevant information.

5. Publicly available information

Publicly available information such as press reports, newspaper and magazine articles and annual financial reports published by companies which are available to the public can also be used when determining the credit limit for customers / potential customers.

SUMMARY



Test Yourself 2

The total receivables of Ambition Ltd on 31 December 20X7 are Tshs123 million; the details of the receivables are as follows:

Invoice No.	Date	Tshs'0
43	04/05/20X7	53,000
102	08/09/20X7	34,000
123	28/10/20X7	13,000
145	30/12/20X7	23,000

State how much of the trade receivables are older than 180 days.

A Tshs53,000,000
B Tshs87,000,000
C Tshs36,000,000
D Tshs23,000,000

3. Record the ledger accounting entries to write off a bad (irrecoverable) debt.
Identify the impact of bad (irrecoverable) debts on the statement of profit or loss and on the statement of financial position.
Record the ledger accounting entries for a bad (irrecoverable) debt recovered.
[Learning Outcomes e, g and f]

3.1 Bad debt

Sometimes, despite effort taken to establish the creditworthiness of customers, there are still amounts that are not recoverable. These amounts are called bad debts or irrecoverable debts in business parlance.

Bad debts could arise as a result of various reasons including:

Insolvency of a customer
Death of a customer
Dishonesty

Having understood this problem, let's understand the implications of incurring bad debts in the accounts of the supplier / seller:

Whatever the reason, if the company gives up the hope of receiving the payment due from a customer and stops following it up, the debt is said to become bad. The following entries are made to write off a bad debt:

1.

Dr	Bad debts expense	X	
Cr	Trade receivable		X

Being removing the receivable amount and transferring it to bad debts expenses

In the receivables individual ledger accounts, these balances will be removed from the ledger.

Macintosh sold goods to Jones for Tshs5 million on credit terms. However, Jones died leaving behind no asset to pay off his debt to Macintosh. Macintosh has no alternative but to write off the debt from his books of account as a bad debt.

3.2 Impact of bad debts on the statement of profit or loss and the statement of financial position

1. **Statement of profit or loss:** a bad debt is after all, an added cost to the organisation. This is because the costs of selling, distributing and collecting it have not been and will not be recovered by the organisation. As a result, the net profit for the year is reduced.

2. **Statement of financial position**: with a debt being termed as irrecoverable / bad, the resultant balance in the trade receivables account is reduced. While trade receivables on the assets side are reduced; an equal reduction occurs in the owner's equity because of the reduced profits.

At the year end 31 December 20X6, the financial statements of Donald Co showed a trade receivable of Tshs60 million. The trade receivables comprised the amounts to be received from the following customers:

Rogers Tshs15 million
Ronnie Tshs12 million
Ambush Tshs6 million
Ian Tshs27 million

On investigation it was revealed that Ambush had died and his estate paid only Tshs4.5 million to Donald Co i.e. the remaining Tshs1.5 million is not recoverable in future. Rogers is facing financial losses and has expressed his inability to pay the debt. The debt is settled at Tshs10 million. Donald Co's management has decided to write off the remaining Tshs5 million as a bad debt.

Continued on the next page

We will see how these transactions can be recorded in the books of Donald Co and the impact of bad debts on its statement of profit or loss for the year ended 31 December 20X6.

When bad debts are written off the following entry is made:

		Tshs'000	Tshs'000
Dr	Bad debts	6,500	
Cr	Trade receivables		6,500

Being amount receivable from Ambush and Rogers written off partly

Trade receivable account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Balance b/d	60,000	31/12/20X6	Bad debts	6,500
			31/12/20X6	Balance c/d	53,500
	Total	**60,000**		**Total**	**60,000**

Bad debts account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
31/12/20X6	Trade receivable	6,500	31/12/20X6	Transferred to SOPL	6,500
	Total	**6,500**		**Total**	**6,500**

Presentation in financial statement:

Statement of profit or loss		
	Tshs'000	Tshs'000
Income	X	
Less: Expenses		
Bad debts	(6,500)	
Total		**X**

Statement of financial position		
	Tshs'000	Tshs'000
Non-current assets		X
Current assets		
Trade receivable	53,500	
	Total	

3.3 Bad debts recovered

At times a bad debt that was written off earlier is recoverable at a later date. Here, there is no point in crediting receivables as the amount is no longer in receivables (remember it was written off as an expense). It is brought into the statement of profit or loss as any other unexpected income. Hence the entry to be made will be:

Dr	Cash	X	
Cr	Bad debts recovered account (income, hence SOPL)		X

Being cash received from accounts receivables which had already been written off

Example

Continuing the example of Donald Co

The amount of Tshs5 million which was written off as a bad debt in the financial year 20X6 is recovered in the financial year 20X7. When the debt subsequently becomes recoverable in 20X7, the accounting entry is recorded in the books of 20X6, as follows:

Dr	Cash	Tshs5 million	
Cr	other income		Tshs5 million

Being the entry, unexpected cash received from an accounts receivable that was previously accounted for as a bad debt

Statement of profit or loss	Tshs'000
Income	X
Bad debts recovered	5,000
Less: Expenses	(X)
Total	**XX**

Test Yourself 3

James purchased goods worth Tshs20 million from John on 1 March 20X8. He was unable to pay the amount and was deemed to be irrecoverable on 20 January 20X9. James paid Tshs20 million on 30 December 20X9 to John. Pass the necessary journal entries in John's accounts.

Test Yourself 4

Lambert sold goods worth Tshs30 million to Bambert, in 20X5. During 20X6, since the follow-up yielded no results, Lambert wrote-off the amount as a bad debt. Subsequently, during 20X7, Lambert was delighted to receive this entire amount of Tshs30 million. Prepare accounting entries for these transactions for the years 20X6 and 20X7.

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4. Record the ledger accounting entries to create and subsequently adjust an allowance for receivables.
Illustrate how allowance for receivables and their subsequent adjustments appear in the main financial statements.

[Learning Outcomes h and i]

4.1 Nature and accounting entries of a general allowance for receivables

The management of most companies can reliably estimate the percentage of debts which become bad. They rely heavily on the past accounting data and other general information to arrive at this percentage.

Example

Defratis allows two months' credit for credit sales. Defratis' ageing schedule for its trade receivables as at the year end 31 December 20X6 is as follows:

Debt owing since	Amount	Estimated % doubtful	General allowance
	Tshs'000		**Tshs'000**
Less than 2 months	75,000	-	-
2 months to 3 months	10,000	4%	400
3 months to 6 months	5,000	10%	500
6 months to 1 year	500	25%	125
Total	**90,500**		**1,025**

Therefore the total receivables at the end of the reporting period are Tshs90.5 million. An allowance of Tshs1.025 million is provided for as calculated above.

Prudence dictates that the company must recognise the estimated bad debts as a cost in the statement of profit or loss. This cost recognised as an allowance for receivables ensures that the profits and the assets of an entity are not overstated. However, at this stage, management would not know precisely which accounts have actually become bad. Therefore, it is not possible or desirable to write off any specific accounts. An allowance for receivables also known as an allowance for bad debts allows the entity to recognise the cost, without touching individual receivable accounts. This overall allowance for a certain percentage is known as a general allowance for receivables.

Example

In the above example Tshs1,025 million is shown as an expense (bad and doubtful debt / allowance expense) but individual accounts of the receivables are not touched. A separate general allowance account is created, which is deducted from the total receivables balance.

The accounting entries are as follows:

1. In the year in which the allowance is created:

Dr	Bad and doubtful debts expense	X	
Cr	Allowance for receivables		X

Being an allowance made against doubtful debts

The doubtful debts expense is an expense account in the statement of profit or loss. It usually forms a part of the bad debt expense account.

The allowance for receivables is a separate account which is reduced from trade receivables in the statement of financial position.

2. In subsequent years, the following steps are taken:

a) The allowance required at the end of the financial year will change as the sales figure will have changed. A new allowance is calculated (e.g. on percentage of sales in the subsequent year-end).

b) It is compared with the existing (opening) balance of the allowance.
If the new allowance required is greater than the existing opening balance then allowance has to be increased.

The following journal entry is made:

Dr	Bad and doubtful debts expense	X	
Cr	Allowance for receivables		X

Being an increase in allowance for receivables accounted for

If the new allowance required is less than the existing opening balance then allowance has to be decreased.

The following journal entry is made:

Dr	Allowance for receivables	X	
Cr	Bad and doubtful debts expense		X

Being a decrease in allowance for receivables accounted for

Example

Headsar Ltd has total receivables outstanding on 31 March 20X6 of Tshs32 million. It is estimated that 1.5% of the receivables will not be collected, so therefore it was decided to make an allowance for this. Being the first year there is no opening balance of allowance for receivables. On 31 March 20X7, the receivables outstanding are Tshs52 million. The allowance is made at the rate of 7%. You are asked to make the accounting entries.

1. Journal entry as on 31 March 20X6

		Tshs'000	Tshs'000
Dr	Bad and doubtful debt expense	480	
Cr	Allowance for receivable		480

Being an allowance made for doubtful debts

Allowance required = Tshs32 million x 1.5% = Tshs480,000

2. In the subsequent year i.e. on 31 March 20X7

Dr	Bad and doubtful debt expense	3,160	
Cr	Allowance for receivables		3,160

Being the increase in allowance made against doubtful debts

Note (Amounts in Tshs'000)

Allowance required for the current year =	Tshs52,000 x 7%	= 3,640
Less: Existing balance in the allowance account		480
		3,160

4.2 Presentation in the financial statements

1. Presentation in statement of profit or loss

(a) Bad debts are transferred to the statement of profit or loss as an expense.

(b) The increase in the allowance for receivables during the year is transferred to the statement of profit or loss as an expense.

(c) The decrease in the allowance for receivables during the year is transferred to the statement of profit or loss as a credit in the total bad and doubtful debt expense.

(d) If the decrease in the allowance for receivables during the year is greater than the bad debt expense then the excess is disclosed as an increase in the expenses.

Diagram 1: Credit in statement of profit or loss

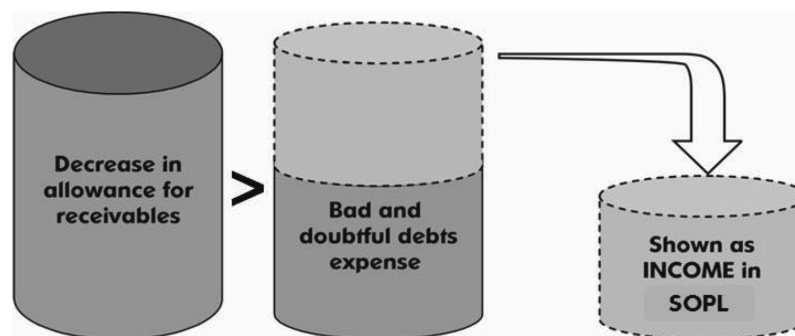
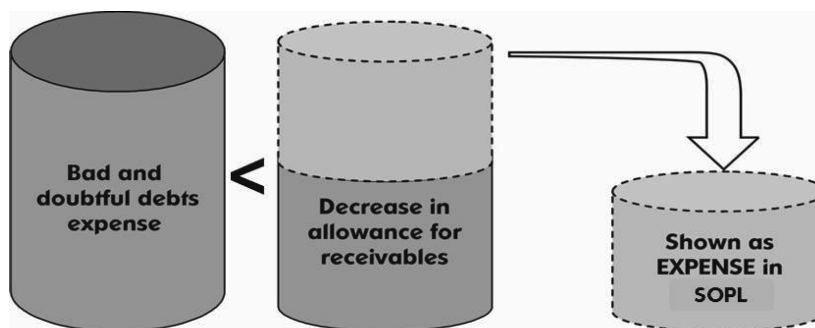


Diagram 2: Debit in statement of profit or loss



Example

The following is date pertaining to Excello Co and Demello Co during 20X6 regarding bad debts written off and change in allowance for receivables:

	Excello	Demello
	Tshs'000	Tshs'000
Bad debts written off	70,000	80,000
Change in the allowance for receivables	(50,000)	(90,000)
Net amount	**20,000**	**(10,000)**

The difference between bad debts written off and allowance for receivables is recognised in the following manner:

Excello Tshs20 million: reflect as an expense in the statement of profit or loss.
Demello (Tshs10 million): reflect as other income in the statement of profit or loss or as a reduction in bad debt expense.

2. Presentation in statement of financial position

The closing balance of the allowance for receivables is always reduced from the trade receivables in the statement of financial position. This reduces the trade receivables to their net realisable value. In real life, the net figure of receivables may be shown directly in the statement of financial position.

In the examination present it in the following manner:

	Tshs'000
Trade Receivables	350,000
Less: Allowance for receivables	(20,000)
Net Trade receivables	**330,000**

This shows the examiner that you know the correct procedure.

Example

Information provided by Clover Ltd for the last three years is as follows:

	31/12/20X5	31/12/20X6	31/12/20X7
	Tshs'000	Tshs'000	Tshs'000
Gross profit	32,000	48,000	64,000
Irrecoverable debts written off	2,000	1,000	3,000
Receivables as at 31 December	45,000	58,000	42,000
Salary	2,000	5,000	4,450
Conveyance	1,000	1,100	1,300
Other expenses	1,000	1,500	2,000
Vehicle expenses	2,000	2,330	2,830

Allowance for receivables at 2% on opening balance of receivables
Being the first year of operation, there were no opening balances for 20X5.

Required:

Prepare the statement of profit or loss and show how the receivables will appear in the statement of financial position.

Answer

Statement of profit or loss for the year

	20X5		20X6		20X7	
	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000	Tshs'000
Gross profit		32,000		48,000		64,000
Expenses:						
Irrecoverable debts written off	2,000		1,000		3,000	
Increase / decrease in allowances for receivables (W1)	900		260		(320)	
Salary	2,000		5,000		4,450	
Conveyance	1,000		1,100		1,300	
Other expenses	1,000		1,500		2,000	
Vehicle expenses	2,000	(8,900)	2,330	(11,190)	2,830	(13,260)
Net profit / loss		**23,100**		**36,810**		**50,740**

Continued on the next page

Extracts from the statement of financial position **as at:**

	31/12/20X5 Tshs'000	31/12/20X6 Tshs'000	31/12/20X7 Tshs'000
Current assets			
Receivables	45,000	58,000	42,000
Less: Allowance for receivables (W1)	(900)	(1,160)	(840)
Net receivables	**44,100**	**56,840**	**41,160**

Workings (Amounts in Tshs'000)

W1 Allowance for receivables

31 December 20X5

Allowance required = 2% of x Tshs45,000= Tshs900
No opening balance of allowances, therefore an allowance should be made for Tshs900.

31 December 20X6

	Tshs'000
Allowance required = 2% x Tshs58,000	1,160
Less: Balance in allowance account	(900)
Increase in allowance	**260**

31 December 20X7

	Tshs'000
Allowance required = 2% x Tshs42,000	840
Less: Balance in allowance account	(1,160)
Decrease in allowance	**(320)**

4.3 Specific allowances for doubtful debts

If we are unsure at the moment whether or not we will receive the money from a specific receivable, it would be wise to set up an allowance against that receivable. This is again in keeping with the principle of prudence that makes provision for any anticipated losses.

Note that the receivable balance still remains in the receivables account, but an allowance is created against it and is shown as a deduction against receivables in the **statement of financial position**.

Also note that a doubtful debt is not the same as an irrecoverable / bad debt. A bad debt is an amount that has been written off as the supplier knows that the receivable is irrecoverable. This means that some event has occurred (such as the debtor has been declared bankrupt) or management has taken an informed decision to classify the debt as irrecoverable. A doubtful debt on the other hand, has its chances of being classified as bankrupt, but there is no event that has taken place, nor has management classified the debt as irrecoverable.

The double-entry is:

		Dr	Cr
Dr	Doubtful receivables expense (expense SOPL)	X	
Cr	Allowance for receivables (deducted from receivables in SOFP)		X

Being a specific allowance made against a particular customer

If, at some point in the future, money is recovered from the receivable, the entries to be made will be:

		Dr	Cr
Dr	Cash	X	
Cr	Trade receivables		X

Being cash received from a receivable

		Dr	Cr
Dr	Allowance for receivables (deducted from receivables in SOFP)	X	
Cr	Doubtful receivables expense (expense SOPL)		X

Being the removal of the allowance that is no longer needed, as the receivable has been paid

Example

Joey has an outstanding receivable from Friends Co for Tshs2 million. Joey's normal credit terms are 60 days, but Friends Co has already taken 90 days and has not indicated when they are likely to pay the receivable due. Joey feels he should make an allowance against this receivable. Currently, the total receivables owed to Joey amount to Tshs43.2 million. Joey also wishes to make a general allowance of 2% on the remaining receivables. Last year he had a general allowance of Tshs600,000.

Required:

(i) Show the double entry that should be made in this case.
(ii) Prepare extracts from the financial statements.

Answer

(i) Accounting entries

As the amount from Friends is unsure, it would be wise to make a specific allowance against receivables.

		Tshs'000	Tshs'000
Dr	Bad and doubtful debt expense	2,000	
Cr	Allowance for receivables		2,000

Being an amount due from Friends Co that has not been paid and therefore doubtful

The receivables after the allowance are (Tshs43.2 million – Tshs2 million) = Tshs41.2 million

Hence, the general allowance will be 2% x Tshs41.2 million which is Tshs824,000. Last year's allowance was Tshs600,000 which means that Joey needs to increase his provision by Tshs224,000.

		Tshs'000	Tshs'000
Dr	Bad and doubtful debt expense	224	
Cr	Allowance for receivables		224

Being provision made for increased provision for doubtful debts

(ii) Extracts from Joey's financial statements

Statement of financial position	**Tshs'000**
Current assets	
Receivables	43,200
Less: Allowance for receivables (Tshs2,000 + Tshs824)	(2,824)
Receivables balance shown in the SOFP	**40,376**

Statement of profit or loss	**Tshs'000**
Allowance for receivables expense (Tshs2,000 + Tshs224)	2,224

4.4 How are bad debts and the allowance for receivables calculated?

When a particular debt is written off as bad, the total receivables are reduced. The **allowance for receivables** is created only for the debts that are still receivable.

Therefore, when bad debts as well as the allowance for receivables is to be calculated:

First deduct the amount of bad debts from the receivables (if they are not already reduced).

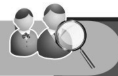
Then deduct any specific allowances.

Finally calculate the allowance based on the remaining 'good' receivables.

Tip

Remember that you MUST deduct the bad debt and any other allowances given first and only then calculate the allowance for receivables. Keep in mind that an allowance for receivables is done on the "good" receivables. "Out these good receivables, which one do we think may not fetch us the money that is due to us?"

Exception to this rule: An exception to this rule is when the question specifically mentions that allowance on receivables is to be made on the "opening balance". This is the only place where you DO NOT deduct the bad debts and any other allowances. (For an example on this exception, refer to the previous example of Clover Ltd discussed earlier in this Learning Outcome.)



Example

Receivables per trial balance	Tshs500,000
Bad debts to be written off	Tshs10,000
Specific allowances to be provided for	Tshs10,000
Allowance for receivables required @5%.	

Amount of the allowance required is 5% x (Tshs500,000 - Tshs10,000 - Tshs10,000) = Tshs24,000

It would be wrong to calculate 5% on Tshs500,000 since we should not show a double allowance on Tshs20,000 that is to be fully written off. That would duplicate expenses.

Test Yourself 5

Somergate Co's books showed the following balances on 31 December 20X7.

	Debit	Credit
Trade Receivables	Tshs300,000	
Allowance for receivables		Tshs5,000

A debt of Tshs10,000 receivable from Tomergate was confirmed to be irrecoverable during 20X7. No accounting entry was made to record this. It was decided that the allowance for receivables would be maintained at 2% of the receivables.

Required:

Show the accounting entries for the above transactions and the presentation in the financial statements.

Test Yourself 6

Allowance for receivables is made:

(i) when, on the basis of past experience, it is estimated that a certain percentage of the receivables are not recoverable on an average
(ii) in accordance with the accounting principle of prudence
(iii) when management is not sure exactly which receivables accounts will definitely become irrecoverable
(iv) on the total amount of receivables without touching individual receivable accounts

Which of the above is correct?

A (i)
B (i) and (ii)
C (i), (ii) and (iii)
D All of the above

5. Account for contras between trade receivables and payables in personal and general ledger accounts.

[Learning Outcome j]

In the practical business world, at times there may be sales to, as well as purchases from the same party.

A contra between trade receivables and payables means of-setting (cancelling) the amounts due to a party in the receivables ledger with the amounts due from the same party in the payables ledger.

This is done with a view to settle the net amount receivable or payable in cash. For this, an accounting entry is needed to transfer the amounts between the receivables and payables ledgers.

Tip

Unless there is a clear intention to actually settle the accounts on a net basis, contra transfers should not be made.

In practice, many people prefer to settle on the net basis, rather than giving one cheque for the amount due to one party and receiving another cheque for the amount receivable from the same party.

Example

Success Co supplies Genu Co with stationery, and also buys exercise books from Genu Co. Success Co will appear both in the receivables ledger and in the payables ledger of Genu Co. Success Co's account in the receivables ledger will normally have a debit balance and in the payables ledger it will normally have a credit balance.

Suppose that the amounts appearing in the books of Genu Co are:

Success Co (receivables)	Dr	Tshs80,000
Success Co (payables)	Cr	Tshs30,000

There is a payment due from Genus Co to Success Co for an order (Tshs30,000) and at the same time a payment from Success Co due to Genus Co (Tshs80,000). The parties may not like to have 2 payments going back and forth, therefore the two payments could be adjusted against each other, and the net balance (Tshs50,000) could be paid by Success Co to Genu Co. This adjustment is known as a **contra adjustment.**

The steps for accounting for a contra-adjustment are:

1. Find out the lower amount of the two payments.
2. The accounting entry made is :

Dr	Trade payables control account (in the nominal ledger)	X	
Cr	Trade receivables control account (in the nominal ledger)		X

Being accounts adjusted for contra entries

These entries are also recorded in the accounts of individual parties in the respective personal ledgers, i.e. receivables ledger and payables ledger. Control accounts and the receivables and payables ledger are explained in Study Guide G2.

Example

Donald Company has the following balances related to Ruskin:

	Ruskin (Tshs'000)
Receivables ledger	4,000
Payables ledger	6,000

Show the contra entry to adjust the balances, assuming that the payment is to be made or received on a net basis. How much cash is paid or received to complete the transaction?

Continued on the next page

Answer

The lower of the two is Tshs4,000,000, which is transferred by making the following entry:

		Tshs'000	Tshs'000
Dr	Trade payables control account (in the nominal ledger)	4,000	
Cr	Trade receivables control account (in the nominal ledger)		4,000

Being accounts adjusted for contra entries

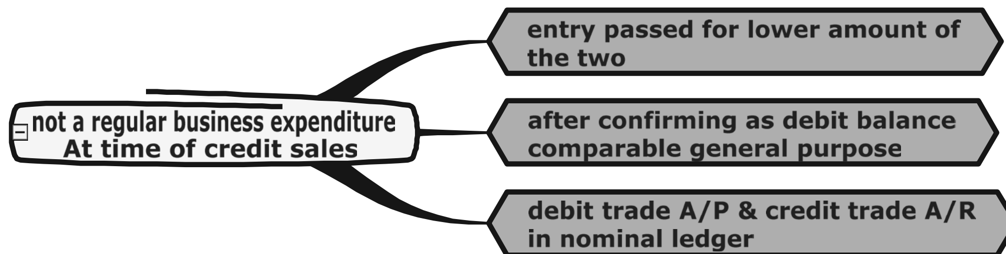
When the net amount is paid the following entry is made:

Dr	Cash (payment made)	2,000	
Cr	Trade payables control account (in nominal ledger)		2,000

Being accounts the cash paid to Ruskin

The individual accounts in the payables ledger and receivables ledger will be adjusted in the same way.

SUMMARY



Test Yourself 7

Telex Plc has the following balances for Fax Ltd on 31 March 20X7. Show the amount that is to be subjected to a contra adjustment, before any cash is paid or received:

Receivables	Tshs14,000,000
Payable	Tshs6,000,000

A Tshs14,000,000
B Tshs6,000,000
C Tshs8,000,000
D No adjustment is required

---

6. Prepare, reconcile and understand the purpose of supplier statements.

[Learning Outcome k]

6.1 Supplier statements

Just as we maintain the accounts of suppliers in our ledgers, suppliers also maintain our accounts in their ledgers. When we credit the supplier for a purchase, the supplier debits us, as it is a sale for him / her. Therefore, ideally, the two accounts should be **mirror images** of each other.

Example

Pen Co sold goods worth Tshs10,000 to Hen Co.

Pen Co makes the following entry:

Dr	Hen Co	Tshs10,000	
Cr	Sales		Tshs10,000

Being the entry to record sales to Hen Co

Continued on the next page

The ledger entry would appear as:

Hen Co Account			
Sales	Tshs10,000		

Hen Co records the following entry:

Dr Purchases Tshs10,000
Cr Pen Co Tshs10,000
Being the entry to record purchases from Pen Co

The ledger extract would appear as:

Pen Co Account			
		Purchases	Tshs10,000

In order to ensure that we have recorded all the transactions with the suppliers correctly, it is very useful to obtain a supplier's statement, and compare it with our records.

Example

Beeline Co purchases goods from Teeline Co on a regular basis. Teelines ledger account appears as follows:

In the books of Beeline
Teeline Account

Dr Cr

(Not recorded by Teeline)

	Tshs		Tshs
Payment - against opening balance	20,000	Balance b/f	25,000
Discount – invoice no. 51	2,000	Purchases - invoice no.51	40,000
Payment - invoice no. 51	38,000	Purchases - invoice no.52	30,000
Partial rejection – invoice no. 52	3,000		
Balance c/f	32,000		
	95,000		**95,000**
Break-down of the closing balance			
Opening balance (Tshs25,000 – Tshs20,000)	5,000		
Invoice no. 52	27,000		
	32,000		

It obtained a statement from Teeline (the supplier) which is as follows:

In the books of Teeline
Beeline Account

Dr Cr

	Tshs		Tshs
Balance b/d	30,000	Payment - against opening balance	20,000
Sales – invoice no.51	40,000		
Sales - invoice no.52	30,000	Payment - invoice no. 51	38,000
		Partial rejection - invoice no. 52	3,000
		Balance c/f	39,000
	100,000		**100,000**
		Break-down of the closing balance	
		Opening balance(Tshs30,000 – Tshs20,000)	10,000
		Invoice no. 51	2,000
		Invoice no.52	27,000
			39,000

(Teeline shows a higher opening balance of Tshs5,000 (Tshs30,000 - Tshs25,000))

Continued on the next page

Pay careful attention to the amounts circled in both of the tables in the above example. Two of the numbers in Beeline's records do not match with its corresponding numbers in the supplier's account. Also, an invoice recorded in Beeline's records is not recorded with the supplier, Teeline.

A comparison may show that certain entries do not match. The reasons could be errors, omissions or differing opinions on:

1. recording an invoice
2. payment on an invoice
3. rejections of certain consignments
4. rates and discounts

These amounts of omissions, errors and differences can be settled through a reconciliation statement.

The break-down of the closing balance is a very useful tool which gives an overall summary of the account. It is not a part of the normal ledger account, but is useful for analysing and reconciling receivables as well as payables.

6.2 Reconciliation of supplier and customer accounts

Reconciliation is an **explanation of the difference** between any two balances. We start at any one balance and arrive at the other balance by a process of addition and subtraction.

We can make a general proforma for the reconciliation:

Balance payable to_____________ according to our records:	X
Add: Items where our credit entries are lower compared to the debit entries in the supplier's statement.	
Purchases not recorded by us.	X
Purchases recorded at a lower amount by us (difference in amount).	X
Any other amounts debited by the supplier to us, but not credited by us, partially or fully.	X
Add: Items where our debit entries are higher compared to the credit entries in the supplier's statement.	
Discounts received recorded only by us.	X
Discounts received recorded at a higher amount by us (difference in amount).	X
Purchase returns recorded only by us.	X
Purchase returns recorded at a higher amount by us (difference in amount).	X
Any other amounts debited by us but not credited by the supplier partially or fully.	X
Less: Items where our credit entries are higher compared to the debits recorded by the supplier (these are less likely items).	
Purchases recorded only by us or recorded at a higher amount by us.	(X)
Less: Items where our debit entries are lower compared to the credit recorded by the supplier (these are less likely items).	
Discounts recorded at a lower amount or not recorded by us.	(X)
Purchase returns recorded at a lower amount or not recorded by us.	(X)
Balance according to the supplier's records.	**X**

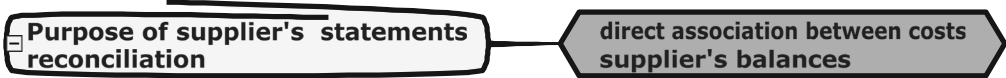
If we compare all the items in the above example one by one, we can cross off the matching items. We can make a reconciliation statement in the records of Beeline, as follows:

Reconciliation statement

	Tshs
Balance payable to Teeline as per our records	32,000
Add: Higher opening balance shown by Teeline	5,000
Add: Discount against invoice no. 51 not recorded by Teeline	2,000
Balance according to Teelines statement	**39,000**

Each company can now concentrate on resolving these differences and record the required accounting entries e.g. Teeline may correct its records to allow the discounts that were agreed.

SUMMARY



Test Yourself 8

Dolcart Co purchases goods from Polcart Inc. The accountant of Dolcart prepared the following extract from the Polcart account:

Books of Dolcart Co
Polcart Inc Account

Dr **Cr**

	Tshs		Tshs
Cash: Payment against opening balance Cash: Payment against invoice no. 1101 Discount: Against invoice no. 1101 Balance c/f	60,000 77,000 3,000 38,000	Balance b/f Purchases: Invoice no. 1101 Purchases: Invoice no. 1103	70,000 88,000 20,000
Total	**178,000**	**Total**	**178,000**

He received a statement of account from Polcart Inc which appeared as follows:

Books of Polcart Co
Dolcart Inc Account

Dr **Cr**

	Tshs		Tshs
Balance b/f Sales: Invoice no. 1101 Sales: Invoice no. 1102 Sales: Invoice no. 1103	70,000 80,000 30,000 20,000	Cash: Payment against opening balance Cash: Payment against invoice no. 1101 Balance c/f	60,000 77,000 63,000
Total	**200,000**	**Total**	**200,000**

Required:

Prepare a reconciliation statement in the records of Dolcart.

7. Classify items as current or non-current liabilities in the statement of financial position. [Learning Outcome l]

7.1 Classify items as current or non-current liabilities in the statement of financial position

In accordance to IAS 1 Presentation of Financial Statements, liabilities on the statement of financial position are to be presented as current and non-current liabilities. Therefore, each payable has to be classified as current and non-current. Also refer Study Guide F1 for current and non-current asset distinction.

1. Current liabilities

Current liabilities are those liabilities that are to be paid **within 12 months** from the date of the reporting period, or form a part of the operating cycle.

Example

Examples of current liabilities are:

Trade payables, including bills of exchange payable
Bank overdraft that is normally payable on demand
Current tax payable
Accrued expenses

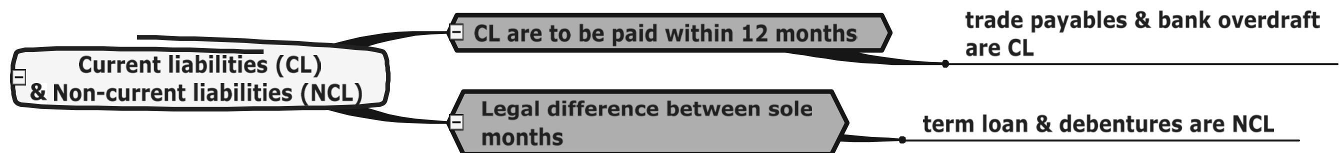
2. Non-current liabilities

Non-current liabilities are the liabilities that are payable after **more than 12 months.**

Examples of non-current liabilities are:

Fixed duration loans taken from a bank, repayable after more than a year
Debentures (securities issued by a limited company, repayable after a specified term)

SUMMARY



State the test for classifying liabilities under current and non-current headings.

Answers to Test Yourself

Answer to TY 1

The correct option is **B**.

When sales are made on credit the amount outstanding on the reporting date should be shown as trade receivables in the books. Here, the outstanding amount is Tshs13 million (Tshs56 million - Tshs43 million).

Answer to TY 2

The correct option is **A**.

	Tshs'000
0 – 90 days	36,000
91 – 180 days	34,000
181 days and above	**53,000**

Answer to TY 3

In John's accounts (All amounts in Tshs'000)

1. For sales to James

Dr	James' account (trade receivable)	Tshs20,000	
Cr	Sales		Tshs20,000

Being removing the receivable amount and transferring it to bad debts expenses

2. James' debt being deemed irrecoverable

Dr	Bad debts expense	Tshs20,000	
Cr	James' account (Trade receivable)		Tshs20,000

Being recording bad debts on amount owned by James

3. Amount finally paid by James

Dr Cash	Tshs20,000	
Cr Bad debts recovered account		Tshs20,000

Being cash received from accounts receivables which had already been written off

Answer to TY 4

(All amounts in Tshs'000)

Year 20X6

Dr Bad debts account (expense)	Tshs30,000	
Cr Trade receivables		Tshs30,000

Being amount receivable from Bambert written off

Year 20X7

Dr Cash	Tshs30,000	
Cr Bad debts recovered account		Tshs30,000

Being debt from Bambert written off in 20X6, now received

Answer to TY 5

Accounting entries

1.

Dr Bad debts account (expense)	Tshs10,000	
Cr Trade receivables		Tshs10,000

Being amount receivable from Tomergate written off

2.

Dr Doubtful debts expense	Tshs800	
Cr Allowance for receivables		Tshs800

Being amount receivable from Tomergate written off

Presentation in the financial statements (extracts)

Statement of profit or loss	**Tshs'000**
Expenses	
Bad debts	10,000
Allowance for bad debts (W1)	800

Statement of financial position	**Tshs'000**
Current assets	
Trade Receivables	290,000
Less: Allowance for receivables (W1)	(5,800)
	284,200

Workings

W1 Calculation of the allowance required

	Tshs'000
Amount of receivables	300,000
Less: Bad debts	10,000
Amount subject to allowance	**290,000**
Allowance @2% of Tshs290,000	5,800
Existing allowance	5,000
Additional allowance required	**800**

Answer to TY 6

The correct option is **D**.

All of the given statements relate to allowances for receivables.

Answer to TY 7

The correct option is **B**.

When, for the same person, a certain amount is receivable as well as payable; the minimum of the two can be adjusted. Therefore the amount to be adjusted is Tshs6,000,000.

Answer to TY 8

Reconciliation statement in the records of Dolcart

	Tshs	**Tshs**
Amount payable to Polcart according to our records:		38,000
Add:		
Invoice No. 1102 debited by Polcart, not recorded by us:	30,000	
Discount against invoice No.1101 debited by us, not recorded by Polcart	3,000	33,000
		71,000
Less:		
Invoice No. 1101 erroneously recorded higher by us (Tshs88,000 - Tshs80,000)		(8,000)
Amount payable to Polcart according to their records		**63,000**

Answer to TY 9

The liabilities to be **paid within 12 months** are classified as **current liabilities** and those **paid after 12 months** as **non-current liabilities**.

Self Examination Questions

Question 1

Which of the following is a disadvantage of allowing credit?

(i) Working capital is tied up in receivables.
(ii) When credit is allowed, there is always the risk of bad debts.
(iii) Managing of accounts receivable involves cost.
(iv) It pushes up the sales.

A (i), (ii) and (iii) **B**
(ii), (iii) and (iv) **C**
(i), (iii) and (iv) **D**
All of the above

Question 2

Shamelon Ltd has total receivables outstanding on 31 March 20X6 of Tshs29 million. It estimated that 2% of the receivables will not be collected and therefore decided to make an allowance for the same. Being the first year, there is no opening balance of allowance for receivables. On 31 March 20X7, the receivables outstanding are Tshs58 million. From the previous year's experience, it is decided that the allowance should be made for 5%.

State the amount of allowance which will be charged to Shamlon's statement of profit or loss in 20X7.

A Tshs2,900,000
B Tshs580,000
C Tshs2,320,000
D Tshs1,160,000

Question 3

Refer to the above question, and determine the amount of receivables that will appear in the statement of financial position on 31 March 20X7.

A Tshs55,100,000
B Tshs55,680,000
C Tshs56,840,000
D Tshs57,420,000

Question 4

Little World completed the following transactions during the year ended 31 December 20X7:

Credit sales during the year	Tshs53,300,000
Collections from receivables	Tshs56,100,000
During the year, total amount irrecoverable	Tshs560,000
Opening balance of receivables	Tshs8,600,000

Calculate the balance of receivables that will appear in the statement of financial position on 31 December 20X7.

A Tshs5,800,000
B Tshs10,840,000
C Tshs5,240,000
D Tshs56,100,000

Question 5

Which of the following statements is incorrect?

A Creditworthiness refers to the dependability of customers to meet their commitments as to payment and other terms of sale.
B Creditworthiness refers to the limit up to which the sales are made to a customer.
C In subsequent years, allowance for doubtful debts is made of the net amount i.e. allowance for the year, less balance of allowance carried forward in the current year.
D The increase in the allowance for receivables during the year is transferred to the statement of profit or loss as an expense.

Question 6

Which of the following statements is incorrect?

A Aged receivables analysis helps an entity to correctly assess the recoverability of a receivable and decide upon the bad debt amount.
B Aged receivables analysis helps the sales team to effectively manage receivables.
C In order to prepare aged receivables analysis, the entity must match each credit entry in the ledger account with the relevant debit entry.
D Aged receivables analysis has to be done on a yearly basis and must form a part of the auditor’s report according to IFRS.

Question 7

Delogs Co has an amount of Tshs70 million payable to Spinneys. An invoice from Spinneys worth Tshs21 million was not recorded by Delogs. Delogs debited a sales return of Tshs5 million to Spinneys’ account which was not recognised by Spinneys. The corrected balance receivable from Delog according to Spinneys’ records will be:

A Tshs91,000,000
B Tshs86,000,000
C Tshs5,000,000
D None of the above

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **A**.

(i), (ii) and (iii) are disadvantages of allowing credit but (iv) is a benefit.

Answer to SEQ 2

The correct option is **C**.

	Tshs'00
Allowance made in the first year = Tshs29,000 x 2%	580
Allowance required in the subsequent year = Tshs58,000 x 5% =	2,900
Increase in allowance charged to statement of profit or loss	**2,320**

Answer to SEQ 3

The correct option is **A**.

(Amounts in Tshs'000)

Balance of receivables on 31/03/20X7	Tshs58,000
Less: Allowance for receivables	Tshs(2,900)
	Tshs55,100

While calculating the amount of receivables that will appear in the SOFP, the total allowance should be considered.

Balance of receivables that appears in the statement of financial position is Tshs55,100

Answer to SEQ 4

The correct option is **C.**

Little world
Trade receivables

Dr **Cr**

	Tshs'000		Tshs'000
Balance b/d	8,600	Cash	56,100
Sales	53,300	Bad debts	560
		Balance c/d	5,240
	61,900		**61,900**

Answer to SEQ 5

The correct option is **B**.

Creditworthiness refers to how reliable the customer is while making the payment. Determining the limit up to which sales are to be made to a customer is called setting the credit limit.

Answer to SEQ 6

The correct option is **D**.

While there is no set regulation or accounting standard that is specifically related to an aged receivables analysis, according to the accounting principle of prudence, an entity must perform an aged receivable analysis. This will enable the entity to arrive at the amount that should be recognised to provide for doubtful and bad debts.

Answer to SEQ 7

The correct option is **B**.

Spinney's records would show the balance in Delogs (Tshs70 million) plus the amount that is not recorded in Delogs's' books (Tshs21 million). In addition, it would not reflect the amount that is not recorded as sales return in its books (Tshs5 million). Hence the corrected balance of Delog's account in Spinney's books would show (Tshs70 million + Tshs21 million – Tshs5 million) = Tshs86 million.

SECTION E

CONTROL ACCOUNTS AND ERRORS

E1

STUDY GUIDE E1: CORRECTION OF ERRORS

Get Through Intro

It is rightly said that "to err is human". As a result, there is plenty of scope for errors to creep into any accounting exercise.

In **this Study Guide** you will learn about **two types of errors**:

- Errors that can be highlighted by the extraction of the trial balance – the debit and credit column of the trial balance are not equal when these errors exist

- Errors that cannot be highlighted by the extraction of the trial balance – the debit and credit column of the trial balance will balance inspite of these errors

You will also learn the accounting entries to correct the detected errors. The latter part of the Study Guide discusses the requirements of International Financial Reporting Standards for the correction of errors.

Questions are regularly asked on this topic in the exams. Also, as an accountant, you will always make errors. If you are not able to rectify your errors then you will have a problem as you will not be able to prepare financial statements. So ensure that you understand this Study Guide!

Learning Outcomes

a) Explain the provision of International Financial Reporting Standards governing financial statements regarding material errors which result in prior period adjustment.
b) Identify the nature of errors and prepare journal entries to correct errors.
c) Calculate and understand the impact of errors on the statement of profit or loss and statement of financial position.

1. Identify the nature of errors and prepare journal entries to correct errors.

[Learning Outcome b]

An error is a mistake which is committed accidentally. If done intentionally, it becomes fraud.

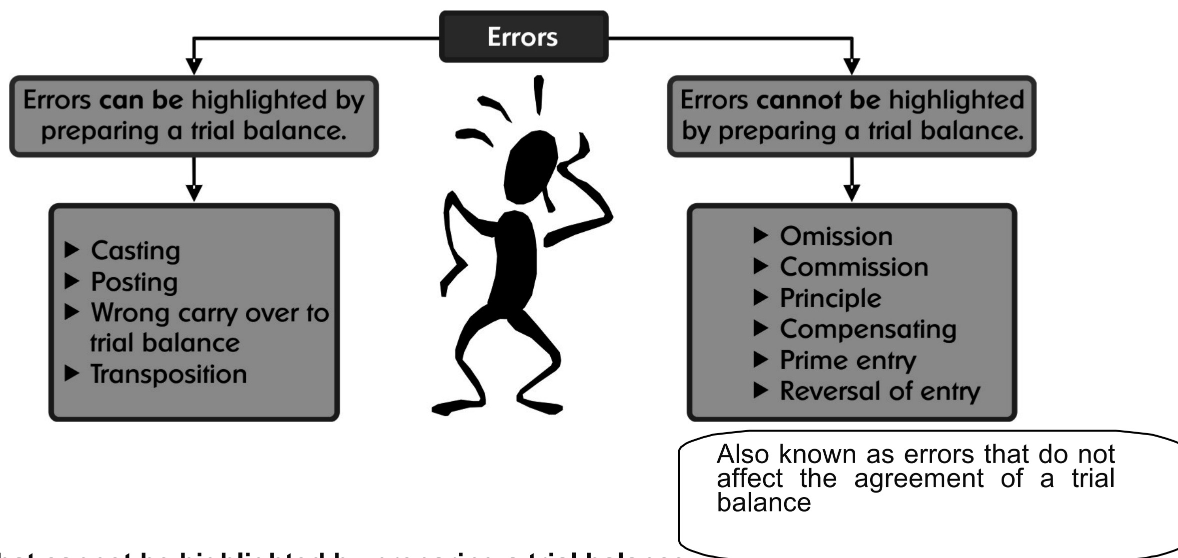
While recording the transactions in the books of accounts, it is quite likely that some mistake may be committed. Errors may happen at any of the following stages.

1. **At the recording stage** (a) Errors of principle (b) Errors of omission (c) Errors of commission	2. **At the posting stage** (a) Errors of omission (b) Error of commission Posting to wrong account Posting on the wrong side Posting of wrong amount
3. **At the balancing stage** (a) Wrong totalling (b) Wrong balancing	4. **At the preparation of the trial balance** (a) Errors of omission (b) Errors of commission Taking the wrong amount Taking the wrong account Taking the account to the wrong side

The trial balance is prepared to check the arithmetical accuracy of the accounts. If the trial balance does not balance, it implies that there are arithmetical errors in the accounts which require **detection and correction**. Even if the trial balance agrees, there may still be errors.

From the point of view of correction, errors are classified into two types:

Diagram 1: Types of errors



1.1 Errors that cannot be highlighted by preparing a trial balance

The main purpose of the trial balance is to ensure that double entry book keeping has been followed correctly and that debits = credits. If using a manual system, it is possible to post just one side of the entry or even to write in an incorrect amount. The trial balance will highlight this if it occurs, as debits ≠ credits.

While it is simple to identify that an error has been made, there is often a long and difficult task of cross checking balances to find out where the error is! We will discuss this in more detail in the next Learning Outcome.

When the totals of debits and credits are equal in a trial balance, this does not assure the correctness of accounting. There may still be errors, which do not create a difference in the debit and credit totals of a trial balance. These errors distort the financial statements, but the trial balance total of debits and credits is equal. These errors are **difficult to detect** compared to those errors that affect the agreement of the trial balance.

Study Guide H2 discusses the errors in a trial balance. These are given in detail below.

1. Error of omission to record

Under this type of error, a transaction is **completely omitted** in the financial records.

Example

ICC Ltd sold goods to Alan for Tshs1,200,000 but omitted to record the transaction in both the sales day book and the receivables ledger. Since both the accounting effects (i.e. the credit in the sales account and the debit in the receivables ledger) of the transaction are not recorded there cannot be a difference in the trial balance.

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2. Error of commission

These are basically the clerical errors committed at the time of recording and / or posting the transactions. This includes errors such as the recording of a transaction to the wrong account or recording a transaction with the wrong amount.

Example

ICC Ltd sold goods to Alan for Tshs1,200,000 and recorded this in the sales day book. However instead of debiting the amount to Alan's account, it was debited to Peter's account. This error will not affect the agreement of the trial balance because whether Alan's account is debited or Peter's account is debited – the posting has gone to the debit side of the account. The credit effect has been correctly taken and so the trial balance will agree.

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3. Error of principle

Errors of principle are errors resulting from the **violation of generally accepted accounting principles**.

Example

Tick-tick Ltd is a pharmaceutical company. It purchased a car for Tshs10,000,000. The payment was made by cheque. The transaction was recorded as follows:

Dr	Purchases account (SOPL)	Tshs10,000,000	
Cr	Bank account (SOFP)		Tshs10,000,000
Being car purchased			

Therefore, the purchases account is debited as opposed to the asset account.

As a result, the company's profits and assets will be reported with a Tshs10,000,000 deficit. .

The trial balance will still balance as one account has been debited with the right amount (it does not matter that the account head is wrong) and one account has been credited with the right amount. Hence this error cannot be detected by preparing a trial balance.

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4. Compensating error

Under this type of error, **two errors are committed**, in such a way that the total **debits** remain **equal** to the total **credits** in the trial balance.

Example

Goods sold to Jay for Tshs1,000 were recorded in the sales day book correctly but were not recorded in Jay-receivables account. At the same time goods purchased from Bob for Tshs1,000,000 were recorded in the purchase day book but not recorded in Bob's payables account.

The two accounting entries were as follows:

Dr	___________________		-
Cr	Sales account		Tshs1,000,000
Dr	Purchases account	Tshs1,000,000	
Cr	___________________		-

The ultimate effect of the above error is that the debit in the first entry falls short by Tshs1,000 and the credit in the second entry falls short by Tshs1,000. Therefore, the two errors will compensate each other and the trial balance will agree in the terms of debit and credit totals.

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5. Errors of prime entry

Under this type of error, the error is committed while recording the transaction from the source document to the books of prime entry.

Example

A sales invoice of Tshs1,400,000 was recorded as Tshs1,600,000 in the sales day book and posted to the receivables ledger account as Tshs1,600,000. This error will not result in any disagreement in the trial balance totals.

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6. Complete reversal of entry

Under this type of error a transaction is recorded in exactly the reverse manner.

Example

Red Ltd sold goods to John for Tshs1,600,000.

The correct accounting entry should have been:

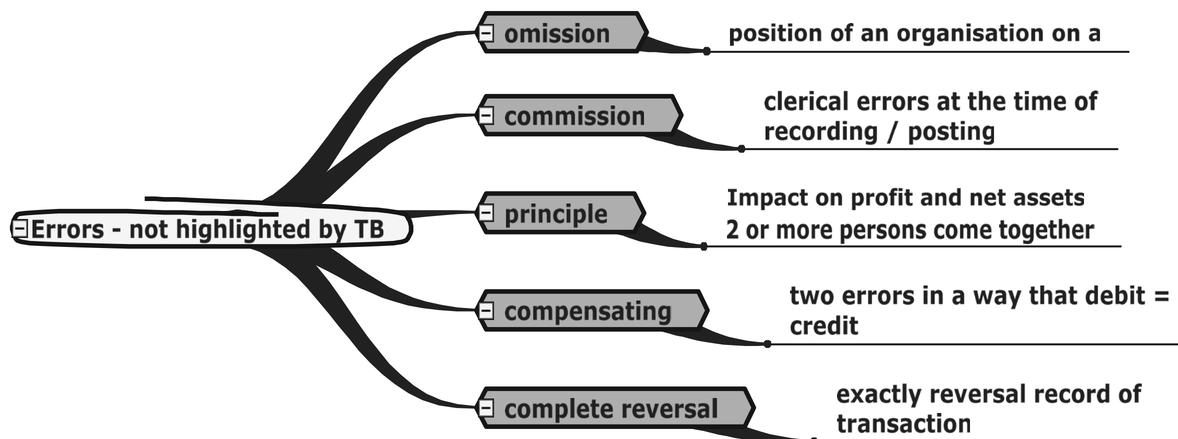
Dr	John account	Tshs1,600,000	
Cr	Sales account		Tshs1,600,000

The wrong accounting entry recorded:

Dr	Sales account	Tshs1,600,000	
Cr	John account		Tshs1,600,000

The trial balance will still balance so this error cannot be detected by preparing a trial balance.

SUMMARY



Test Yourself 1

Name the type of error:

Cash book debit side undercast by Tshs100,000 and purchases account credit side undercast by Tshs100,000.
Interest charged by the bank not recorded.
Payment of Tshs900 recorded for Tshs700,000 in the cash book.
Payment to Sam recorded in Suzy's account.
Receipt of Tshs1,000,000 recorded as Tshs1,200,000 in the cash book.
Payment to supplier not recorded.
Cash book debit side undercast by Tshs100,000 and purchases account debit side overcast by Tshs100,000.
Purchase of non-current asset recorded as expense.
Purchases from Mack recorded in Jack's account.
Receipt from Michael recorded in Jackson's account.
Receipt of loan accounted as receipt of income.
Revenue expenditure recorded as capital expenditure.
Sale of Tshs200,000 to Mack not recorded and the collection from him of Tshs200,000also not recorded.
Sale of Tshs500,000 recorded as sale of Tshs400,000 in the sales day book
Purchases of goods not recorded.

1.2 Errors that can be highlighted by preparing a trial balance

These errors are also known as errors that affect the agreement of a trial balance.

Under the double entry book keeping system, we record the two effects of all transactions as debits and credits. Hence the trial balance totals of debits and credits are equal. Whenever the total of all debits and credits do not match, it means that there is an error in accounting. Common errors of this kind are:

Casting error
- Overcasting
- Undercasting

Posting error
- Posting to the wrong amount
- Omission to post either credit or debit entry
- Posting to wrong side of correct ledger

Wrong carry over to trial balance

Transposition errors

Each of these will be looked at in turn.

1. Casting error

The term **casting means adding up.** This error affects the agreement of a trial balance. This error can be an error of overcasting or an error of undercasting.

Overcasting means summing (i.e. arithmetically adding) the totals to **more than what they are** and
undercasting means summing (i.e. arithmetically adding) the total to **less than what they are.**

Example

Under casting - Margaret sold goods to 3 different customers of Tshs10,000, Tshs25,000 and Tshs15,000 respectively in July 20X9. She entered the 3 amounts correctly in the sales day book. However, when she totalled the month's sales, she came to Tshs40,000 instead of Tshs50,000. Margaret **undercast** the sales day
book by Tshs10,000.

Example

Overcasting - Continuing the previous example of Margaret,

The following month, exactly the same value of goods was bought by customers. Although she correctly entered the figures individually in the sales day book, when she totalled the month's sales, she came to Tshs60,000 instead of Tshs50,000. Margaret **overcast** the sales day book by Tshs10,000.

Test Yourself 2

Jack purchased raw materials from Sam for Tshs20,000. Jack debited the purchase account with Tshs20,000 and credited Sam's account with Tshs15,000.

Is there any error? If yes, which type of error it is?

There can also be casting errors in the trial balance itself that can lead to Debit ≠ Credit.

Example

On 31 December 20X9, Suzy prepared the trial balance of Sun Inc. While totalling the debit side, she arrived at the total Tshs510,000, but the correct grand total was Tshs520,000. So, the trial balance debit side is undercast by Tshs10,000.

Test Yourself 3

The purchases account has a balance of Tshs50,000. The debit side of the account was overcast by Tshs1,000.

What is the correct balance?

A Tshs49,000 debit
B Tshs49,000 credit
C Tshs51,000 debit
D Tshs51,000 credit

Test Yourself 4

The cash book has a balance of Tshs30,000. The credit side of the cash book was overcast by Tshs2,000.

What is the correct balance?

A Tshs32,000 debit
B Tshs32,000 credit
C Tshs28,000 debit
D Tshs28,000 credit

Test Yourself 5

The cash book has a balance of Tshs30,000. The credit side of the cash book was undercast by Tshs2,000.

What is the correct balance?

A Tshs32,000 debit
B Tshs32,000 credit
C Tshs28,000 debit
D Tshs28,000 credit

Test Yourself 6

The audit fees account has a balance of Tshs5,000. The debit side of the account was undercast by Tshs500.

What is the correct balance?

A Tshs4,500 debit
B Tshs4,500 credit
C Tshs5,500 debit
D Tshs5,500 credit

2. Posting error

This error occurs while posting a transaction from the books of prime entry to the ledgers. This can be:

A Posting with wrong amount
B Omission to post either credit or debit entry
C Posting to wrong side of correct ledger

Example

Posting with wrong amount:

Let us see how the following journal is incorrectly posted:

ICC Ltd Journal entry **Opening balance of AAL account is Tshs5,000**				
31/12/20X9	Dr	Bad debts account	Tshs500	
	Cr	AAL account		Tshs500
		Being bad debts written off		

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Here, the posting of the journal entry should have been Tshs500, but was incorrectly posted as Tshs200.

ICC Ltd

Dr **Bad debts account** **Cr**

Date		Tshs	Date		Tshs
31/12/20X9	AAL account	**200**	31/12/20X9	Statement of profit or loss	**200**
	Total	**200**		Total	**200**

Receivables ledger

Dr **AAL account** **Cr**

Date		Tshs	Date		Tshs
1/12/20X9	Balance b/f	5,000	31/12/20X9	Bad debts	500
			31/12/20X9	Balance c/f	4,500
	Total	**5,000**		Total	**5,000**

Tip

The most common form for posting the wrong amount is a **transposition error**.

Example

Omission to post either credit or debit entry

Let us see how the posting of the following journal is wrongly omitted.

ICC Ltd Journal entry				
31/12/20X9	Dr	Bad debts account	Tshs500	
	Cr	AAL account		Tshs500
	Being bad debts written off			

The ledger should have been posted with Tshs500. An error was made, and this amount was omitted and posted with zero.

Dr **Bad debts account** **Cr**

Date		Tshs	Date		Tshs
31/12/20X9	**AAL account**	**0**	31/12/20X9	Statement of profit or loss	**0**
	Total	**0**		**Total**	**0**

Dr **AAL account** **Cr**

Date		Tshs	Date		Tshs
1/12/20X9	Balance b/f	5,000	31/12/20X9	Bad debts	500
			31/12/20X9	Balance c/f	4,500
	Total	**5,000**		**Total**	**5,000**

Example

Posting on the wrong side of the correct account:

Let us see how the posting of the following journal is made to the wrong side of the correct account.

ICC Ltd Journal entry				
31/12/20X9	Dr	Bad debts account	Tshs500	
	Cr	AAL account		Tshs500
	Being bad debts written off			

The AAL account should have been on the debit side, and not on the credit side.

Dr **Bad debts account** **Cr**

Date		**Tshs**	**Date**		**Tshs**
31/12/20X9	**Statement of profit or loss**	**500**	31/12/20X9	**AAL account**	**500**
	Total	**500**		**Total**	**500**

Dr **AAL account** **Cr**

Date		**Tshs**	**Date**		**Tshs**
1/12/20X9	Balance b/f	5,000	31/12/20X9	Bad debts	500
			31/12/20X9	Balance c/f	4,500
	Total	**5,000**		**Total**	**5,000**

3. Figures incorrectly carried over to the trial balance

If the balance of a ledger account is incorrectly recorded in the trial balance, this will also result in the trial balance not balancing.

Example

Continuing the previous example of the AAL account.

The bad debt account is correctly posted from the journal with Tshs500. While taking the balance of the bad debt accounts to the trial balance, it is incorrectly carried over from Tshs500 to Tshs900.

Dr **Bad debts account** **Cr**

Date		**Tshs**	**Date**		Tshs
31/12/20X9	AAL account	**500**	31/12/20X9	**Statement of profit or loss**	**500**
	Total	**500**		**Total**	**500**

Trial balance as at 31 December 20X9		
	Debit Tshs	**Credit Tshs**
Bad debts (Note1)	**900**	-

Note: it should have been Tshs500 and not Tshs900. The trial balance will not balance and there will be a difference of Tshs400.

4. Transposition error

Under this type of error, a transaction is recorded in the books of prime / original entry with the **figures in the wrong sequence.**

Example

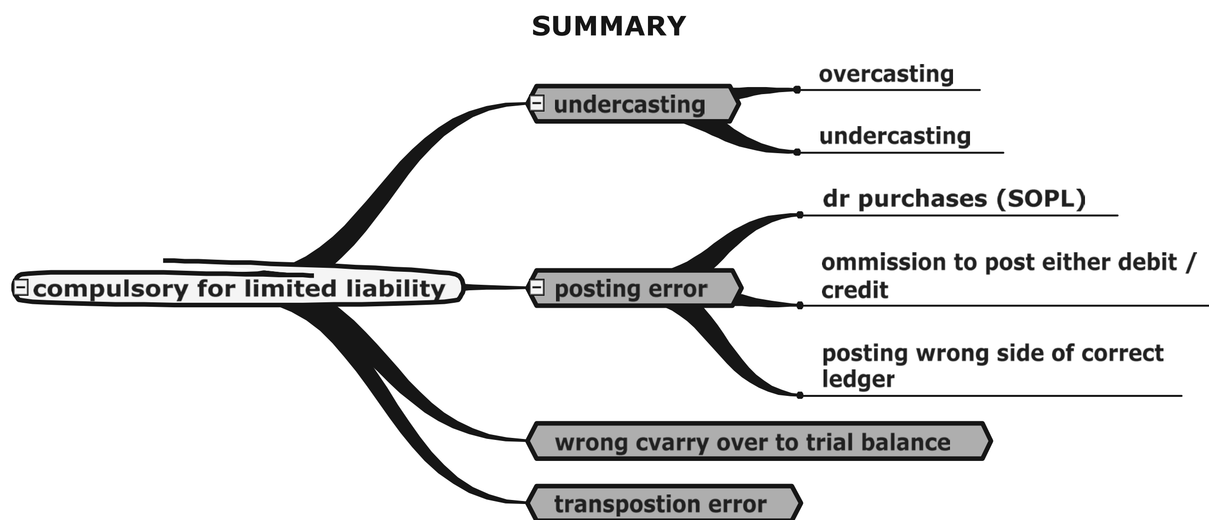
A sale to Alan for Tshs5,100 is recorded as Tshs1,500 in the Alan-receivable account, and as Tshs5,100 in the sales account. The error is the transposition of the numbers 1 and 5. As a result, the totals of the debit and credit balances in trial balance will not agree.

Test Yourself 7

Samuel purchased raw materials from Sam for Tshs5,200. He debited the purchase account with Tshs2,500 and credited Sam's account with Tshs5,200.

Has any error been committed by Samuel? If yes, what is the error?

SUMMARY



1.3 Journal entries to rectify errors

Errors can be rectified by passing correct journal entries and recording them in the ledgers.

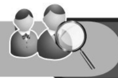
1. Correcting the errors that can be highlighted by extraction of a trial balance

Due to the errors mentioned above, the debit total ≠ credit total in a trial balance. You must check through your accounting entries to ensure that all debits and credits have been correctly recorded and posted. In addition you must check for any casting and transposition errors. Debits ≠ credits indicate that there is a mathematical error. A **suspense account is used to rectify these errors.** This is explained later in detail in Study Guide H5.

2. Correcting the errors that cannot be highlighted by extraction of a trial balance

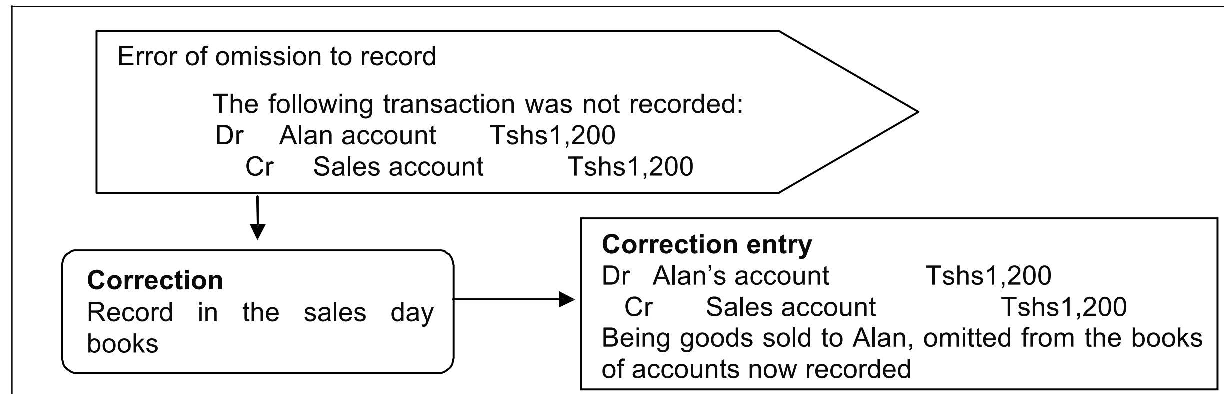
These errors do not affect the balancing of the trial balance. In other words, in spite of these errors, the trial balance will show debit totals = credit totals. Hence, we need to make **journal entries to correct these errors.** Such journal entries can be called **correction entries.**

a) Error of omission to record



Example

ICC Ltd sold goods to Alan for Tshs1,200 but omitted to record the transaction in both the sales day book and the receivables ledger.



Reasons and explanations

The sale transaction of Tshs1,200 has not been recorded in the books of accounts. Therefore, we need to record the transaction by writing a journal entry.

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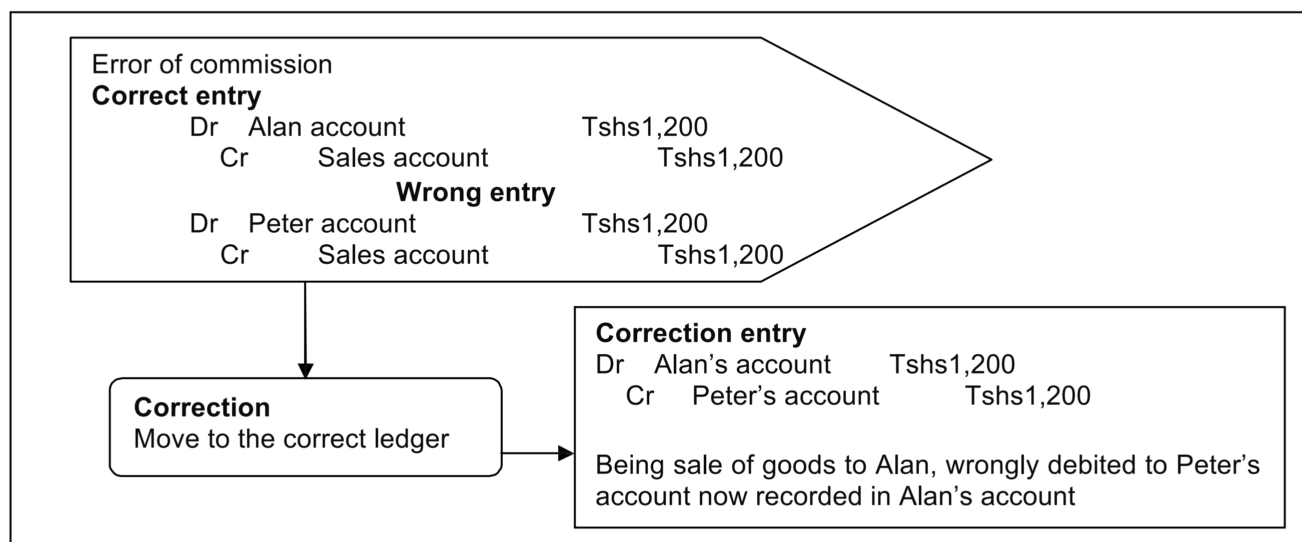
b) Error of commission

Example

ICC Ltd sold goods to Alan for Tshs1,200 and recorded this in the sales day book. However it debited the amount to Peter's account instead of Alan's account.



Thus, after correction, Peter's account will have 0 balances (being his account once debited (wrong entry) and once credited (correction entry). Similarly, Alan's account will have a balance of Tshs1,200.

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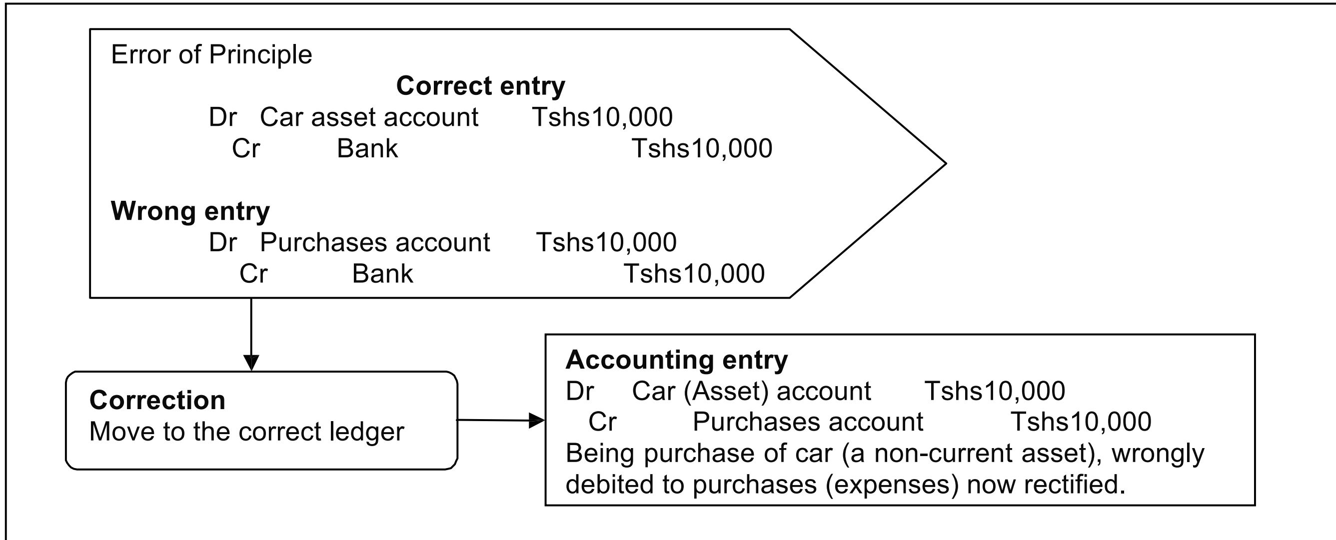
c) Error of principle

Example

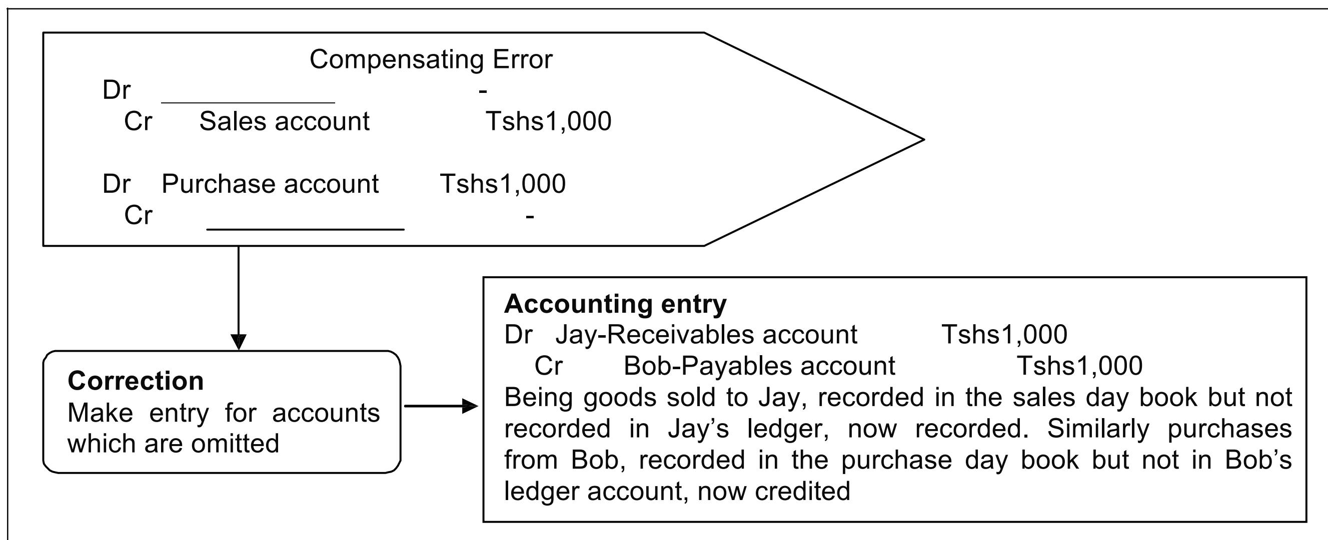
Tick-tick Ltd purchased a car for Tshs10,000. The transaction was recorded as purchases in the statement of profit or loss instead of purchases of assets.



d) Compensating error

Example

Goods sold to Jay for Tshs1,000 recorded in the sales day book correctly but not recorded in the Jay-receivables account. At the same time, goods purchased from Bob for Tshs1,000 recorded in the purchases day book but not recorded in the Bob-payables account.

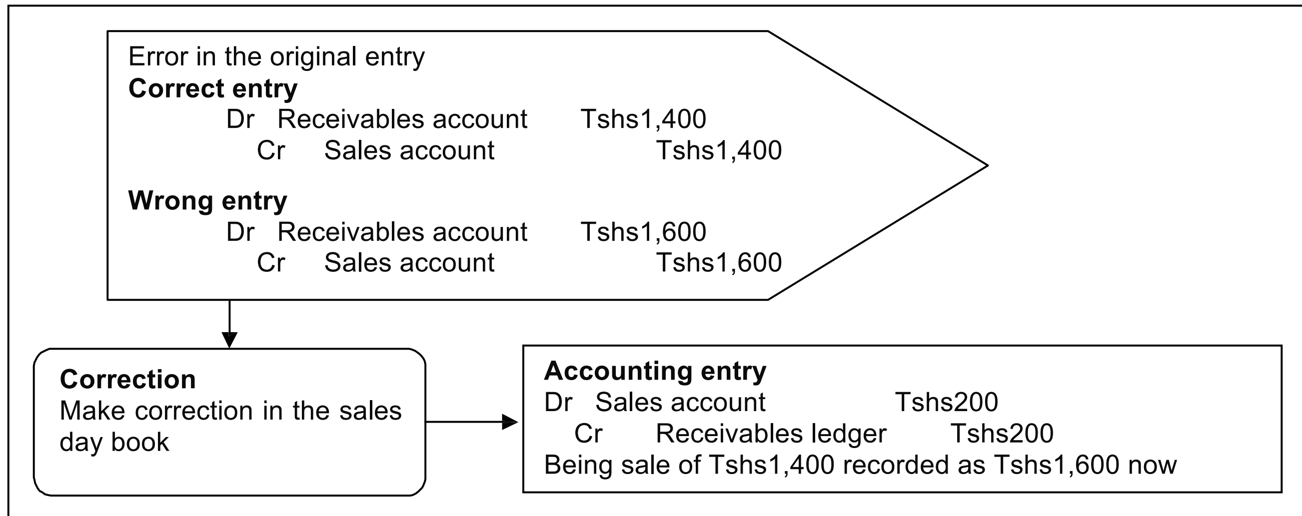


Reasons and explanation

The error is that a sale to Jay is recorded in the sales day book but not in the Jay- receivables account. Now we need to debit the Jay- receivables account. On the other hand, purchases from Bob are also not recorded in the Bob- payables account, so we need to credit Bob- payables account.

e) Errors of prime entry

A sale invoice of Tshs1,400 was recorded as Tshs1,600 in the sales day book and posted to the receivables ledger account as Tshs1,600.



Reasons and explanation

The sales amount was shown higher. Instead of recording Tshs1,400 as a sale, we have recorded Tshs1,600.

That means the sales are overstated by Tshs200. To adjust the over booking of sales we should reverse Tshs200. To reverse the excess sale we have to post an entry to debit the sales account and credit the receivables account.

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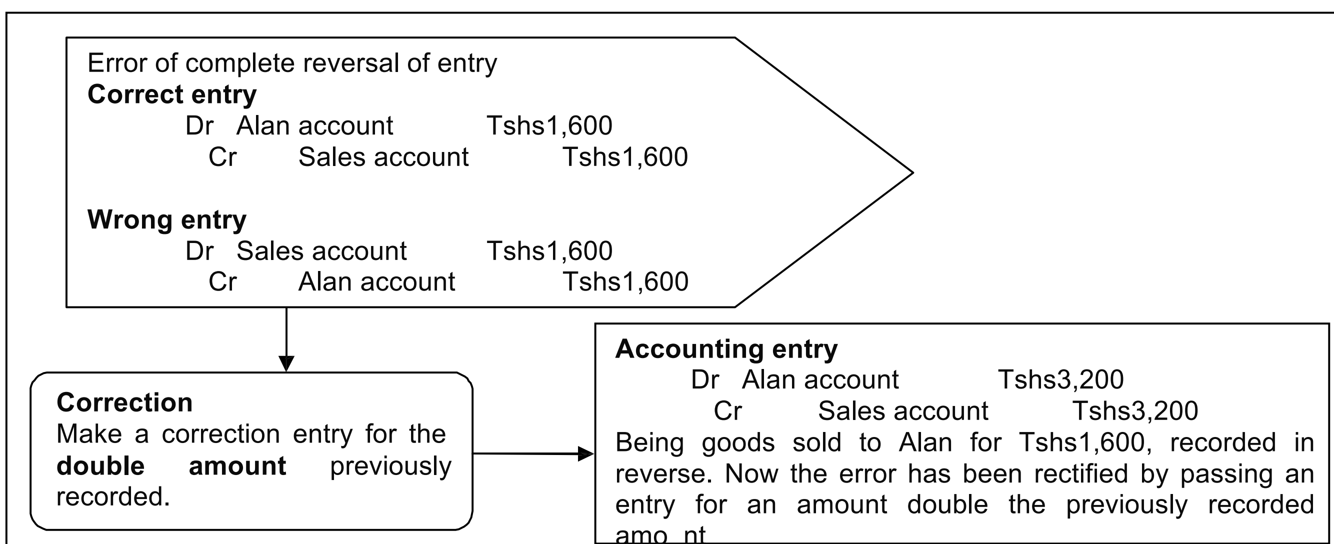
f) Complete reversal of entry

Sold goods to Alan for Tshs1,600, but recorded as:

Dr	Sales account	Tshs1,600	
Cr	Alan account		Tshs1,600



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Reasons and explanation

Remember, here the entry was made in reverse. There are two requirements needed to correct this error.
The first is to rectify the mistake and
Then record the correct transaction.

The sales account should have been credited when making a sale, but we have debited the sales account by Tshs1,600. So, first we have to credit the sales account by Tshs1,600 to rectify this mistake, we then need to show the sale. So altogether, we credit the sales account with Tshs1,600+Tshs1,600 = Tshs3,200, the corresponding debit being made to Alan's account.

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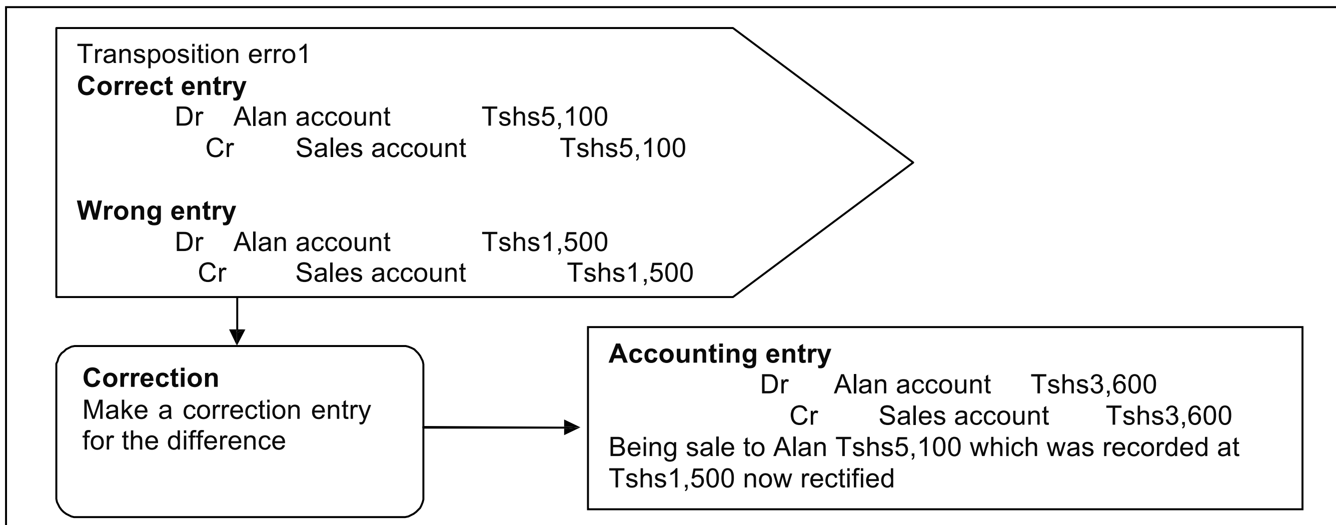
g) Transposition error

Example

Goods sold to Alan for Tshs5,100 but recorded as Tshs1,500.



Reasons and explanation

In this error, the original entry was transposed i.e.Tshs5,100 was recorded as Tshs1,500, therefore the sales account is understated by Tshs3,600. To rectify this amount, we debit Alan's account and credit the sales account.

Test Yourself 8

Gemini Ltd issued 10,000 equity shares of Tshs1 each at Tshs1.5 per share. However the accountant recorded the whole amount in the share capital account. What is the accounting entry to rectify the error?

Test Yourself 9

Gemini Enterprise paid Tshs5,000 for stationery which was recorded in the office expense account. However, the auditor treated the expense as material, needing a separate disclosure. What is the correction entry?

Test Yourself 10

A customer of JJ Collections died. Because the debts (Tshs150) were not recoverable the accountant debited the bad debt account and credited the customers' account. Rectify the error.

Test Yourself 11

State which of the following is an error of principle?

A While calculating depreciation, the wrong percentage was used.
B An item was entered in the wrong class of account.
C When stock was issued, the invoice was not issued.
D A sales invoice of Tshs500 was entered in the sales journal as Tshs400.

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2. Calculate and understand the impact of errors on the statement of profit or loss and statement of financial position.

[Learning Outcome c]

The impact of the errors can either be on the statement of profit or loss and other comprehensive income or the statement of financial position or on both.

Let's look at an illustration to see how a few of the most common errors can affect the statement of profit or loss and other comprehensive income and the statement of financial position.

Example

Given below is the draft trial balance of ICC Ltd.

	Debit Tshs'000	Credit Tshs'000
Purchases Directors'	600,000	
fees Distribution	40,000	
expense Car	50,000	
Stationery	50,000	
Plant and machinery	20,000	
Receivables	300,000	
John		
Jerry	10,000	
Kerry	5,000	
Angle	6,000	
Others	7,000	
Cash	80,000	
Sales	35,000	
Share capital		1,000,000
Payables		175,000
Xiang		
Others		8,000
Total		20,000
	1,203,000	**1,203,000**

The following errors were discovered:

1. Error of omission to record: sales to John for Tshs1,200,000 were omitted from the sales day book.

2. Error of commission: sales to Jerry for Tshs1,200,000 were recorded in the sales day book but debited to Kerry's account and not Jerry's account.

3. Error of principle: purchase of a car for Tshs10,000,000 was recorded as a distribution expense.

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4. Compensating error: goods sold to Angle for Tshs1,000,000 were recorded in the sales day book correctly but not recorded in Angle's-receivables account. At the same time goods purchased from Xiang for Tshs1,000,000 were recorded in the purchase day book but not recorded in Xiang's-payables account.

5. Errors of original entry: a sales invoice (cash) of Tshs1,400,000 was recorded as Tshs1,600,000 and carried to the ledger accounts with the same amount of Tshs1,600,000.

6. Complete reversal of entry: directors' fees paid were credited to directors' fees account and debited to cash Tshs5,000,000.

7. Transposition error: a stationery bill for Tshs5,100,000 is recorded as Tshs1,500,000 in the cash book.

Show the journal entries for correction of errors, and also show statement of profit or loss and other comprehensive income and statement of financial position after correction of errors.

Answer

Correction entries

			Tshs'000	**Tshs'000**
1.	Dr	John-receivables account	Tshs1,200	
		Cr Sales account		Tshs1,200
		Being goods sold to John which were not recorded in the books of accounts, now recorded		
2.	Dr	Jerry-receivables account	Tshs1,200	
		Cr Kerry-receivables account		Tshs1,200
		Being sale of goods to Jerry, wrongly debited to Kerry's account now rectified.		
3.	Dr	Car account	Tshs10,000	
		Cr Distribution expenses account		Tshs10,000
		Being purchase of car (a non-current asset), wrongly debited to distribution expense, now rectified.		
4.	Dr	Angle's receivables account	Tshs1,000	
		Cr Xiang-payables account		Tshs1,000
		Being goods sold to Angle, recorded in sales day book but not recorded in Angle's ledger, now recorded. Similarly purchases from Xiang, recorded in purchase day book but not in Xiang's ledger account, now credited		
5.	Dr	Sales account	Tshs200	
		Cr Cash		Tshs200
		Being sale of Tshs1,400, recorded as Tshs1,600 now rectified		
6.	Dr	Directors fees account	Tshs10,000	
		Cr Cash		Tshs10,000
		Being directors' fees paid, recorded in reverse. Now rectified the error by passing an entry for an amount double the previously recorded amount		
7.	Dr	Stationery expenses account	Tshs3,600	
		Cr Cash		Tshs3,600
		Being expense of stationery Tshs5,100 which was recorded at Tshs1,500 now rectified		

Continued on the next page

(Amounts in Tshs'000)

Correction of incomes and expenses ledger accounts						
Errors	**Sales**	**Purchases**	**Distribution expenses**	**Directors fees**	**Stationery**	**Increase \ (decrease) in profit**
Balances before errors	1,000,000	600,000	50,000	40,000	20,000	290,000
Error of omission (Note1)	1,200					1,200
Error of commission (Note2)						
Error of principle (Note3)			(10,000)			10,000
Compensating error (Note4)						
Error in original entry	(200) (Note 5)					(200)
Complete reversal of entry (Note6)				10,000		(10,000)
Transposition error (Note7)					3,600	(3,600)
Balances after errors adjusted for	**1,001,000**	**600,000**	**40,000**	**50,000**	**23,600**	**287,400**

Notes (1), (2) etc. are the references for the correction entries.

You can see that some errors affect the statement of profit or loss while others affect the statement of financial position.

Correction of assets and liabilities ledger accounts

(Amounts in Tshs'000)

Errors	**John-receiv-Ables**	**Jerry – receiv-Ables**	**Kerry-receivables**	**Angle-receivables**	**Car**	**Cash on hand**	**Xiang-payables**
Balances for errors	10,000	5,000	6,000	7,000	50,000	35,000	8,000
Error of omission (Note1)	1,200						
Error of commission (Note2)		1,200	(1,200)				
Error of principle (Note3)					10,000		
Compensating error (Note4)				1,000			1,000
Error in original entry (Note5)						(200)	
Complete reversal of entry (Note5)						(10,000)	
Transposition error(Note6)						(3,600)	
Balances after errors adjusted for	**11,200**	**6,200**	**4,800**	**8,000**	**60,000**	**21,200**	**9,000**

ICC Ltd
SOPL for the year ended 31 December 20X9

Before correction	
	Tshs'000
Sales	1,000,000
Purchases	(600,000)
Gross profit	400,000
Less: Expenses	
Distribution expenses	(50,000)
Directors' fees paid	(40,000)
Stationery expenses	(20,000)
Profit	**290,000**

After correction	
	Tshs'000
Sales	1,001,000
Purchases	(600,000)
Gross profit	401,000
Less: Expenses	
Distribution expenses	(40,000)
Directors' fees paid	(50,000)
Stationery expenses	(23,600)
Profit	**287,400**

Continued on the next page

You can see the impact of errors on the profitability. The effect of errors on profits can be summarised as follows:

	Tshs'000
Incorrect profit	**290,000**
Add: adjustments which lead to an increase in the profit	
Error of omission: goods sold to John	1,200
Complete reversal of entry: director's fees	10,000
	301,200
Less: adjustments which lead to a decrease in the profit	
Error of principle: purchase of car wrongly debited to distribution expense	(10,000)
Error in original entry: Sales of Tshs1,400,000 recorded as Tshs1,600,000	(200)
Transposition error: stationary	(3,600)
Correct profit	**287,40**

On similar lines the statement of financial position will also be affected by errors.

Statement of financial position as at 31 December 20X9

Before correction		
Assets	**Tshs'000**	**Tshs'000**
Car		50,000
Plant and machinery		300,000
Receivables		
John	10,000	
Jerry	5,000	
Kerry	6,000	
Angle	7,000	
Others	80,000	108,000
Cash in hand		35,000
Total		**493,000**
Capital and liability		
Share capital	175,000	
Net profit	290,000	465,000
Payables		
Xiang	8,000	
others	20,000	28,000
Total		**493,000**

After correction		
Assets	**Tshs'000**	**Tshs'000**
Car		60,000
Plant and machinery		300,000
Receivables		
John	11,200	
Jerry	6,200	
Kerry	4,800	
Angle	8,000	
Others	80,000	110,200
Cash in hand		21,200
Total		**491,400**
Capital and liability		
Share capital	175,000	
Net profit	287,400	462,400
Payables		
Xiang	9,000	
others	20,000	29,000
Total		**491,400**

Error affecting statement of profit or loss and statement of financial position

There are some errors that affect both the statement of profit or loss and the statement of financial position at the same time.

Example

Enterprise Co purchased equipment for Tshs100,000. However the accountant recorded the amount in the equipment expenses account. Enterprise Co charges 5% depreciation every year.

The above error affects both the statement of profit or loss and the statement of financial position. The financial statements before rectifying the error of Enterprise Co will be as follows:

Continued on the next page

Equipment Co

Statement of profit or loss	
	Tshs
Sales	1,000,000
Purchases	(600,000)
Gross profit	400,000
Equipment expenses	(100,000)
Profit	**300,000**

Statement of financial position	
	Tshs
Equipment	-
Other assets	500,000
Total	**500,000**
Capital	200,000
Net profit	300,000
Total	**500,000**

Correction of the above error is made as follows:

1. We need to rectify the error by crediting the equipment expenses account and debiting the equipment account.

Dr Equipment account Tshs100,000
Cr Equipment expenses account Tshs100,000
Being purchase of equipment incorrectly recorded as equipment expense, now rectified.

2. Equipment is a non-current asset and should be depreciated as follows:

Dr Depreciation account Tshs5,000
Cr Equipment account Tshs5,000
Being depreciation provided on equipment

After rectifying the above errors, the financial statements would be as follows:

Equipment Co

Statement of profit or loss	
	Tshs
Sales	1,000,000
Purchases	(600,000)
Gross profit	400,000
Equipment expenses	-
Depreciation	**(5,000)**
Profit	395,000

Statement of financial position		
	Tshs	**Tshs**
Equipment	**100,000**	
Less: depreciation	(5,000)	95,000
Other assets		500,000
Total		**595,000**
Capital		200,000
Net profit		395,000
Total		**595,000**

Decrease in errors due to computerisation

It is common practice today to use computers to perform much of the work that was once carried out manually by accounts staff. The introduction of computers in accounting has cut down a lot of the duplication of work, reduced casting errors and posting errors (as one-sided entries cannot be processed). However, many of the other types of errors (e.g. errors of principle) are still possible as wrong information can be input into the computer. It should be ensured that safeguards against these errors must be adopted.

Test Yourself 12

Jack sold goods to Sam for Tshs100,000. Sam's account was correctly posted but the sales account was wrongly credited with Tshs90,000.

This error will have an impact on:

A Statement of financial position
B Statement of profit or loss
C Sales account
D None of the above

Test Yourself 13

Jack sold goods to Sam for Tshs100,000. The sales account was correctly posted, but Sam's account was incorrectly debited with Tshs90,000.

This error will have an impact on:

A Statement of financial position
B Statement of profit or loss
C Sam's account
D None of the above

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3. Explain the provision of International Financial Reporting Standards governing financial statements regarding material errors which result in prior period adjustment.
[Learning outcome a]

If material errors are discovered in the financial statements, these should be rectified immediately whenever discovered.

Depending on the time of occurrence, **errors are of two types**:

Errors **committed** and **discovered in** the **current** year

Errors **committed earlier** but **discovered in** the **current** year; also known as **prior period errors**

Correction of errors

1. **Errors committed and discovered in the current year** should be rectified immediately in the current year.

2. **Errors committed earlier but discovered in the current year** should be rectified by:

   restating the comparative amounts for the prior period(s) presented in which the error occurred;

   if the error occurred before the earliest prior period presented, **restating the opening balances of assets, liabilities and equity for the earliest prior period presented in the financial statements.**

Definition of prior period errors

Definition

Prior period errors are omissions from, and misstatements in, the entity's financial statements for one or more prior periods arising from a failure to use, or misuse, reliable information that:

(a) was available when the financial statements for those periods were authorised for issue; and

(b) could reasonably be expected to have been obtained and taken into account, in the preparation and presentation of those financial statements.

IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors

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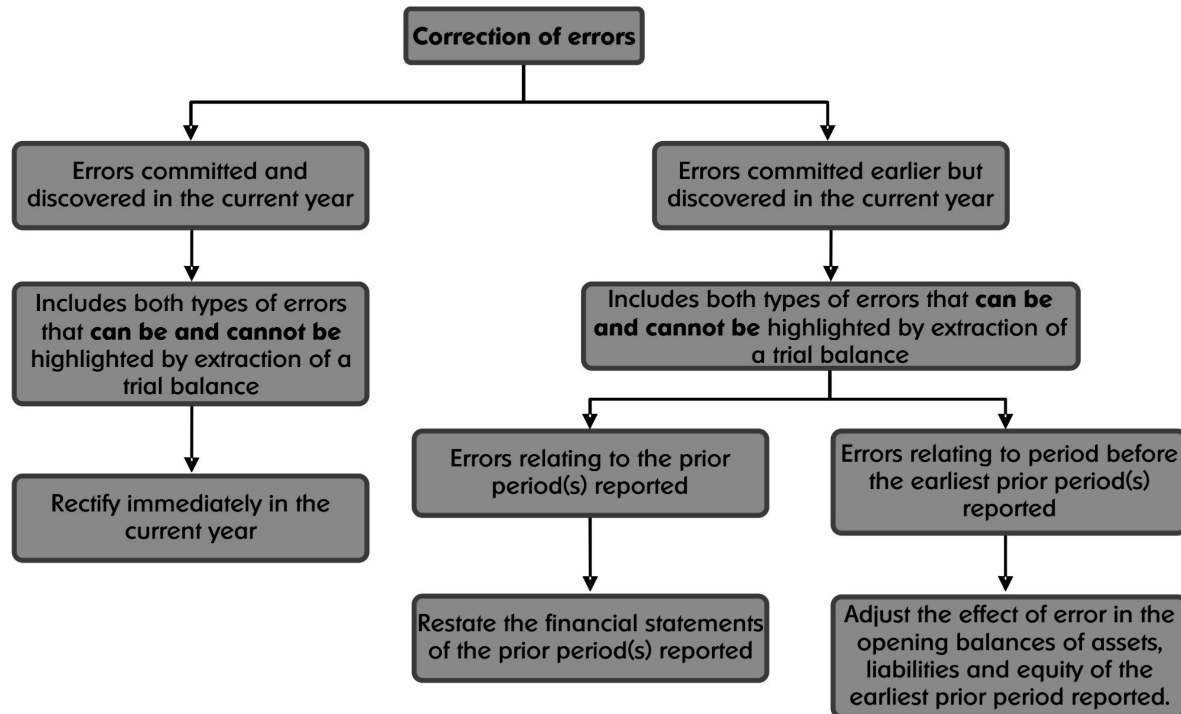
Such errors include the effects of mathematical mistakes, mistakes in applying accounting policies, oversights or misinterpretations of facts, and fraud.

Diagram 2: Correction of current and prior period errors



Prior period errors are not rectified in the current year. Think why?

The basic purpose for preparing financial statements is to understand the financial performance and position of the entity for a particular period, generally an accounting year. The primary objective of accounting is to extract true and fair statements for the accounting year. The current year's performance should not be affected by the errors relating to previous years. Hence prior period errors are not rectified in the current year.

Let us understand the above procedure by way of the following example.

Example

The draft statements of Almond Inc for 20X9 are as follows:

Financial statements 20X9				
SOPL		**SOFP**		
	Tshs		**Tshs**	**Tshs**
Revenue	900,000	Assets		850,000
Less: Expenses	(650,000)	Receivables		200,000
Profit	**250,000**	**Total**		**1,050,000**
		Equity		
		Share capital	400,000	
		Retained earnings		
		Balance b/d	200,000	
		Profit for year	250,000	850,000
		Accrued expenses		50,000
		Other liabilities		150,000
		Total		**1,050,000**

The following errors were identified.

1. During 20X8 there were unrecorded accrued expenses for Tshs50,000 which were paid in 20X7.
2. During 20X9 there were unrecorded accrued expenses for Tshs20,000 which were paid in 20X7.
3. During 20X8 there were unrecorded incomes of Tshs30,000 which were received in 20X7.
4. During 20X9 there were unrecorded incomes of Tshs80,000 which were received in 20X7.
5. The company is not reporting any other year's financial statements along with this.

Continued on next page

All these items are material.

The accounting entries for correcting the above errors are:

Dr Retained earnings Tshs50, 000
Cr Accrued expenses (liability) Tshs50,000
Being unrecorded expenses of previous year, now recorded

20X8 profits are represented by retained earnings. We have to reduce 20X8 profits hence debit retained earnings.

Dr Expenses account Tshs20,000
Cr Accrued expenses (liability) Tshs20,000
Being unrecorded expenses now recorded and liability created

Dr Receivables (asset) Tshs30,000
Cr Retained earnings Tshs30,000
Being unrecorded income of previous year, now recorded.

20X8 profits are represented by retained earnings. We have to increase 20X8 profits, hence credit retained earnings

Dr Receivables (asset) Tshs80,000
Cr Revenue Tshs80,000
Being unrecorded incomes now recorded and asset recognised.

After above corrections, the financial statements for 20X9 will be as follows:

Financial statements 20X9

SOPL	
	Tshs
Revenue (Tshs900,000+Tshs80,000)	980,000
Expenses (Tshs650,000+Tshs20,000	(670,000)
Profit	**310,000**

SOFP		
	Tshs	**Tshs**
Assets		850,000
Receivables	200,000	
Error of 20X8	30,000	
Error of 20X9	80,000	310,000
Total		1,160,000
Equity		
Share capital	400,000	
Retained earnings		
Balance b/d	200,000	
Add: error in income during 20X8	30,000	
Less: error in expenses during 20X8	(50,000)	
Profit for year	310,000	890,000
Accrued expense	50,000	
Error of 20X8	50,000	
Error of 20X9	20,000	120,000
Other liabilities		150,000
Total		**1,160,000**

Unrecorded income

Unrecorded expenses

Test Yourself 14

Michael prepared the final accounts for 20X9. He found that the purchase of raw material of Tshs50,000 on 15 November 20X9 was incorrectly omitted. What action should be taken by him?

A Pass the rectifying entry next year
B Pass the rectifying entry this year
C Omit the entry

Answers to Test Yourself

Answer to TY 1

Error of omission to record

Purchases of goods not recorded.
Payment to supplier not recorded.
Interest charged by the bank not recorded.

Error of commission

Receipt from Michael recorded in Jackson's account.
Purchases from Mack recorded in Jack's account.
Payment to Sam recorded in Suzy's account.

Error of principle

Purchase of non-current asset recorded as expense.
Receipt of loan accounted as receipt of income.
Revenue expenditure recorded as capital expenditure.

Compensating error

Cash book debit side undercast by Tshs100,000 and purchases account credit side undercast by Tshs100,000.
Cash book debit side undercast by Tshs100,000 and purchases account debit side overcast by Tshs100,000.
Sale of Tshs200,000 to Mack not recorded, and the collection from him of Tshs200,000 also not recorded.

Error of original entry

Sale of Tshs500,000 recorded as sale of Tshs400,000 in the sales day book
Payment of Tshs900,000 recorded for Tshs700,000 in the cash book.
Receipt of Tshs1,000,000 recorded as Tshs1,200,000 in the cash book.

Complete reversal of entry

Wages paid for Tshs200,000 recorded on the receipt side of the cash book and posted to the credit side of the wages account.
Depreciation on machinery debited to accumulated depreciation account, and credited to machinery account.
Purchase return to supplier recorded in sales return day book.

Answer to TY 2

Yes, there is a casting error. Sam's account has been undercast (added less) by Tshs5,000.

Answer to TY 3

The correct option is **A**.

The purchase account has a debit balance. If the debit total is overcast by Tshs1,000, it means that the balance (which is a debit balance) will also show an excess amount of Tshs1,000. Hence the correct balance of the purchase account is Tshs49,000 (Tshs50,000 - Tshs1,000) debit.

Wrong total

Dr **Purchases account (before correction)** **Cr**

	Tshs		Tshs
		Balance c/f	50,000
Total	**X**	**Total**	**X**

Tshs50,000 - Tshs1,000

Dr **Purchases account (after correction)** **Cr**

	Tshs		Tshs
		Balance c/f	49,000
Total	**X – 1,000**	**Total**	**X – 1,000**

Answer to TY 4

The correct option is **A**.

The cash account has a debit balance. When credit of Tshs2,000 is wrongly recorded, it means the cash account balance is wrongly reduced by Tshs2,000. In order to rectify this error, we have to increase the cash balance by Tshs2,000. Hence, the correct balance of the cash account is Tshs32,000.

Credit overcast by Tshs2,000

Cash book (before correction)

Dr	Tshs		Cr Tshs
			X
		Balance c/f	30,000
Total	**X**	**Total**	**X**

Credit reduced byTshs2,000. Therefore, balance is Tshs30,000 + Tshs2,000

Cash book (after correction)

Dr	Tshs		Cr Tshs
		Balance c/f	32,000
Total	**X**	**Total**	**X**

Answer to TY 5

The correct option is **C**.

The cash book has a debit balance. When credit is recorded as Tshs2,000 less than the actual amount, it means the cash book balance is wrongly increased by Tshs2,000. So, the correct balance is Tshs28,000 debit.

Credit less by Tshs2,000

Cash book (before correction)

Dr	Tshs		Cr Tshs
			X
		Balance c/f	30,000
Total	**X**	**Total**	**X**

AS credit increased by Tshs2,000, balance is Tshs30,000 - Tshs2,000

Cash book (after correction)

Dr	Tshs		Cr Tshs
		Balance c/f	28,000
Total	**X**	**Total**	**X**

Answer to TY 6

The correct option is **C**.

(The audit fees (an expense) account has a debit balance. It has been undercast by Tshs500. So, to arrive at the correct balance, we have to add Tshs500 to Tshs5,000).

Debit less by Tshs500

Audit fees account (extract) (before correction)

Dr	Tshs		Cr Tshs
		Balance c/f	5,000
Total	**X**	**Total**	**X**

As the debit increased by 500, the correct balance is Tshs5,000 + Tshs500

Audit fees account (extract) (after correction)

Dr	Tshs		Cr Tshs
		Balance c/f	5,500
Total		**Total**	

Answer to TY 7

Yes, there is an error of transposition because while posting the figures to the purchase account, they were reversed, i.e. Tshs5,200 was wrongly posted as Tshs2,500.

Answer to TY 8

Wrong entry recorded by accountant	Correct entry that should have been recorded	Correction entry to correct the error
Dr Cash Tshs15,000 Cr Share capital Tshs15,000 Being equity shares issued.	Dr Cash Tshs15,000 Cr Share capital Tshs10,000 Cr Share premium Tshs5,000 Being equity shares issued with premium	Dr Share capital Tshs5,000 Cr Share premium Tshs5,000 Being no effect given to share premium account, now corrected.

Answer to TY 9

Wrong entry recorded by accountant	Correct entry that should have been recorded	Correction entry to correct the error
Dr Office expense Tshs5,000 Cr Cash Tshs5,000 Being office expenses paid.	Dr Stationery expenses Tshs5,000 Cr Cash Tshs5,000 Being stationary expenses paid.	Dr Stationery expenses Tshs5,000 Cr Office expenses Tshs5,000 Being stationary expenses wrongly debited to office expenses, now rectified.

Answer to TY 10

The accounting entry posted by the accountant is correct because the bad debt account is to be debited and the customer's account is to be credited.

Answer to TY 11

The correct option is **B**.

The accounting treatment will be different when an item is posted in a different class of account. So, it is an error of principle.

Answer to TY 12

The correct option is **B**.

The sales account is recorded in the statement of profit or loss and retained earnings from the statement of profit or loss are carried over to the statement of financial position.

Answer to TY 13

The correct option is **A.**

As Sam- the receivable account is recorded in the statement of financial position.

Answer to TY 14

The correct option is **B**.

For errors committed in the current year, the rectifying entry has to be passed in the current year.

Self Examination Questions

Question 1

Prepare the correct ledger accounts for BBG Inc, after rectifying the following errors:

BBG Inc omitted to record a cash collection from Tony of Tshs5,000.
BBG Inc purchased machinery but recorded it as machinery expenses of Tshs6,000.
BBG Inc sold goods for Tshs200 to customer A, but omitted to record it. It also collected the cash for this sale but omitted to record it.
BBG Inc paid wages of Tshs900 but recorded Tshs700 in the cash book. Tshs700 was posted to the wages account.
BBG Inc received Tshs1,000 from a customer but recorded it as Tshs1,500 in the cash book.

Question 2

A company's profit was Tshs60,000. However it was found that Tshs16,000 paid for a motor van was debited to the motor expenses account. The useful life of the motor van was 3 years with Tshs1,000 residual value.

What will be the correct profit after rectifying the error?

A Tshs60,000
B Tshs11,000
C Tshs55,000
D Tshs71,000

Question 3

A company posted Tshs20,000 capital expenditure as revenue expenditure and Tshs5,000 revenue expenditure as capital expenditure. **Hence the profits were:**

A Overstated by Tshs5,000
B Understated by Tshs20,000
C Overstated by Tshs15,000
D Understated by Tshs15,000

Answers to Self Examination Questions

Answer to SEQ 1

Correction entry

Dr Cash Tshs5,000
Cr Tony's account Tshs5,000
Being cash received which was omitted earlier now recorded.

Tony's account (before correction)

Dr **Cr**

	Tshs		Tshs
Sales	5,000		
		Balance c/f	5,000
Total	**5,000**	**Total**	**5,000**

Tony's account (after correction)

Dr **Cr**

	Tshs		Tshs
Sales	5,000	Cash	5,000
Total	**5,000**	**Total**	**5,000**

Correction entry

Dr Machinery account Tshs6,000
Cr Machinery expense a/c Tshs6,000

BBG Inc has incorrectly debited the machinery expense account; hence to rectify this mistake it must credit the machinery expense account.

Machinery expense account (before correction)

Dr	Tshs		Tshs Cr
Cash	6,000		
		Balance c/f	6,000
Total	**6,000**	**Total**	**6,000**

Machinery expense account (after correction)

Dr	Tshs		Tshs Cr
Cash	6,000	Machinery exp a/c	6,000
		Balance c/f	0
Total	**6,000**	**Total**	**6,000**

Machinery account (before correction)

Dr	Tshs		Tshs Cr
	0	Balance c/f	
Total	**0**	**Total**	**0**

Machinery account (after correction)

Dr	Tshs		Tshs Cr
Machinery exp a/c	6,000		
		Balance c/f	6,000
Total	**6,000**	**Total**	**6,000**

As entries have been omitted, we have to rectify the mistake by recording the entries.

Correction entry

Dr Customer-A account Tshs200
Cr Sales account Tshs200
Being sales to customer A recorded

Dr Cash Tshs200
Cr Customer-A account Tshs200
Being cash collected from customer-A

Customer-A account (before correction)

Dr	Tshs		Tshs Cr
	0	Balance c/f	0
Total	**0**	**Total**	**0**

Customer-A account (after correction)

Dr	Tshs		Tshs Cr
Sales	2,00	Cash	2,00
		Balance c/f	0
Total	**2,00**	**Total**	**2,00**

Correction entry

Dr Wages account Tshs200
Cr Cash Tshs200
Being shortfall of Tshs200 rectified in wages account
.

Wages account (before correction)

Dr	Tshs		Tshs Cr
Cash	700		
		Balance c/f	700
Total	**0**	**Total**	**700**

Wages account (after correction)

Dr	Tshs		Tshs Cr
Cash	700		
Cash	200	Balance c/f	900
Total	**2,00**	**Total**	**900**

Correction entry

Dr Customer account Tshs500
Cr Cash Tshs500
Being excess Tshs500 recorded in the cash journal, now rectified

Customer account (before correction)

Dr	Tshs		Tshs Cr
Sales	5,000	Cash	1,500
		Balance c/f	3,500
Total	**5,000**	**Total**	**5,000**

Customer account (after correction)

Dr	Tshs		Tshs Cr
Sales	5,000	Cash	1,500
Cash	500	Balance c/f	4,000
Total	**5,500**	**Total**	**5,500**

Answer to SEQ 2

The correct option is **D**.

Profit before correction of errors = Tshs60,000

Profit after rectification of error

	Tshs
Profit shown	60,000
Add: Expense overstated	16,000
Less: Depreciation on car (16,000 – 1,000) / 3 years	(5,000)
Revised profit	**71,000**

Therefore the revised profits are Tshs71,000. Profits were understated by Tshs11,000 due to this error.

Answer to SEQ 3

The correct option is **D**.

Capital Expenditure affects the statement of financial position and revenue expenditure affects the statement of profit or loss.

Capital expenditure shown as revenue expenditure – as a result, profit under cast by Tshs20,000
Revenue expenditure shown as capital expenditure – as a result, profit over cast by Tshs5,000

Hence, Tshs20,000 – Tshs5,000 = Tshs15,000 understatement of profits.

SECTION E

CONTROL ACCOUNTS AND ERRORS

E2

STUDY GUIDE E2: CONTROL ACCOUNTS

Get Through Intro

In Study Guide G2 we studied the accounting procedure for accounts of receivables and payables. However, **there is another method** of **maintaining total payables and receivables** accounts using '**control accounts'**. In **this Study Guide** we will learn the procedure of maintaining **control accounts**.

In large companies where customers and suppliers are large in number it is not sensible to include all the customer accounts in the nominal ledger. The nominal ledger will become too big! The way out is to have just one account called the receivable control account for all the receivables, and one account called the payables control account for all the payables.

The individual receivable ledger accounts and the individual payable ledger accounts for individual customers and suppliers are maintained separately. Only the total of the debits and credits of these individual accounts are posted in the control accounts.

This serves a dual purpose. The nominal ledger does not become too bulky and one can have an effective control on the individual receivables and payables account as well.

How is this control obtained? To get the answer to this question you must go through this Study Guide.

Learning Outcomes

a) Explain the purpose of control accounts for accounts receivable and accounts payable.
b) Explain how control accounts relate to the double-entry system including the general ledger, personal ledgers and books of prime entry.
c) Prepare ledger control accounts from given information.
d) Perform control account reconciliations for accounts receivable and accounts payable.
e) Identify errors which would be highlighted by performing control account reconciliation.
f) Identify and correct errors in control accounts and general and personal ledger accounts.

1. Explain the purpose of control accounts for accounts receivable and accounts payable. [Learning Outcome a]

1.1 Control accounts

Definition

A **Control Account** is an account maintained in the general ledger that records only the total value of different subsidiary ledgers.

Let us begin with an example.

Example

Suppose there are three customers of Plaza Corp and each one owes Tshs1,000 at the end of 20X8, what will be the total amount of receivables from all customers?

The answer is simple and it should be Tshs3,000.

Example

Continuing with the above example of Plaza Corp

Suppose during 20X9 Plaza made further credit sales of Tshs500 to Customer-I, Tshs1,000 to Customer-II and then Tshs2,000 to Customer-III.

What will be the total receivables at the end of 20X9?

Answer: Tshs6,500

	Tshs	**Tshs**
Customer-I	1,500	(1,000 + 500)
Customer-II	2,000	(1,000 + 1,000)
Customer-III	3,000	(1,000 + 2,000)
Total	**6,500**	

Example

Continuing with the above example of Plaza Corp

Suppose during 20X9 Customer-I paid Tshs1,000 and Customer-II paid Tshs1,500. What will be the total receivables at the end of 20X9?

Answer: Tshs4,000

	Tshs	**Tshs**
Customer-I	500	(1,500 - 1,000)
Customer-II	500	(2,000 - 1,500)
Customer-III	3,000	
Total	**4,000**	

If a total receivables account is being maintained for the year to record only the gross summary of transactions with customers, it will be much easier to control the movement in the receivables account.

Continued on the next page

Using the figures above, the control account can be prepared as follows:

These accounts will be maintained as memorandum accounts

These amounts will be reflected in receivables control account

	Customer-I Tshs	Customer-II Tshs	Customer-III Tshs	Total Tshs
Balance b/d	1,000	1,000	1,000	3,000
Credit sales	500	1,000	2,000	3,500
	1,500	2,000	3,000	6,500
Payment received	(1,000)	(1,500)	-	(2,500)
Balance c/d	**500**	**500**	**3,000**	**4,000**

The balance in the total column reflects the total of the columns – Customer - I, Customer - II and Customer - III.

The above examples were very simple. There were only three accounts and relatively few transactions. However, in a normal business there may be hundreds of individual accounts, and innumerable transactions. Under such circumstance it would be very difficult not to make an error! Even the most careful accountant would make an error – for example a mathematical error, error of transposition, omission etc.

To make it easier for the accountant a **control account** is prepared. The control account is maintained in the nominal ledger and is a part of the double entry book keeping. The personal accounts of customers and suppliers are maintained under memorandum receivables and payables ledger and these are not part of the double entry book-keeping if control accounts are maintained.

1.2 Purpose of control accounts

A control account keeps a record of the total sales and the total receipts from customers. It keeps the general ledger free of details, yet has the correct balance for the financial statements.

For example, for the accounts in the receivable ledger, we can have a receivable control account. This account is updated with the following information for a period:

total collections
total credit sales
total returns and
total discounts etc

The period for which the information is recorded is decided keeping in mind the number of transactions and the requirements of the entity. The period can range from a day to a year.

The details about each customer and each transaction will not be recorded in the receivable control account. These details will be recorded in the receivable subsidiary ledger.

Receivables control account and individual receivable (customer) account

How control exists

After all the postings to the receivable control account are completed; the total of the individual customer balances = the balance in the receivable control account (in the receivable subsidiary ledger).

If the total of the individual customer balances ≠ the balance in the receivable control account (in the receivable subsidiary ledger) then it means that there is some **error in the customers' accounts** in the receivable ledger.

Example

Continuing with the above example of Plaza Corp

The receivable control account and individual customer accounts will appear as follows-

Dr — Receivables control account — Cr

Date		Tshs	Date		Tshs
	Balance b/d	3,000			
	Credit sales	3,500		Cash (collected from customers)	2,500
				Balance c/d	**4,000**
	Total	**6,500**		**Total**	**6,500**

Dr — Customer – I account — Cr

Date		Tshs	Date		Tshs
	Balance b/d	1,000		Cash (collected from customers)	1,000
	Invoice -	500		Balance c/d	**500**
	Total	**1,500**		**Total**	**1,500**

Dr — Customer – II account — Cr

Date		Tshs	Date		Tshs
	Balance b/d	1,000		Cash received	1,500
	Invoice -	1,000		Balance c/d	**500**
	Total	**2,000**		**Total**	**2,000**

Dr — Customer - III account — Cr

Date		Tshs	Date		Tshs
	Balance b/d	1,000			
	Invoice -	2,000		Balance c/d	**3,000**
	Total	**3,000**		**Total**	**3,000**

The **benefits** of preparing **control accounts** are:

1. They provide a **mathematical check** on the accuracy of the individual ledger accounts. If the total of the individual accounts within the ledger account do not agree with the balance of the respective control account, this denotes the existence of an error which needs to be identified and corrected.

2. Control accounts can be **prepared quickly to provide** the **total outstanding balance** in customers' and suppliers' accounts, without having to add up all the individual accounts. As a result, the control account is often used as the account for double entry, and the individual ledger accounts are maintained as memorandum accounts. This is explained in detail in the next learning outcome.

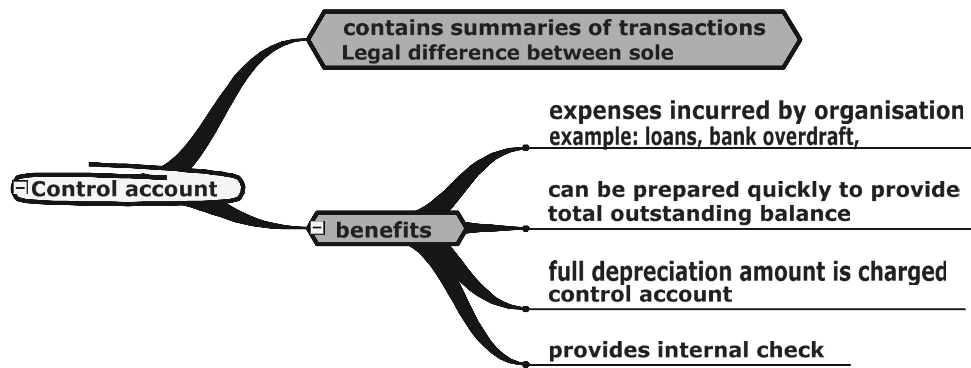
3. If control account reconciliations are prepared on a regular basis they can be used to **locate** the **errors**. Regular reconciliations will reduce the amount of data you need to check in order to identify the discrepancies.

4. In a large company, one person may not post all the transactions. E.g. purchase invoices are posted by the purchases ledger clerk and cash payments are posted by the cashier. The control account provides an **internal check** to ensure that all entries are being correctly posted.

Important

Receivables control account is also known as total receivables account or **sales ledger control account.**
Payables control account is also known as total payables account or **purchases ledger control account.**

SUMMARY



Test Yourself 1

Control accounts are maintained so as to assist accountant in:

(i) locating errors and reducing the risk of irregularities
(ii) managing credit customers and credit suppliers
(iii) improving the reliability of financial data

A (i) and (ii)
B (i) and (iii)
C (i) and (iv)
D (i), (ii) and (iii)

---

2. Explain how control accounts relate to the double-entry system including the general ledger, personal ledgers and books of prime entry.

[Learning Outcome b]

A transaction is first recorded in the books of prime entry and then posted to respective ledger accounts.

Example

Consider the sales day book given below:

Sales day book (Book of prime entry)

Date	Customer name	Invoice number	Tshs
05/06/20X9	AAL Inc	1	2,600
15/06/20X9	XY Corp	2	12,500
25/06/20X9	AAL Inc	3	21,500
		Total	**36,600**

If control accounts are not maintained

Normally the entries from the sales day book are posted to the ledger account as follows:

Nominal ledger

Dr **AAL Inc account** **Cr**

Date		Tshs	Date		Tshs
05/06/20X9	Invoice-1	2,600			
25/06/20X9	Invoice-3	21,500		Balance c/f	24,100
		24,100			**24,100**

Dr **XY Corp account** **Cr**

Date		Tshs	Date		Tshs
15/06/20X9	Invoice -2	12,500		Balance c/f	12,500
		12,500			**12,500**

Continued on the next page

Dr		Sales account			Cr
Date		**Tshs**	**Date**		**Tshs**
				Receivables	36,600
	Balance c/f	36,600			
		36,600			**36,600**

(Note: There will be also be similar entries for the purchase day book, cash book, sales returns book and purchase returns day book)

If control accounts not maintained

If the control account method is used, instead of posting to the individual customer's account in the receivable ledger, the posting will be made to the sales ledger control account. The double entry is:

Dr	Receivables control account	X	
Cr	Sales account		X

Being sales posted to control account

Receivables Memorandum ledger – These ledger do not form part of double entry system.

Dr		AAL Inc account			Cr
Date		**Tshs**	**Date**		**Tshs**
0/5/06/20X9	Invoice-1	2,600			
25/06/20X9	Invoice-3	21,500		Balance c/f	24,100
		24,100			**24,100**

Dr		XY Corp account			Cr
Date		**Tshs**	**Date**		**Tshs**
15/06/20X9	Invoice -2	12,500		Balance c/f	12,500
		12,500			**12,500**

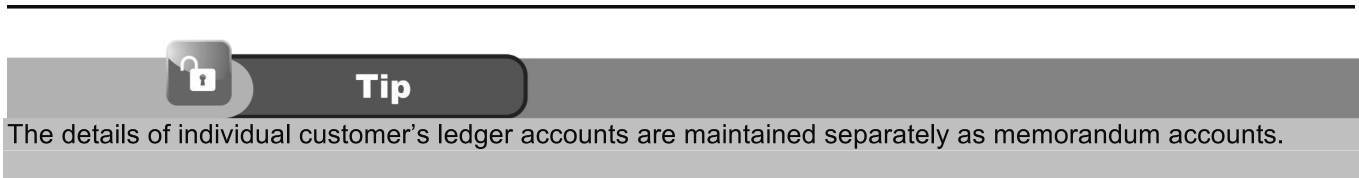
Nominal ledger – These ledger will form part of the double entry system.

Dr		Sales account			Cr
Date		**Tshs**	**Date**		**Tshs**
				Total sales	36,600
	Balance c/d	36,600			
	Total	**36,600**		**Total**	**36,600**

Dr		Receivables control account			Cr
Date		**Tshs**	**Date**		**Tshs**
	Sales Jun 20X9	36,600			
				Balance c/d	36,600
	Total	**36,600**		**Total**	**36,600**

The trial balance for the nominal ledger is as follows:

	Debit	**Credit**
	Tshs	**Tshs**
Sales A/c		36,600
Receivables A/c	36,600	
Total	**36,600**	**36,600**



The details of individual customer's ledger accounts are maintained separately as memorandum accounts.

We can see that while maintaining control accounts, the following stages are necessary.

	Stage-I Record in books of Prime Entry	**Stage-II** Record in Memorandum a/c s	**Stage-III** Double Entry	**Stage-IV** Double Entry
Sales day book	Record sales in the sales day book	Record in the individual customer's ledger account	Post periodic totals to sales and other accounts in the nominal ledger **Cr Sales account**	Post periodic totals to the receivables control account in the nominal ledger **Dr Receivables control account**
Purchase day book	Record purchases in the purchase day book	Record in the individual supplier's ledger account	Post periodic totals to purchases and other accounts in the nominal ledger **Dr Purchases account**	Post periodic totals to the payables control account in the nominal ledger **Cr Payables control account**

The control accounts are prepared from the books of prime entry as summaries of a group of accounts.

The totals posted in a control account should agree with the total of all the individual accounts in that group. One must perform reconciliations on a regular basis to ensure this relationship holds true. Any errors or discrepancies must be investigated and resolved.

Test Yourself 2

When preparing the payables ledger reconciliation for a client, you noted the following errors:

(i) an invoice for Tshs215 from a supplier was not entered in the accounting records
(ii) an invoice for Tshs465 was recorded as $456 in the purchase day book

Which of the errors will cause a difference between the balance on the control account in the nominal ledger and the total of the list of balances from the personal ledger?

A Only (i)
B Only (ii)
C Both (i) and (ii)
D Neither (i) or (ii)

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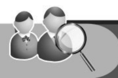
3. Prepare ledger control accounts from given information.

[Learning Outcome c]

We will learn about how the control account operates with the help of an exercise.

3.1 Preparation of books of prime entry and posting to the nominal ledger



Example

The following information was supplied by ICC Ltd for January 20X9. Prepare the books of prime entry and post to the nominal ledger using control accounts. Write up the ledger accounts as memorandum books of accounts and ensure that the total reconciles to the payables control account.

1. Purchases

02/01/20X9: Steel Company Tshs5,000 (invoice-8)
05/01/20X9: Coal Company Tshs4,000
31/01/20X9: Steel Company Tshs6,000 (invoice-15)

2. Cash book

05/01/20X9: Payment to Steel Company Tshs4,500 against invoice-8 (discount received)
06/01/20X9: Payment to Coal Company Tshs2,000

Continued on the next page

3. Journal

05/01/20X9: cash discount recorded for Tshs500 from Steel Company

Answer

(a) Books of original entry of ICC Ltd

Purchases day book for January 20X9

Date		Invoice	Tshs
02/01/20X9	Steel Company	8	5,000
05/01/20X9	Coal Company	-	4,000
31/01/20X9	Steel Company	15	6,000
		Total	**15,000**

Cash book for the month of January 20X9

Date	Receipts	Tshs	Date	Payments	Tshs
			05/01/20X9	Steel Co	4,500
			06/01/20X9	Coal Co	2,000
	Total			**Total**	**6,500**

ICC Ltd

Journal for January 20X9

05/01/20X9	Dr	Payables control account	Tshs500	
	Cr	Discount received		Tshs500
		Being discount received		

(b) Nominal ledger accounts of ICC Ltd

Post all entries from the books of prime entry into the nominal ledger.

Nominal Ledger

Dr — Purchases account — Cr

Date		Tshs	Date		Tshs
31/12/20X9	Payables		31/12/20X9	Balance c/f	15,000
	Total	**15,000**		**Total**	**15,000**

Dr — Discount received account — Cr

Date		Tshs	Date		Tshs
			05/01/20X9	Steel company	500
31/12/20X9	Balance c/d	500			
	Total	**500**		**Total**	**500**

Dr — Cash account — Cr

Date		Tshs	Date		Tshs
			05/01/20X9	Cash received	4,500
			06/01/20X9	Cash received	2,000
31/12/20X9	Balance c/d	6,500			
	Total	**6,500**		**Total**	**6,500**

Continued on the next page

Dr		Payables control account			Cr
Date		Tshs	Date		Tshs
05/01/20X9	Discount / Steel Co	500	31/01/20X9	Purchases-Jan	15,000
31/01/20X9	Cash book -Jan	6,500			
	Balance c/d	8,000			
	Total	**15,000**		**Total**	**15,000**

The trial balance for the nominal ledger is as follows:

	Debit	Credit
	Tshs	Tshs
Purchase A/c	15,000	
Payables A/c		8,000
Discount received A/c		500
Cash A/c		6,500
Total	**15,000**	**15,000**

3.2 Memorandum books of accounts

As discussed, if the control accounts are maintained, these accounts are used for double entry purposes. The **individual payables ledgers become memorandum books of accounts** i.e. additional books of accounts which do not form part of a double entry book keeping system.

In the trial balance only one figure of total payables will be taken, that of the ledger control account.

Example

Continuing the previous example of ICC Ltd Memorandum

Payables ledger

Dr		Steel company account			Cr
Date		Tshs	Date		Tshs
05/01/20X9	Cash	4,500	02/01/20X9	Purchases	5,000
05/01/20X9	Discount	500	31/01/20X9	Purchases	6,000
	Balance c/d	6,000			
		11,000			**11,000**

Dr		Coal company account			Cr
Date		Tshs	Date		Tshs
06/01/20X9	Cash	2,000	05 01/20X9	Purchases	4,000
	Balance c/d	2,000			
		4,000			**4,000**

3.3 Reconciliation of control account to memorandum accounts

The closing total of all individual accounts in the memorandum payables account should be equal to the balance in payables control account.

Example

Continuing the previous example of ICC Ltd Memorandum

	Cr
	Tshs
Steel company	6,000
Coal company	2,000
Total	**8,000**
Balance in payables control account	8,000

Continued on the next page

The control account procedure can be followed for various accounts and not just for payables and receivables. Common examples are:

inventory control accounts,
wages and salaries control accounts,
cash control accounts,
interest control accounts (normally used in banks) etc

Tip

In a trial balance, the closing total of the payables or receivables control account will be taken. The customers' or suppliers' closing balances will not be taken to the trial balance. These individual accounts do not form part of the double entry book keeping system, but are memorandum accounts.

Below are **examples** of entries you would expect to see in a control account:

Example

Summary of receivables control account

Gemini Ltd

Dr **Receivables control account** **Cr**

Date		Tshs	Date		Tshs
	Balance b/d	50,000		Cash collected from customers	180,000
	Credit sales	250,000		Sales returns	25,000
	Interest charged on overdue balance	3,500		Discount allowed	5,000
	Cash refunds to credit customers	1,000		Bad debts	6,000
				Contra against payables	16,000
				Balance c/d	72,500
	Total	**304,500**		**Total**	**304,500**

Summary of payables control account

Gemini Ltd

Dr **Payables ledger control account** **Cr**

Date		Tshs	Date		Tshs
	Cash paid to suppliers	160,000		Balance b/d	80,000
	Purchases returns	9,000		Credit purchases	180,000
	Discount received	5,000		Interest charged on overdue balance	6,000
	Contra against receivables	16,000			
	Balance c/d	76,000			
	Total	**266,000**		**Total**	**266,000**

Test Yourself 3

Calculate the closing balances on the receivables and payables control accounts for Gamma Ltd.

	Customer	Supplier
	Tshs'000	Tshs'000
Balance b/d		
Alpha Ltd	5,000	
Beta Ltd	10,000	
Chris Trades		6,000
BBG Inc		4,000
Sales during the year		
Alpha Ltd	15,000	
Beta Ltd	12,000	
Alpha Ltd	6,000	
Purchases during the year		
Chris Trades		5,000
BBG Inc		12,000
BBG Inc		1,200
Cash discount		
BBG Inc		600
Alpha Ltd	1,000	
Payments & receipts		
Chris Trades		6,000
BBG Inc		12,000
Alpha Ltd	15,000	

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4. Perform control account reconciliations for accounts receivable and accounts payable.
Identify errors which would be highlighted by performing control account reconciliation.
Identify and correct errors in control accounts and general and personal ledger accounts.
[Learning Outcomes d, e and f]

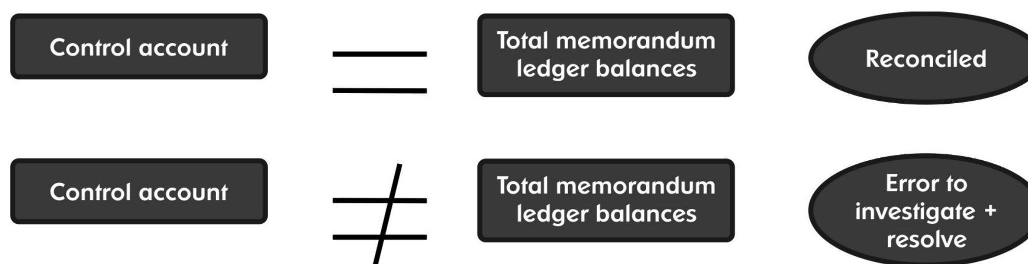
The word 'reconcile' means to settle, make consistent or agree. In accounting, the term reconciliation means to agree the discrepancies between two balances.

While preparing control account reconciliations for receivables and payables accounts the two balances which have to be reconciled are:

Closing balance in receivables / payables control account
Total of all individual ledger account balances in receivables / payables ledger (these are memorandum ledgers)

These two balances must agree with each other. If they do not agree, then there are errors in the accounting exercise. In the reconciliation process we locate the errors and rectify them. After rectification of the errors the two balances have to agree with each other.

Diagram 1: Control account reconciliations



4.1 How to reconcile?

Stage 1: the first stage is to locate any errors / omissions in the preparation or total of memorandum ledger balances and control accounts.

The following errors can be identified by performing control account reconciliation:

Possible errors in maintaining control accounts

Error	Solution
1. posting incorrect amount to control account due to miscast of totals in the books of prime entry	post rectification accounting entry
2. transactions omitted in control account but recorded in memorandum accounts	post rectification accounting entry
3. transactions omitted in memorandum accounts but recorded in control account	rectify the memorandum accounts
4. recording / casting errors in control account	post rectification accounting entry
5. recording / casting errors in memorandum account	rectify the memorandum accounts
6. "exclusion of customer's / supplier's account" in the list of memorandum accounts	"include the customer's / supplier's balance" in the "list of total customers / suppliers' balances"

It is impossible to give a full and complete list of every error that a person can make when posting entries to the control account and recording items in the individual ledger. Put simply, a person can record the wrong amount, fail to record a transaction, incorrectly enter a debit as a credit or simply just take wrong totals.

However, it is important to remember that if an item is incorrectly entered in the wrong individual ledger account (i.e. an error of commission), but the value is correct; no error will be identified in the control account reconciliation. Remember, a reconciled control account does not guarantee that there are no errors, but it does reduce the number and type of errors that may be embedded within the financial statements.

Stage 2: the next stage is to rectify the errors / omissions located in stage one

The following is an example which shows how, because of error, control accounts and memorandum ledgers are not reconciled.

Example

Fred & Ginger Dance Shoes Inc have a very select clientele and only sell to professional dance companies. In January 20X9 they made the following sales on credit:

Sales day book

	Customer name	Invoice number	Tshs
	Twinkle Toes	21	5,000
	Tap & Rap	22	10,000
	Boogey Days	23	7,500
	Twinkle Toes	24	2,500
		Total	**25,000**

At the beginning of the month they had no amounts receivable. During the month, Twinkle Toes paid Tshs5,000 and Tap & Rap paid Tshs2,000.

The accountant who wrote the receivables ledger recorded Tshs5,000 received from Twinkle Toes as Tshs2,500. However the accountant who wrote the cash book recorded it correctly.

Fred & Ginger Dance Shoes Inc

Dr **Receivables control account** **Cr**

Date		Tshs	Date		Tshs
	Balance b/d	0		Cash (collected from customers)	7,000
	Credit sales (Jan)	25,000		Balance c/f	18,000
	Total	**25,000**		**Total**	**25,000**

Continued on the next page

Dr		Twinkle Toes account			Cr
Date		**Tshs**	**Date**		**Tshs**
	Invoice-21	5,000		Cash received	2,500
	Invoice-24	2,500		Balance c/f	5,000
	Total	**7,500**		**Total**	**7,500**

Dr		Tap & Rap account			Cr
Date		**Tshs**	**Date**		**Tshs**
	Invoice-22	10,000		Cash received	2,000
				Balance c/f	8,000
	Total	**10,000**		**Total**	**10,000**

Dr		Boogey Days account			Cr
Date		**Tshs**	**Date**		**Tshs**
	Invoice-23	7,500			
				Balance c/f	7,500
	Total	**7,500**		**Total**	**7,500**

Balance according to receivables control account Dr Tshs18,000
Balance according to memorandum ledgers:
Twinkle Toes Tshs5,000
Tap & Rap Tshs8,000
Boogey Days Tshs7,500 Dr Tshs20,500

Not reconciled

Rectification of the above error

When an error is made, it must be rectified. The method required, will depend on the type of error made. **Not all errors will require a journal entry.**

Example

Continuing the above example of Fred & Ginger Dance Shoes Inc

In the above error, the **memorandum account of Twinkle Toes has to be corrected.** As this does not form part of the double entry of the accounts, no journal entry is required. After correction, **Twinkle Toes account** will appear as follows:

Dr		Twinkle Toes account			Cr
Date	**Particulars**	**Tshs**	**Date**	**Particulars**	**Tshs**
	Invoice-21	5,000		Cash received	5,000
	Invoice-24	2,500		Balance c/d	2,500
	Total	**7,500**		**Total**	**7,500**

Stage 3: reconciliation

If all the errors \ omissions in the memorandum ledger accounts and control accounts are rectified correctly then the total of the memorandum ledger balances **must agree** with the control account balance.

Example

Continuing the above example of Fred & Ginger Dance Shoes Inc

Balance according to receivables control account Dr Tshs18,000
Balance according to memorandum ledgers:
Twinkle Toes Tshs2,500
Tap & Rap Tshs8,000
Boogey Days Tshs7,500 Dr Tshs18,000

Reconciled

The following example gives understanding of the whole reconciliation process in brief.

Example

The total of the suppliers' memorandum ledger balances of Excellent Ltd was Tshs877,800,000 on 31 March 20X9 while the payables control account balance on that date was Tshs875,660,000.

The following errors were discovered:

1. An entry for payment of Tshs1,960,000 was recorded in the payables control account, but not in the suppliers' account in the memorandum ledger.
2. An invoice for Tshs8,688,000 was posted to the suppliers' account as Tshs8,868,000.

Reconciliation

The first step is to locate errors / omissions in the preparation or total of memorandum ledger balances and control accounts: these have already been located.

The second step is to rectify the errors.

1. An entry for payment of Tshs1,960,000 should be recorded on the debit side in the suppliers' account in the memorandum ledger. As a result of rectification, the closing balance will be decreased by Tshs1,960,000.

2. Supplier's account should be debited by the difference amount of Tshs180,000, because purchases are recorded by greater amount than what they should have been. As a result of rectification, the closing balance will be decreased by Tshs180,000.

The third step is reconciliation.

Particulars	**Tshs'000**
Total of suppliers' memorandum ledger balances	877,800
Less: Payment not recorded in the suppliers account in the memorandum ledger	(1,960)
Less: Excess amount recorded for invoice (Tshs8,868 - Tshs8,688)	(180)
	875,660

Once the errors are rectified, then the total of the memorandum ledger balances and control accounts agree.

Example

Black Ltd has a receivable control account balance of Tshs17,500,000 on 30 June 20X9. However, the total of the customers' memorandum ledger balance is Tshs17,670,000. Upon investigation, the accountant finds the following errors:

1. Sales amounting to Tshs1,190,000 were omitted from the control account.
2. The total of the customers' memorandum ledger balances was under cast by Tshs420,000.
3. Discount of Tshs140,000 allowed to customer Ted, had not been recorded in the control account.
4. A bad debt of Tshs700,000 had not been recorded in the control account.
5. Cash of Tshs112,000 was received from customer Jack, but was recorded in his account as Tshs12,000.
6. A customer account balance had been undercast by Tshs280,000.
7. Goods of Tshs280,000 were returned by customer John, but were not entered in the control account.
8. Cash received of Tshs350,000 had been debited to Trish's memorandum ledger account.

Now we will reconcile the receivable control account balance with the total of the balances from the customers' memorandum ledger accounts.

Errors / omissions in the preparation or total of the memorandum ledger balances and control accounts have already been located.

Continued on the next page

Rectification of errors in the memorandum ledger

Particulars	Tshs'000
Total of customer's memorandum ledger balances	**17,670**
Add: Undercasting of total	420
Add: Customer account balance undercast	280
Less: Understatement of cash received	(100)
Less: Cash received debited instead of credited	(700)
Correct closing balance of customers' memorandum ledger	**17,570**

Rectification of errors in the control accounts

Dr **Receivables control account** Cr

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d	**17,500**			
	Sales omitted to record	1,190		Discount omitted to record	140
				Cash-discount	
				Bad debts omitted to record	700
				Goods returned omitted to record	280
				Balance c/d	**17,570**
	Total	**18,690**		**Total**	**18,690**

Once these errors are rectified then the total of the memorandum ledger balances and control accounts agree.

Balance according to receivables control account Dr Tshs17,570,000

Balance according to memorandum ledgers: Dr Tshs17,570,000

Reconciled

4.2 Limitations of control accounts

Complex: the system is complex and there is some duplication of work.

Does not identify all errors: in the example of Fred & Ginger Dance Shoes Inc, had the cash book clerk also made an error and recorded Tshs2,500 instead of Tshs5,000, the error would have gone undetected in spite of maintaining control accounts. Control accounts are unable to identify errors of principle, errors of commission and errors in the original entry.

Maintaining control accounts **requires additional recording** which can increase both time consumption and costs. Many small businesses may find this additional recording a burden, and difficult to maintain.

Test Yourself 4

The following control account has been prepared by a trainee accountant:

Dr **Payables control account** Cr

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d	25,000			
	Cash-purchases	21,500		Cash paid	60,000
	Credit-purchases	50,000			
				Balance c/d	36,500
	Total	**96,500**		**Total**	**96,500**

What should be the correct closing balance in the account?

A Tshs16,500,000
B Tshs35,000,000
C Tshs15,000,000
D Tshs25,000,000

Test Yourself 5

The following control account was prepared by the sales ledger clerk:

Dr **Receivables control account** **Cr**

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d	25,000			
	Cash-sales	18,500		Cash received	60,000
	Credit-sales	50,000		Cash-discount	900
				Bad debts	600
				Balance c/d	32,000
	Total	**93,500**		**Total**	**93,500**

What should be the correct closing balance in the account?

A Tshs13,500,000
B Tshs12,000,000
C Tshs33,500,000
D Tshs32,900,000

Test Yourself 6

Fill in the blanks with either debited or credited.

(a) The periodic total of all credit purchases is ______________to the payables control account and __________ to the purchases account.

(b) A periodic total of all credit sales is _____________________ to the receivables control account and to the sales account.

Answers to Test Yourself

Answer to TY 1

The correct option is **D.**

A Control Account is an account maintained in the general ledger that records only the total value of different subsidiary ledgers. It is maintained to keep an arithmetical check on the accuracy of individual ledger accounts. It also helps in managing credit customers and suppliers and helps in improving the reliability of financial data.

Answer to TY 2

The correct option is **D**.

Since the invoice of Tshs215 was not entered in the accounting books at all, it will not result in a difference between control account and list of balances in personal ledger.

Also, in case of invoice for Tshs465, the amount is properly recorded in personal ledger and posted properly to control account. Hence there would not be any difference. However, there would be difference between purchase day book and the purchase account in nominal ledger.

Answer to TY 3

Dr **Receivables control account** **Cr**

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d (Tshs5,000 + Tshs10,000)	15,000			
	Sales (Tshs15,000 + Tshs12,000 + Tshs6,000)	33,000		Discount	1,000
				Cash	15,000
				Balance c/d	32,000
	Total	**48,000**		**Total**	**48,000**

Dr **Payables control account** **Cr**

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
				Balance b/d (Tshs6,000 + Tshs4,000)	10,000
	Discount	600		Purchases (Tshs5,000 + Tshs12,000 + Tshs1,200)	18,200
	Cash (Tshs12,000 + Tshs6,000)	18,000			
	Balance c/d	9,600			
	Total	**28,200**		**Total**	**28,200**

Answer to TY 4

The correct option is **C**.

Cash paid is a decrease in an asset. Hence cash account is credited

Remember, payables is a liability, hence it has a credit balance

A purchase is an increase in expenses. Hence purchase account is debited

Dr **Payables control account** **Cr**

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
				Balance b/d	25,000
				Credit-purchases	50,000
	Cash paid	60,000			
	Balance c/d	15,000			
	Total	**75,000**		**Total**	**75,000**

Remember cash purchases will not be recorded in the payables account.

Answer to TY 5

The correct option is **A**.

Dr **Receivables control account** **Cr**

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d	25,000			
	Credit-sales	50,000		Cash received	60,000
				Cash-discount	900
				Bad debts	600
				Balance c/d	**13,500**
	Total	**75,000**		**Total**	**75,000**

Answer to TY 6

(a) credited, debited,
(b) debited, credited

Self Examination Questions

Question 1

Calculate the correct closing balance in the following control account:

Dr — Receivables ledger control account — Cr

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d	25,000		Cash received	55,000
	Credit-sales	50,000		Sales returns	5,000
				Interest on overdue balance	6,000
				Bad debts	1,000
				allowance for bad debts	800
				Balance c/d	7,200
	Total	**75,000**		**Total**	**75,00**

A Tshs8,000,000
B Tshs13,200,000
C Tshs15,00,000
D Tshs20,00,000

Question 2

Calculate the correct closing balance of the following account:

Dr — Receivables ledger control account — Cr

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Balance b/d	25,000		Cash received	60,000
	Credit-sales	50,000		Allowance for bad debts	800
	Interest on overdue balance	6,000			
	Contras against payables	6,000		Balance c/d	26,200
	Total	**87,000**		**Total**	**87,000**

A Tshs15,000,000
B Tshs27,000,000
C Tshs20,200,000
D Tshs14,200,000

Question 3

Calculate the correct closing balance of the following account:

Dr — Payables ledger control account — Cr

Date	Particulars	Tshs'000	Date	Particulars	Tshs'000
	Opening balance	25,000			
	Credit-purchases	50,000		Cash paid	60,000
	Interest on overdue balance	6,000		Discount	800
	Contras against receivables	6,000			
	Cash purchases	6,000			
	Purchases returns	6,000			
				Balance c/d	38,200
	Total	**99,000**		**Total**	**99,000**

A Tshs38,200,000
B Tshs28,200,000
C Tshs8,200,000
D Tshs14,200,000

Question 4

An inexperienced bookkeeper has drawn up the following receivables ledger control account:

Dr **Receivables ledger Control Account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Opening balance	180,000		Credit sales	190,000
	Cash from credit customers	228,000		Bad debts written off	1,500
	Sales returns	8,000		Contras against payables	2,400
	Cash refunds to credit customers	3,300		Closing balance (balancing figure)	229,600
	Discount allowed	4,200			
	Total	**423,500**		**Total**	**423,500**

What is the closing balance after rectification of errors?

A Tshs130,600,000
B Tshs129,200,000
C Tshs142,400,000
D Tshs214,600,000

Question 5

Michael's payables control ledger account does not match with the total of the payables ledger. The following errors were located.

(i) The payables column of the cash received day book has been overcast by Tshs600,000.
(ii) A contra of Tshs400,000 against the sales ledger has only been entered in the control account.
(iii) A purchase invoice has been entered twice into the purchase day book.

Which of the above errors would cause a difference between the payables control account and the total of the payables ledger?

A (i) and (iii)
B (ii)
C All of the above.
D None of the above.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **D**.

Dr **Receivables ledger control Account** **Cr**

Date		Tshs'000	Date		Tshs'000
	Opening balance	25,000			
	Credit-sales	50,000		Cash received	55,000
	Interest on overdue balance	6,000		Sales returns	5,000
				Bad debts	1,000
				Balance c/d	**20,000**
	Total	**81,000**		**Total**	**81,000**

Allowance for bad debts is not credited to the receivables account. Refer to Study Guide G2.

Answer to SEQ 2

The correct option is **A**.

Receivables ledger control account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	25,000		Cash received	60,000
	Credit-sales	50,000		Contras against payables	6,000
	Interest on overdue balance	6,000		**Balance c/d**	**15,000**
	Total	**81,000**		**Total**	**81,000**

Answer to SEQ 3

The correct option is **C**.

Payables ledger control account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
	Cash paid	60,000		Balance b/d	25,000
	Discount	800		Credit-purchases	50,000
	Contras against receivables	6,000		Interest on overdue balance	6,000
	Purchases returns	6,000			
	Balance c/d	8,200			
	Total	**81,000**		**Total**	**81,000**

Answer to SEQ 4

The correct option is **B**.

Receivables ledger control account

Dr **Cr**

Date		Tshs'000	Date		Tshs'000
	Balance b/d	180,000		Cash from credit customers	228,000
	Credit sales	190,000		Sales returns	8,000
	Cash refunds to credit customers	3,300		Discount allowed	4,200
				Bad debts written off	1,500
				Contras against payables	2,400
				Balance c/d (balancing figure)	1,29,200
	Total	**373,300**		**Total**	**373,300**

Answer to SEQ 5

The correct option is **A**.

An error in recording the sales ledger does not affect the reconciliation of the payables control account and payables ledger.

SECTION E

CONTROL ACCOUNTS AND ERRORS

E3

STUDY GUIDE E3: SUSPENSE ACCOUNTS

Get Through Intro

A trial balance is prepared by an entity to ensure arithmetical accuracy. The balances in a trial balance are used as a basis for preparing the financial statements.

When all the ledger account balances are finalised, they are posted to the trial balance. The debits and credits total of the trial balance must be equal. **If for any reason a trial balance does not balance,** then a suspense account is opened and the **difference in the trial balance is posted to this account.**

The suspense account is a very useful tool in the hands of an accountant. With the help of a suspense account, he can balance the trial balance. However, the existence of a suspense account indicates the existence of errors which must be discovered and corrected. Financial statements cannot be prepared unless the balance in the suspense account is reduced to zero. This is because a suspense account is not an asset account, a liability account, an income account or an expense account. Then where can it be posted? Neither in the statement of profit or loss nor in the statement of financial position…

This Study Guide discusses why a suspense account is created, how it helps in identifying errors and how these errors should be rectified. You will no doubt come across some errors during your life as an accountant – a suspense account can help to solve them!

Learning Outcomes

a) Explain the purpose of a suspense account.
b) Identify errors leading to the creation of a suspense account.
c) Record entries in a suspense account.
d) Make journal entries to clear a suspense account.
e) Assess the effect on profit and net assets of adjustments made.

1. Explain the purpose of a suspense account.
[Learning Outcome a]

Before preparing the financial statements, we prepare a trial balance. If the debit and credit totals of a trial balance do not balance, it indicates that some error has crept into the accounts. Any error in the accounts is unacceptable. These errors have to be identified and rectified before financial statements can be prepared.

Whenever a trial balance does not balance, all possible efforts are made to locate the error and rectify it. However, if the error cannot be found, the difference in the trial balance is temporarily transferred to a **suspense account.** In this way the debit and credit totals of the trial balance become equal.

Definition

A suspense account is a temporary account used to carry the difference between the debit and credit total of the trial balance.

Purpose of a suspense account

The purpose of the suspense account is to put the sum of all the errors in one visible place – in one account. The accountant can then concentrate on locating and rectifying these errors. It is important to ensure that the balance of the suspense account is reduced to zero i.e. all errors are identified and corrected before the financial statements are prepared.

Therefore, a **suspense account** is **temporarily included in** a **trial balance** to balance the debit and credit totals. Any of the two methods explained below can be used to create a suspense account.

1. If the credit total of a trial balance is more than the debit total then the suspense account has a debit balance.

Example

Trial balance before including suspense account

	Debit	Credit
	Tshs	**Tshs**
X account	50,000	
Y account		60,000
Total	**50,000**	**60,000**

Trial balance after including suspense account

	Debit	Credit
	Tshs	**Tshs**
X account	50,000	
Y account		60,000
Suspense account	**10,000**	
Total	**60,000**	**60,000**

The above indicates a debit balance of Tshs10,000 in the suspense account.

Dr **Suspense account** **Cr**

	Tshs		Tshs
Difference in trial balance	10,000		

---

2. If the debit total of a trial balance is more than the credit total then the suspense account has a credit balance.

Example

Trial Balance before including suspense account

	Debit	Credit
	Tshs	**Tshs**
X account	45,000	
Y account		40,000
Total	**45,000**	**40,000**

Trial Balance after including suspense account

	Debit	Credit
	Tshs	**Tshs**
X account	45,000	
Y account		40,000
Suspense account		5,000
Total	**45,000**	**45,000**

Continued on the next page

This means that in this example, the suspense account has a credit balance of Tshs5,000.

Dr **Suspense account** **Cr**

	Tshs		Tshs
		Difference in trial balance	5,000

After opening a suspense account, all those errors that affect the agreement of a trial balance are rectified by either debiting or crediting the suspense account. **It is imperative that you investigate and eliminate the balance of the suspense account before proceeding to produce the financial statements.**
In some instances, it is also possible that an accountant might knowingly post entries to the suspense account, thereby creating an error.

Example

An amount of Tshs500,000 paid directly into the bank account of Nelson Co by a customer. The bank statement of Nelson Co refelects the payment deposited by the customer. However, the accountant is not sure which customer has paid the money. The accountant has two choices:

He can make no entries in his books until the matter is resolved and have Tshs500,000 as a reconciling item on his bank reconciliation or

The following journal entry can also be made:

Dr	Cash account	Tshs500,000	
Cr	Suspense account		Tshs500,000

Being difference in trial balance hence suspense account created

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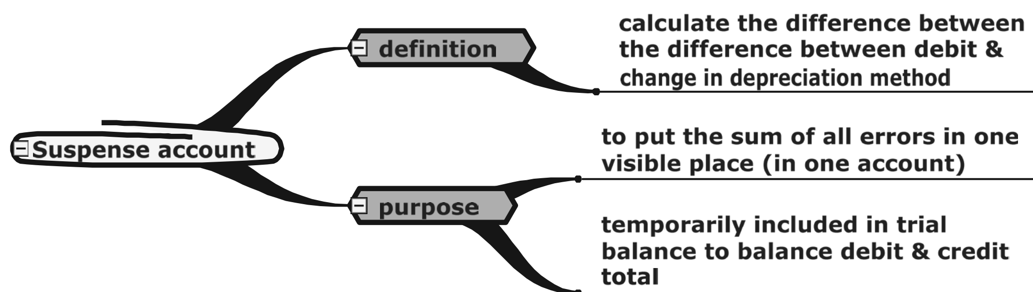
Once a suspense account is opened – it is essential to locate and rectify errors so that the account can be reduced to zero.

Both methods are valid; provided that the suspense account and the reconciling items in the bank statement are investigated on a timely basis. Company procedure will usually dictate which approach is to be adopted.

SUMMARY



2. Identify errors leading to the creation of a suspense account. [Learning Outcome b]

The errors that can occur while preparing a trial balance have already been discussed in Study Guide H2. They can be summarised as follows:

1. **Casting error** (i.e. errors of adding up)

   Undercasting of the credit side
   Undercasting of the debit side
   Overcasting of the credit side
   Overcasting of the debit side

2. Posting error

Posting the wrong amount and transposition error
Omitting to post the debit or credit side of the transaction
Posting a transaction to the wrong side of the correct ledger account

3. Figures incorrectly carried over to the trial balance

Tip

Refer back to Study Guide H2 to refresh your memory

3. Record entries in a suspense account.
[Learning Outcome c]

Let's look at some errors that give rise to an unbalanced trial balance which results in the creation of a suspense account.

Tip

Remember that:

The creation of a suspense account is temporary.
The suspense account may contain more than one entry if a number of errors have been made during a period.
The balance in the suspense account has to be reconciled and reduced to zero before preparing the financial statements.

Example

The nominal balance of Fancy Paints Ltd has the following balances as on 31/12/20X9:

	Tshs'000		Tshs'000
Cash	11,000	Plant & Machinery	13,000
Capital	15,000	Trade payables	9,000
Purchases	13,000	Sales	18,000
Trade receivables	3,000	Other expenses	2,000

Ted, the accountant, prepares the trial balance and by mistake he reports other expenses as a credit. In order to ensure Debit = Credit he must create a suspense account:

Trial balance

	Debit	Credit
	Tshs'000	**Tshs000**
Cash	11,000	
Plant and Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	13,000	
Sales		18,000
Trade receivables	3,000	
Other expenses		2,000
Suspense	4,000	
Total	**44,000**	**44,000**

Should be a debit balance as it is an expense

We will see the accounting entry to correct this later.

Because of an error in recording the amount of other expenses, the trial balance does not agree. Hence the accountant has created a suspense account to balance the trial balance.

Let's take another example of error, which leads to the creation of a suspense account in the trial balance.

Continuing the previous example of Fancy Paints Ltd

Consider Fancy Paints Ltd's ledger balances once again. Let us assume that a totalling error had been made when closing the purchases account. Instead of posting the correct balance of Tshs13 million, Ted (the accountant) recorded the amount as Tshs13.5 million.

The trial balance will now look as follows:

	Debit	Credit
	Tshs'000	**Tshs'000**
Cash	11,000	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	13,500	
Sales		18,000
Trade receivables	3,000	
Other expense		2,000
Suspense	3,500	
Total	**44,000**	**44,000**

Overstated by Tshs500,000,000

Should be a debit balance as it is an expense

You can see that the balance on the suspense account is now Tshs3.5 million which is built up of:

	Tshs'000
Expense entered as credit rather than debit	4,000
Less: Totalling mistake of purchase account	(500)
	3,500

Continuing the previous example of Fancy Paints Ltd

Consider Fancy Paints Ltd once again, Ted was having a really bad day. When posting entries from the sales day book he correctly made the entries in the sales account, but entered Tshs1 million in the trade receivables account rather than Tshs100,000.

The trial balance will now look: as follows:

	Debit	Credit
	Tshs'000	**Tshs'000**
Cash	11,000	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	13,500	
Sales		18,000
Trade receivables	3,900	
Other expense		2,000
Suspense	2,400	
Total	**44,000**	**44,000**

Continued on the next page

Error of posting to the trade receivables account overstated by Tshs900,000

You can see that the balance on the suspense account is now Tshs2,400,000 which is built up of:

	Tshs'000
Expense entered as credit rather than debit	4,000
Totalling mistake of purchase account	(500)
Error in posting trade receivables	(900)
	2,400

The example of Fancy Paint's Ltd above shows that errors can creep into the accounts at any stage. If there is an error in totalling or taking the double entry or in posting these entries in the ledger accounts, then the trial balance will not balance. We will then need to open a suspense account.

Tip

From all the above examples you can see that a suspense account is needed when total debits ≠ total credits.

Test Yourself 1

A sales invoice for Tshs750,000 has been recorded in the receivables ledger but omitted from the sales account.

What would you expect to see in the suspense account?

A Tshs750,000 credit
B Tshs750,000 debit
C Tshs1,500,000 credit
D Tshs1,500,000 debit

Test Yourself 2

A purchase of raw material for Tshs580,000 was recorded as Tshs850,000 in the purchases account. What would you expect to see in the suspense account?

A Tshs580,000 credit
B Tshs850,000 credit
C Tshs270,000 credit
D Tshs850,000 debit

Test Yourself 3

A sales invoice for Tshs600,000 was recorded in the sales account, but was not recorded in the individual customer's receivables ledger. However, posting to the receivables ledger control account was correct. What would you expect to see in the suspense account?

A Tshs600,000 credit
B Tshs600,000 debit
C Tshs1,200,000 credit
D Nil

Test Yourself 4

A discount allowed of Tshs1,600,000 was incorrectly debited by Tshs6,100,000 and a discount received of Tshs5,400,000 was incorrectly credited by Tshs4,500,000 to the discount received account. What would you expect to see in the suspense account if the correct amounts were posted to the control account?

A Tshs3,600,000 debit
B Tshs3,600,000 credit
C Tshs5,400,000 debit
D Tshs5,400,000 credit

Test Yourself 5

Which of the following errors require opening a suspense account?

A A cash sale of Tshs500,000 was neither recorded in the cash book nor in the sales account.
B A purchase of trading goods for Tshs1,800,000 was recorded as a purchase of an asset.
C A purchase for Tshs900,000 was recorded on the receipt side of the cash book and posted to the credit side of the purchases account.
D The cash book debit side was overcast by Tshs500,000.

Test Yourself 6

Which of the following errors require opening a suspense account?

A Bank charges of Tshs500,000 were not recorded in the cash book
B Bad debts of Tshs350,000 were debited to the customer's account and credited to the bad debts account
C All of the above
D None of the above

Test Yourself 7

How much will appear in the suspense account due to the following errors?

(i) Cash sales of Tshs1,500,000 were recorded as Tshs5,100,000 in both the cash book and the nominal ledger.
(ii) Cash purchases of Tshs9,100,000 were posted to the purchases account as Tshs1,900,000.
(iii) Plant account was undercast by Tshs500,000 and the accrued expense account was undercast by Tshs500,000.
(iv) Vehicle account was overcast by Tshs1,000,000 and the goodwill account was overcast by Tshs1,000,000.

A Tshs7,200,000 debit
B Tshs5,200,000 credit
C Tshs5,200,000 debit
D Tshs7,200,000 credit

Test Yourself 8

Find the balance in the suspense account for the following errors?

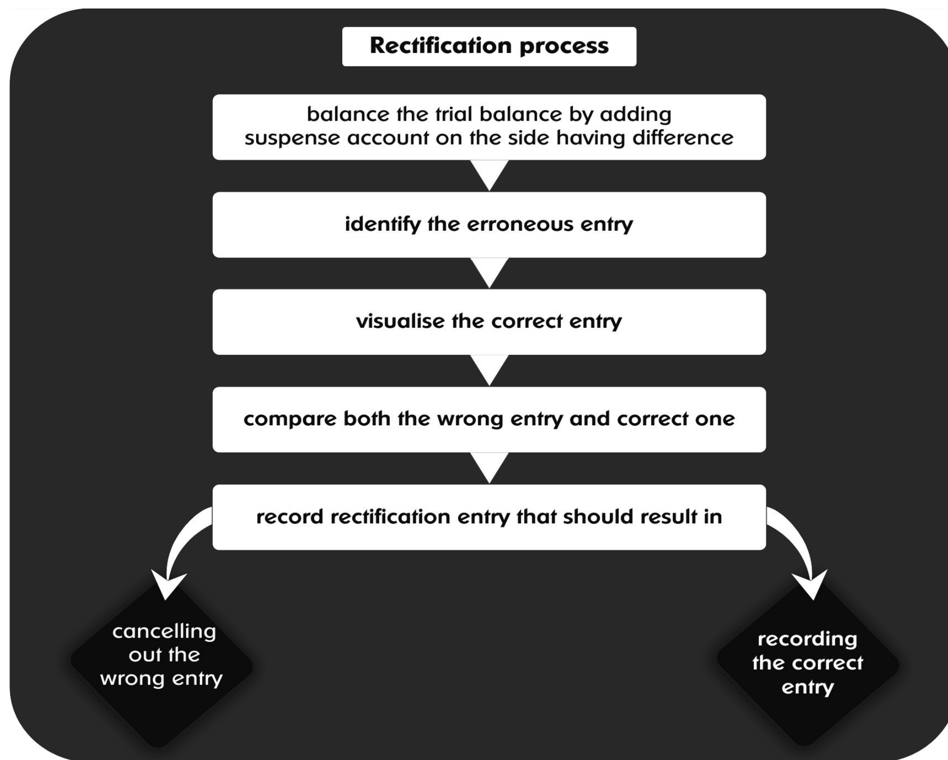
(i) Carriage inward of Tshs600,000 has been omitted from the trial balance.
(ii) Other income of Tshs900,000 has been omitted from the trial balance.
(iii) Discount received of Tshs550,000 was posted to the credit of the supplier's account.
(iv) Receipt of Tshs700,000 from a customer, Alistair, was posted to Bill's account.

A Tshs800,000 debit
B Tshs800,000 credit
C Tshs200,000 debit
D Tshs200,000 credit

4. Make journal entries to clear a suspense account.
Assess the effect on profit and net assets of adjustments made
[Learning Outcome d and e]

Before we learn journal entries let us visualise the process.

Diagram 1: Process of error rectification



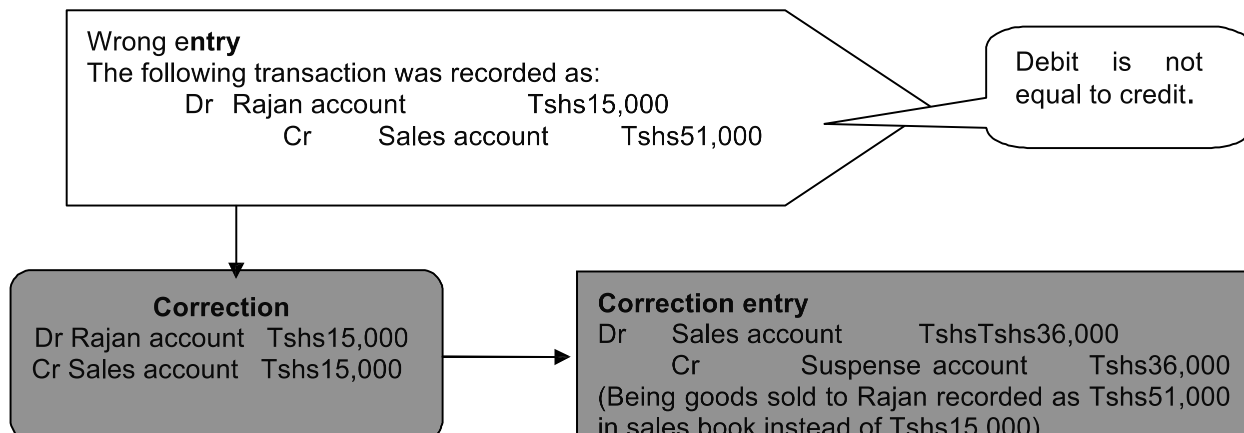
Throughout this Study Guide we have indicated that suspense accounts are temporary, and the balance must be reduced to zero. We will now consider some of the most common errors made and how they are corrected through the suspense account.

Tip

A suspense account arises only when the debit is not equal to credit.

Example

Goods are sold to Rajan for Tshs15,000. The amount recorded in the sales book is Tshs51,000; however the correct amount is posted in the account receivables control account.



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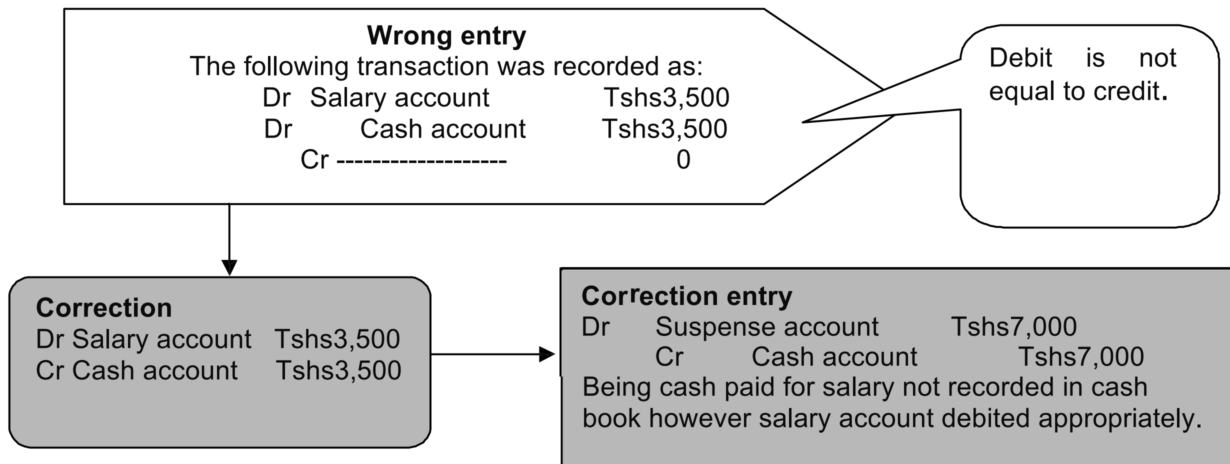
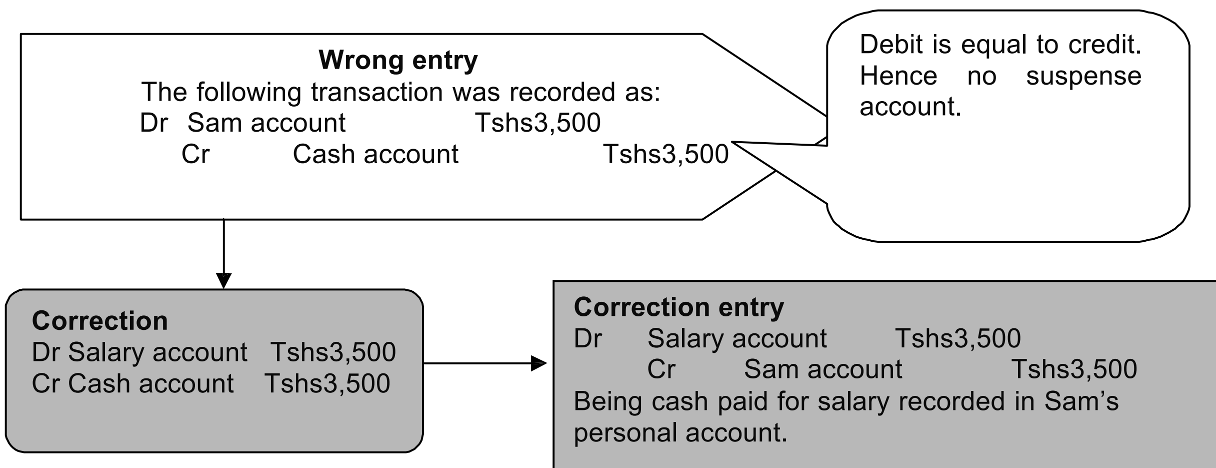
A salary amount of Tshs3,500 is paid to Sam. The accountant erroneously records the entry in the debit side of the salary account and in the receipt side of the cash book.



Salary paid to Sam of Tshs3,500 was debited to Sam's account and posted on the payment side of the cash book.



Tip

When correcting an error it is important that you identify the wrong entries made while committing the error. Then it is a simple task to reverse the error and post the correct amount to the correct account.

Let's take some more examples to show the methods of clearing the suspense account and showing the relevant journal entries to be made.

Example

Party Shirts Ltd has drafted its trial balance. It has to correct the imbalance by opening a suspense account having a debit balance of Tshs425.

	Debit Tshs	Credit Tshs
Cash	13,700	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		9,000
Purchases	6,000	
Sales		10,000
Trade receivables	3,000	
Other expenses		2,000
Discount received		125
Suspense	**425**	
Total	**36,125**	**36,125**

Investigation has shown that the following errors have been made:

1. Sales were recorded as Tshs10,000 instead of Tshs11,000 in trial balance.

2. A purchase invoice of Tshs1,500 was omitted from the purchases account. However, the correct entry was made in the supplier's account.

3. A cash discount of Tshs75 is recorded in the receivables ledger, but not in the discounts received account.

4. Collection of Tshs900 from Alistair (a customer) is credited to Bob (a supplier).

The journal entries required to clear the suspense account are as follows:

1.

Dr	Suspense account	Tshs1,000	
Cr	Sales account		Tshs1,000

Being sales account of Tshs11,000 incorrectly recorded as Tshs10,000 in the trial balance, now corrected

Reasons and explanations

The credit balance of the sales account was short on the trial balance. Therefore we need to credit the sales account and debit the suspense account.

2.

Dr	Purchases account	Tshs1,500	
Cr	Suspense account		Tshs1,500

Being purchase invoice of Tshs1,500 omitted from the purchases account, now recorded

Reasons and explanations

Omission of the purchase invoice results in a short debit balance on the purchases account in the trial balance. Hence we need to increase the debit in the purchases account and credit the suspense account.

3.

Dr	Suspense account	Tshs75	
Cr	Discount received account		Tshs75

Being discount received not recorded in the discount received account, now corrected

Continued on the next page

Reasons and explanations

Due to a one sided posting of the cash discount; the discount received account has a short credit of Tshs75. Therefore we need to credit the discount received and debit the suspense account.

4.

Dr	Bob-payable account	Tshs900	
Cr	Alistair-receivable account		Tshs900

Being cash received from Alistair wrongly credited to Bob's account, now corrected

Reasons and explanations

This is an error of commission that doesn't affect the suspense account. The amount received from Alistair is not recorded in his account, hence we need to credit Alistair's account and debit Bob's account

After correcting the above errors, the trial balance will be as follows:

	Debit	Credit
	(Tshs)	**(Tshs)**
Cash	13,700	
Plant & Machinery	13,000	
Capital		15,000
Trade payables		8,100
Purchases	7,500	
Sales		11,000
Trade receivables	2,100	
Other expenses		2,000
Discount received		200
Suspense	-	
Total	**36,300**	**36,300**

Dr **Suspense account** **Cr**

	Tshs		Tshs
Balance b/d	425	Purchases	1,500
Sales	1,000		
Discount received	75	Balance c/f	0
Total	1,500	Total	1,500

Example

The accountant of Gemini Enterprises asks for your help to correct his trial balance. The trial balance totals were:

Debit - Tshs138,660
Credit- Tshs158,000

The suspense account was created by Tshs19,340 Dr to balance the trial balance.

The following errors, that need rectification, were identified:

1. Omission from the trial balance of the audit fees expense account, Tshs8,000.
2. A discount allowed was debited to the discount received account, Tshs600.
3. A cash sale of Tshs900 was not recorded in the cash book.
4. Accrued expenses of Tshs330 were entered on the debit side of the trial balance.
5. Accumulated depreciation of Tshs900 was taken to the credit side of the trial balance.
6. Loss on the sale of plant for Tshs6,000 was credited as a profit on the sale of plant.
7. Goods taken by proprietor valued at Tshs3,200 were credited to the drawings account and debited to the purchases account.

Write the correction entry and calculate the closing totals of the trial balance.

Continued on the next page

Answer

Explanations for each of the above items are given sequentially below:

No	Wrong Entry	Tshs	Tshs		Correction Entry	Tshs	Tshs
1	Dr Suspense A/c Cr --------------	8,000	-	→	Dr Audit fees Cr Suspense A/c	8,000	8,000
2	Dr Discount received Cr Customer's A/c	600	600	→	Dr Discount allowed Cr Discount received	600	600
3	Dr -------------- Cr --------------			→	Dr Cash Cr Sales	900	900
4	Dr Accrued expense Cr Suspense A/c	660	660	→	Dr Suspense A/c Cr Accrued expense	660	660
5	Not an error			→	------------------		
6	Dr Asset disposal Cr Profit on sale of plant	6,000	6,000	→	Dr Profit on sale of plant Dr Loss on sale of plant Cr Asset disposal	6,000 6,000	12,000
7	Dr Purchases A/c Cr Drawings	3,200	3,200	→	Dr Drawings Cr Purchases A/c	6,400	6,400

Explanation

1. The audit fees account has a debit balance. Due to the omission of this account there arises a debit balance in the suspense account of Tshs8,000. Therefore we must debit the audit fees account and credit the suspense account.

2. There was an error in posting to the wrong account. We have not debited the discount allowed account, hence we will debit the discount allowed account and credit the discount received account.

Tip

This error does not cause **the trial balance not to balance; hence there will be no effect on the suspense account.**

3. This is an error of omission. We need to record the entry.

4. Accrued expense has a credit balance of Tshs330. Since it was taken to the wrong side of the trial balance, it created a credit balance in the suspense account of Tshs660. We need to debit the suspense account and credit the accrued expense account.

5. Not an error.

6. Instead of debiting the loss, an incorrect credit was given to the profit on sale of plant account. Therefore, the profit on sale of plant account should be reversed by Tshs6,000 to rectify the error. We also need to debit the loss on sale of the plant for the same amount and credit the asset disposal account by Tshs12,000

7. This is a complete reversal of entry so it does not imbalance the trial balance. Instead of debiting the drawings account by Tshs3,200 the accountant has credited it by Tshs3,200. While correcting the error we need to first reverse the wrong credit and include the correct debit. This requires debiting the drawings account by Tshs6,400 and crediting the purchases account by Tshs6,400.

Continued on the next page

Dr	Suspense account		Cr
	Tshs		Tshs
Balance b/d	19,340	Audit fees	8,000
Accrued expense	660	Profit on sale of asset	12,000
		Balance c/f	0
Total	**20,000**	**Total**	**20,000**

Trial balance totals after rectification

	Debit	Credit
	(Tshs)	(Tshs)
Balance earlier	138,660	158,000
Suspense account cleared	19,340	
	158,000	**158,000**
Other adjustments		
Discount	600	600
Cash sales	900	900
Drawings	6,400	6,400
Revised totals	**165,900**	**165,900**

Example

The debit side of a company's trial balance was Tshs500 more than the credit side. Which of the following errors is the sole cause of the difference?

1. Discount received of Tshs500 was recorded on the debit side of the account.
2. Share premium of Tshs500 was credited to the share capital account.
3. Receipt from the customer of Tshs500 was omitted from the records.
4. Discount received of Tshs250 was recorded on the debit side of the account.

Post the rectification entry for each of the above errors.

Answer

In order to correct the error it is necessary to first identify it. It is then a simple task to correct the error and make the correct entries. Further explanation is provided below each of the errors.

	Accounting entry with error			Effect on suspense account	Correction entry		
		Tshs	Tshs			Tshs	Tshs
1	Dr Discount received Dr Supplier's account	50 0 50 0	- -	Suspense account will have a credit balance of Tshs1,000	Dr Suspense account Cr Discount received	1,00 0	1,00 0
2	Dr Cash Cr Share capital	500 -	- 500	No effect on suspense account.	Dr Share capital Cr Share premium	50 0	50 0
3	Dr -------------------- Cr --------------------			No effect on suspense account.	Dr Cash Cr Customer	500 -	- 500
4	Dr Discount received Cr Suppliers account	25 0	- 250	Suspense account will have a credit balance of Tshs500	Dr Suspense account Cr Discount received	50 0	50 0

Continued on the next page

Explanation

1. There is an **error in posting**. Instead of recording the discount on the credit side we have recorded it on the debit side. This will create a difference in the trial balance for twice the amount of error i.e. twice of Tshs500 = Tshs1,000.

2. This error does not affect the agreement of the trial balance. We have not credited the share premium account. While rectifying the error we need to credit the share premium account and debit the share capital account.

3. Complete **omission** does not affect the agreement of the trial balance. We need to record the entries for the first time.

4. There is an **error in posting**. Instead of recording the discount received on the credit side we have recorded it on the debit side. This will create a difference in the trial balance for twice the amount of error i.e. twice Tshs250 = Tshs500

Tip

Errors that can be highlighted by extraction of a trial balance will require a suspense account.
Errors that cannot be highlighted by extraction of a trial balance will not require a suspense account.

Example

Rectify the following errors:

1. Other income received of Tshs880 was correctly recorded in the cash book, but was debited to the other income account.

2. Cash paid for wages of Tshs9,600 was posted to the wages account as Tshs6,900.

3. The purchases day book was overcast by Tshs2,000.

4. The sales day book was undercast by Tshs6,000.

5. The cash book credit side was undercast by Tshs1,300.

6. The prepaid expense account debit side was undercast by Tshs600.

7. A sale of Tshs1,500 was fully credited to the sales account. However, sales tax of Tshs500 was included in it.

8. A building purchased for Tshs60,000 was entered in the building account as Tshs50,000. The company charges 2% depreciation.

9. Repairs to machinery of Tshs5,000 were capitalised and a depreciation of 5% was charged on it.

Also classify these errors into:

Errors requiring suspense account
Errors not requiring suspense account

Continued on the next page

Error	Wrong entry			Whether Suspense A/c required	Correction entry		
		Tshs	Tshs			Tshs	Tshs
1	Dr Cash Dr Other income	880 880	- -	Yes	Dr Suspense A/c Cr Other income	1,760	 1,760
2	Dr Wages Cr Cash	6,900	 9,600	Yes	Dr Wages Cr Suspense A/c	2,700	 2,700
3	Dr Purchases Cr ------------	12,000	 10,000*	Yes	Dr Suspense A/c Cr Purchases account	2,000	 2,000
4	Dr -------------- Cr Sales	16,000*	 10,000	Yes	Dr Suspense A/c Cr Sales A/c	6,000	 6,000
5				Yes	Dr Suspense A/c Cr Cash	1,300	 1,300
6	Dr Prepaid expense Dr--------	1,000	 1,600*	Yes	Dr Prepaid expense Cr Suspense A/c	600	 600
7	Dr Cash Cr Sales account	1,500	 1,500	No	Dr Sales account Cr Sales tax A/c	500	 500
8	Dr Building Cr Cash	50,000	 60,000	Yes	Dr Building Cr Suspense account	10,000	 10,000
					Dr Depreciation Cr Accumulated depreciation (2% on 10,000) (Refer Explanation 8)	200	 200
9	Dr Machinery A/c Cr Cash	5,000	 5,000	No	Dr Repairs to machinery Cr Machinery A/c	5,000	 5,000
					Dr Accumulated depreciation Cr Depreciation (5% on 5,000) (Refer Explanation 9)	250	 250

***-** figures are assumed for explanation

Explanation

1. There is an error in posting. Instead of recording the other income on the credit side we have recorded it on the debit side. This will create a difference in the trial balance for twice the amount of error i.e. twice Tshs880 = Tshs1,760. We will credit the other income account by Tshs1,760 and debit the suspense account by Tshs1,760.

2. There is an error in posting. Instead of posting Tshs9,600 to the debit side of the wages account we have posted Tshs6,900. This means there was a short debit posting of Tshs2,700. Therefore to rectify the error we will debit the wages account by Tshs2,700 and credit the suspense account by Tshs2,700.

3. The purchases account has a debit balance. Overcasting of the purchases day book means the purchases account has a higher debit balance than it should have in the trial balance. Hence to rectify this we need to reduce the excess balance by crediting the purchases account and debiting the suspense account.

Continued on the next page

4. The sales account has a credit balance. Undercasting of the sales day book means that the sales account has a lower credit balance than it should have in the trial balance. Hence to rectify this we need to credit the sales account and debit the suspense account by Tshs6,000.

5. The cash book payment side has a credit balance. Undercasting of the payment side of the cash book means the credit in the cash balance is too low. Therefore to rectify this we need to credit the cash and debit the suspense account by Tshs1,300.

6. The prepaid expense account debit side has been undercast. Therefore we need to debit the prepaid expense account and credit the suspense account by Tshs600.

7. Sales tax included in the sales was not credited to the sales tax account. Therefore to correct the error we need to credit the sales tax account and debit the sales account by Tshs500.

8. There is an error in posting. Instead of posting Tshs60,000 to the debit side of the building account we have posted Tshs50,000. This means the debit side was short by Tshs10,000. Therefore to rectify the error we will debit the building account by Tshs10,000 and credit the suspense account by Tshs10,000.

   However, this error also has an impact on depreciation. Due to this error, a lower depreciation was calculated on the building than should have been. We need to increase the depreciation. This entry will not affect the suspense account.

9. This is an error of principle. Revenue expenditure was incorrectly capitalised. To rectify the error we need to debit the repairs to machinery account and credit the machinery account by Tshs5,000.

   Due to this error, extra depreciation was recorded. Therefore we also need to reduce the depreciation. This reduction in depreciation will be a correcting journal that does not affect the suspense account.

Test Yourself 9

You will credit the cash in the rectification entry for:

A The credit side of the cash book was undercast.
B The credit side of the cash book was overcast.
C The debit side of the cash book was undercast.
D None of the above

Test Yourself 10

You will debit the cash in the rectification entry for:

A The credit side of the cash book was undercast.
B The credit side of the cash book was overcast.
C The debit side of the cash book was overcast.
D Undercast the debit side of the cash book.

Test Yourself 11

Which of the following errors do not require creation of a suspense account?

(i) Depreciation of machinery Tshs500 is recorded as maintenance of machinery Tshs550.
(ii) Credit sales of Tshs10,000 are recorded on the debit side of the sales account, and the same was posted correctly into customers' account.
(iii) Office expenses of Tshs5,000 are omitted, and not recorded in the books of accounts.

A (i) and (iii)
B (iii)
C All of the above
D None of the above

Answers to Test Yourself

Answer to TY 1

The correct option is **A**.

The accounting entry should have been:

Dr	Receivables account	Tshs750,000	
Cr	Sales account		Tshs750,000

Only the debit posting has been made. The credit entry has been omitted. Hence, when preparing the trial balance, a credit balance will have to be created in the suspense account to ensure debit = credit. Suspense account = Tshs750,000 Credit.

Answer to TY 2

The correct option is **C**.

Purchases are a debit balance within the trial balance (Expense). Hence the debit side of the trial balance is overstated by (Tshs850,000 - Tshs580,000) = Tshs270,000. Suspense account = Tshs270,000 Credit.

Answer to TY 3

The correct option is **D**.

When control accounts are maintained, the individual customer ledgers become memorandum accounting books. Hence there is no double entry required for rectifying mistakes in the memorandum books. The suspense account balance is zero.

Answer to TY 4

The correct option is **A**.

The accounting entry should have been:

Dr	Discount allowed	Tshs1,600,000	
Cr	Customers control account		Tshs1,600,000

However the debit posting was made for Tshs6,100, which creates Tshs4,500,000 more on the debit side. The suspense account will have **Tshs4,500,000 C**redit.

The accounting entry should have been:

Dr	Suppliers control account	Tshs5,400,000	
Cr	Discount received		Tshs5,400,000

However, the credit posting was made for Tshs4,500; this creates Tshs900 less on the credit side. The suspense account will have **Tshs900,000 D**ebit.

Suspense account

Dr **Cr**

	Tshs'000		**Tshs'000**
Discount received	900	Discount allowed	4,500
Balance c/f (credit balance)	**3,600**		
Total	**4,500**	**Total**	**4,500**

Answer to TY 5

The correct option is **D**.

A This is an **error of omission** and needs to be recorded for the first time. This does not create a difference on the trial balance.
B This is an **error of principle**. This does not create a difference in the trial balance.
C The accounting **entry is reversed**. However debit = credit in the entry. This does not create a difference in the trial balance.
D This error makes the debit > credit hence a suspense account is required.

Answer to TY 6

The correct option is **D**.

It is an **error of omission** and needs to be recorded for the first time. This does not create a difference in the trial balance.
The accounting entry has been **reversed.** However debit = credit, so this does not create a difference on the trial balance.

Answer to TY 7

The correct option is **B**.

	Accounting entry	Effect on suspense account		
		Debit	**Credit**	**Balance**
i.	Tshs'000	Tshs'000	Tshs'000	Tshs'000
ii. Mistake in the original entry (**Transposition error**)	Dr Cash 5,100 Cr Sales 5,100			-
iii. Error in posting to purchases account	Dr Purchases 1,900 Cr Cash 9,100	7,200		7,200 Dr
iv. Undercasting of plant account Undercasting of accrued expense (**Compensating errors**)	(-) asset (debit) by 500 (-) liability (credit) by 500			-
v. Overcasting of vehicle Overcasting of goodwill	(+) asset (debit) by 1,000 (+) asset (debit) by 1,000		2,000	5,200,

Dr **Suspense account** **Cr**

	Tshs'000		Tshs'000
Purchases account	7,200	Overcasting of vehicle account	1,000
		Overcasting of goodwill account	1,000
		Balance c/f	5,200
Total	**7,200**	**Total**	**7,200**

Answer to TY 8

The correct option is **A**.

	Accounting entry	Effect on suspense account		
		Debit	**Credit**	**Balance**
	Tshs'000	**Tshs'000**	**Tshs'000**	**Tshs'000**
1. Omission of carriage inward from trial balance		600		600 Dr
2. Omission of other income from trial balance			900	300 Cr
3. Wrong posting to supplier's account	Cr Discount received - 550 Cr Suppliers account - 550	1,100		800 Dr
4. Error of commission	Dr Cash 700 - Cr Bill's - 700			800 Dr

Suspense account

Dr					Cr
Date		**Tshs**	**Date**		**Tshs**
	Omission of carriage inward account from trial balance	600		Omission of other income from trial balance	900
	Posting to the wrong side in suppliers account	1,100			
				Balance c/d	**800**
	Total	**1,700**		**Total**	**1,700**

Answer to TY 9

The correct option is **A**.

Cash has a debit balance. When the credit side is undercast, it makes the closing balance of cash more than the actual. Therefore we need to credit the cash in the rectification entry.

Answer to TY 10

The correct option is **B**.

Cash has a debit balance. When the credit side is overcast, it makes the closing balance of cash less than the actual. Therefore we need to increase the cash balance by debiting cash.

Answer to TY 11

The correct option is **B**.

The first error is an error of principle and transposition, which requires a suspense account.
The second is an error of posting, which requires a suspense account.
The third is an error of omission, which does not require a suspense account.

Self Examination Questions

Question 1

Tshs8,000 paid for building maintenance has been correctly entered in the cash book but debited to the building asset account.

What is the correct entry to rectify this error?

A	Dr		Depreciation account	Tshs8,000	
		Cr	Building asset account		Tshs8,000
B	Dr		Building maintenance	Tshs8,000	
		Cr	Building asset account		Tshs8,000
C	Dr		Building maintenance	Tshs16,000	
		Cr	Building asset account		Tshs16,000
D	Dr		Building asset account	Tshs8,000	
		Cr	Building maintenance		Tshs8,000

Question 2

Discount allowed Tshs900 has been debited to the discount allowed account, but credited to the customer's account.

What is the correct entry to rectify this error?

A	Dr		Discount allowed	Tshs900	
		Cr	Suspense account		Tshs900
B	Dr		Customers account	Tshs900	
		Cr	Discount allowed		Tshs900
C	Dr		Suspense account	Tshs1,800	
		Cr	Discount allowed		Tshs1,800
D	No entry required				

Question 3

Discount allowed Tshs900 has been debited to the discount received account.

What is the correct entry to rectify this error?

A	Dr		Discount allowed	Tshs1,800	
		Cr	Discount received		Tshs1,800
B	Dr		Suspense account	Tshs900	
		Cr	Discount allowed		Tshs900
C	Dr		Discount allowed	Tshs900	
		Cr	Discount received		Tshs900
D	No entry required				

Question 4

The cash balance of Tshs1,700 has been omitted from the trial balance.

The correct entry to rectify this error is:

A	Dr		Cash	Tshs1,700	
		Cr	Suspense account		Tshs1,700
B	Dr		Suspense account	Tshs1,700	
		Cr	Cash		Tshs1,700
C	Dr		Cash	Tshs3,400	
		Cr	Discount received		Tshs3,400
D	No entry required				

Question 5

Interest received of Tshs34,000 was posted to the interest received account as Tshs43,000. There was no error in the cash posting. **What is the correct entry to rectify this error?**

A	Dr		Cash	Tshs9,000	
		Cr	Interest received account		Tshs9,000
B	Dr		Suspense account	Tshs9,000	
		Cr	Interest received account		Tshs9,000
C	Dr		Interest received account	Tshs9,000	
		Cr	Suspense account		Tshs9,000
D	No entry required				

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

Dr	Building maintenance	Tshs8,000	
Cr	Building asset account		Tshs8,000

Explanation:

The building asset account was incorrectly debited by Tshs8,000. We need to credit this account by Tshs8,000, i.e. reverse the wrong entry and debit the building maintenance account by the correct amount.

Nature:

An error of principle does not affect the trial balance; therefore no entry to the suspense account is needed.

Answer to SEQ 2

The correct option is **D**.

It is not an error therefore needs no entry.

Answer to SEQ 3

The correct option is **C**.

Dr	Discount allowed account	Tshs900	
Cr	Discount received account		Tshs900

Explanation:

There was an incorrect debit to the discount received account. Hence we will credit the discount received account to reverse the entry, and debit the correct account i.e. the discount allowed account.

Nature:

Error of principle- does not affect the trial balance therefore no entry to the suspense account is needed.

Answer to SEQ 4

The correct option is **A**.

Dr	Cash account	Tshs1,700	
Cr	Suspense account		Tshs1,700

Explanation:

Omission of cash balance in the trial balance will require opening a suspense account. As debit ≠ credit on the trial balance, the cash has a debit balance in the trial balance and so the suspense account will be credited.

Nature:

Wrong carry over to the trial balance - affects the trial balance. Therefore an entry to the suspense account is needed.

Dr	Interest received account	Tshs9,000	
Cr	Suspense account		Tshs9,000

Answer to SEQ 5

The correct option is **C**.

Dr	Interest received account	Tshs9,000	
Cr	Suspense account		Tshs9,000

Explanation:

This error will create a balance in the suspense account as debit □ credit in the original entry.

Dr	Cash account	Tshs34,000	
Cr	Interest received account		Tshs43,000

Hence, to reduce the above excess we need to debit the interest received by Tshs9,000 to reverse the error and credit the suspense account to reduce the imbalance.

Nature: Error of transposition in posting - affects the agreement of the trial balance. Therefore an entry to the suspense account is needed.

SECTION F

PREPARING BASIC FINANCIAL STATEMENTS

F1

STUDY GUIDE F1: STATEMENT OF INCOME AND STATEMENT OF COMPREHENSIVE INCOME

Get Through Intro

Cooking food well is only half the job: The food will not be relished unless it is served in a proper manner! Similarly, doing day-to-day accounting well is only half the job. It will not serve its purpose unless the results are presented in a proper format, with the required content.

The end-result of the accounting process is the financial statements. The statement of profit or loss (which is a component of the financial statements) is very important because it states whether the entity has made a profit or a loss in the period for which it is prepared.

All users of financial statements are interested in the profitability of an entity, because in the long run if an entity is unable to make profits it will have to wind up its operations. For example, Daisy Inc. is a cash rich company and has numerous assets. However, if it is not able to earn profits for a long period it means that it is eating into its asset base.

The statement of profit or loss is closely linked with the statement of financial position and the statement of changes in equity. Accounting for many transactions and events has a simultaneous effect on both the statements.

This Study Guide discusses the preparation of the statement of profit or loss and analyses the inter-relationship between the statement of profit or loss and the statement of financial position.

Learning Outcomes

a) Prepare a statement of profit or loss and other comprehensive income from given information.
b) Explain in non-complex cases how generally accepted accounting practice applies to revenue and expenses.
c) Calculate revenue, cost of sales, gross profit, profit from operations, profit for the year and total comprehensive income from given information.
d) Disclose items of income and expenditure in the statement of profit or loss.
e) Explain the inter-relationship between the statement of financial position and the statement of profit or loss and other comprehensive income.
f) Identify items requiring separate disclosure on the face of the statement of profit or loss and other comprehensive income.
g) Describe the usefulness of statement of profit or loss and other comprehensive income to users of accounting information.

1. Calculate revenue, cost of sales, gross profit, profit from operations, profit for the year and total comprehensive income from given information.

[Learning Outcome c]

The following items are presented in the statement of profit or loss and other comprehensive income:

1. Revenue

Revenue is the gross inflow of economic benefits towards sale of goods or services by the entity on its own account.

Definition

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

IAS 18 Para 7

Amounts collected on behalf of third parties such as sales tax, goods and services tax and value added tax are not economic benefits which flow to the entity and do not result in an increase in equity. Hence they are excluded from revenue.

Example

Bright Brains Ltd is a professional firm. Brilliant Academy is a major client of Bright Brains. Bright Brains charges professional fees on a monthly basis, at Tshs650,000 per month. The fees for ten months are received but those for two months are outstanding i.e. not received for the year to 31 March 20X7.

In this case, revenue from Brilliant Academy will be calculated as Tshs650,000 x 12 months on an accrual basis. Therefore, the revenue will be Tshs7,800,000. Cash received (Tshs6,500,000) as well as a receivable created (Tshs1,300,000) are economic benefits that represent revenue earned.

Fees, interest, dividends, royalties or rent are also revenue. However, they are recognised as other income and not main revenue (assuming that receipt of such income is not the main activity of the reporting entity).

SUMMARY

2. Cost of sales

Cost of sales is:

- the purchase cost for the traded goods sold and
- the production cost for the manufactured goods sold.

For an entity rendering services, cost of sales would mean the cost of services rendered.

Production cost = Cost of the raw materials used + Labour cost to make the goods + Production overheads cost

The following is the information given by Manufax, a manufacturing company. Calculate the cost of goods sold.

	Tshs
Direct material consumed	33,500
Direct labour	12,400
Overheads	8,200
Sales	60,000

Cost of goods sold = Material consumed + labour + overheads
= Tshs33,500 + Tshs12,400 + Tshs8,200
= Tshs54,100

---

3. Gross profit

Gross profit = Sales value - Cost of sales

It is also represented as a percentage of sales (i.e. gross profit margin).

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

Gross profit calculations are relevant only when the **function of expenses** presentation is used for the statement of profit or loss (see the next Learning Outcome).

The following information is available from the books of Harrison Enterprise for the year to 31 December 20X9.

Sales during the year are Tshs120,000.
Gross profit is Tshs24,000.

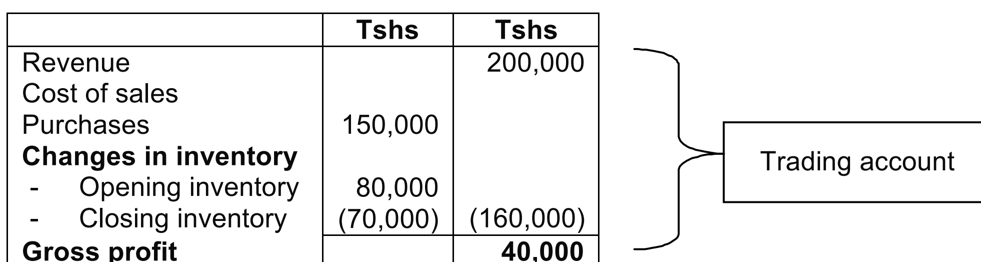
In this case:

Cost of goods sold = Sales - Gross profit
= Tshs120,000 - Tshs24,000
= Tshs96,000

Gross profit ratio = Gross profit/Sales
= Tshs24,000/Tshs120,000 x 100
= 20%

The part of a statement of profit or loss which shows the calculations up to the gross profit earned by the reporting entity is popularly known as a **trading account**.

Statement of profit or loss for the year to 31 December 20X9



	Tshs	Tshs
Revenue		200,000
Cost of sales		
Purchases	150,000	
Changes in inventory		
- Opening inventory	80,000	
- Closing inventory	(70,000)	(160,000)
Gross profit		**40,000**

Test Yourself 1

From the following information calculate the cost of goods sold and the sales.

	Tshs
Opening inventory	16,400
Purchases	87,200
Closing inventory	14,560

Gross profit is 20% on sales.

---

4. Profit or loss for the period

IAS 1 requires that all items of income and expenses recognised in a period shall be included in profit and loss, unless a standard or an interpretation requires otherwise. Some IFRSs require or permit that some components to be excluded from profit or loss and instead, be included in other comprehensive income.

For the purpose of Paper T05, we would limit our discussion to presentation of gains on revaluation of property, plant and equipment. Treatment of revaluations on property, plant and equipment is explained in detail in Study Guide F1.

Important

An entity may present a single statement of profit or loss and other comprehensive income, with profit or loss and other comprehensive income presented in two sections. The sections shall be presented together, with the section presented first followed directly by the other comprehensive income section. An entity may present the profit or loss section in a separate statement of profit or loss. If so, the separate statement of profit or loss shall immediately precede the statement presenting comprehensive income, which shall begin with profit or loss.

IAS 1 Para 10A

From the above, we can conclude that an entity may calculate profit or loss for the year, **using either:**

a single statement: comprising profit or loss for the period and other comprehensive income presented in two sections; or

two statements: statement of profit or loss which calculates the profit or loss for the period and statement of profit or loss and other comprehensive income which begins with profit or loss for the period along with other comprehensive income.

In either case, the analysis of expenses recognised in the profit or loss could be made using a classification based on either their nature or their function within the entity, whichever provides information that is reliable and more relevant. The formats are discussed below:

Important

The income statement is also referred to as statement of profit or loss or the statement of income. For the purpose of Paper T05, we would be referring to the income statement as the statement of profit or loss in the entire Paper.

Nature of expenses method

Under this method, expenses are presented in the statement of profit or loss according to their nature. For example, depreciation, employee costs and rent. The expenses are not allocated to functions and therefore, this method is simpler.

XYZ Ltd – Statement of profit or loss for the year ended 31 December 20X9 (based on classification of expenses by nature)

	20X9	20X8
	Tshs'000	**Tshs'000**
Revenue	X	X
Other income	X	X
Changes in inventories of finished goods and work in progress	X	X
(Positive figure indicates increase; negative figure, decrease)	(X)	(X)
Raw materials and consumables used	(X)	(X)
Employee benefits expense	(X)	(X)
Depreciation and amortisation expense	(X)	(X)
Other expenses	(X)	(X)
Total expenses	(X)	(X)
Profit	**XX**	**XX**

Function of expense method

Under this method, expenses are classified according to their function. For example, expenses need to be classified under cost of sales or costs of distribution or administrative activities. At a minimum, an entity discloses its cost of sales under this method separately from other expenses.

Although this method can provide more relevant information to users than the classification of expenses by nature, the disadvantage is that the allocating of costs to functions may require arbitrary allocations which may involve considerable judgement.

XYZ Ltd – Statement of profit or loss for the year ended 31 December 20X9 (based on classification of expenses by function)

	20X9	20X8
	Tshs'000	**Tshs'000**
Revenue	X	X
Cost of sales	(X)	(X)
Gross profit	**X**	**X**
Other income	X	X
Distribution costs	(X)	(X)
Administrative expenses	(X)	(X)
Other expenses	(X)	(X)
Finance costs	(X)	(X)
Profit before tax	**X**	**X**
Income tax expense	(X)	(X)
Profit for the year	**XX**	**XX**
Other comprehensive income		
Gains on property revaluation	X	X
Total comprehensive income for the year	**XX**	**XX**

Tip

If the examination question refers to a statement of profit or loss and other comprehensive income, it means that it includes the statement of profit or loss elements and the other comprehensive income.

If the examination question refers to an income statement, it means that it includes the elements from revenue to profit for the year. This is now also called the statement of profit or loss.

5. Total comprehensive income

The revised IAS 1 brought in the concept of comprehensive income. Total comprehensive income is the total of profit or loss for the period and other comprehensive income for the period.

If there are no items of other comprehensive income, the profit or loss for the year will be equal to the total comprehensive income. The items included in other comprehensive income are the items which are not considered in the calculation of profit or loss e.g. gains on property revaluations and actuarial gains and losses.

Example

Statement of profit or loss and other comprehensive income

	Tshs'000	Tshs'000
Revenue Cost of		10,000
sales **Gross**		(7,000)
profit		**3,000**
Distribution costs	500	
Administrative expenses	300	
Other expenses Profit	200	(1,000)
before tax Income tax		2,000
expense **Profit for**		(600)
the year (a)		**1,400**
Other comprehensive income		
Gains on property revaluations	150	
Income tax relating to the above gain	(30)	
Other comprehensive income for the year (b)		**120**
Total comprehensive income for the year (a + b)		**1,520**

Alternative presentation

Statement of profit or loss

	Tshs'000	Tshs'000
Revenue Cost of		10,000
sales **Gross**		(7,000)
profit		**3,000**
Distribution costs	500	
Administrative expenses	300	
Other expenses	200	(1,000)
Profit before tax		2,000
Income tax expense		(600)
Profit for the year (a)		**1,400**

Statement of profit or loss and other comprehensive income

	Tshs'000	Tshs'000
Profit for the year (a)		1,400
Gains on property revaluations	150	
Income tax relating to the above gain	(30)	
Other comprehensive income (b)		120
Total comprehensive income for the year (a) + (b)		**1,520**

Tip

For the purpose of this study text, unless a question specifically asks for a two statement format, we will generally be following the single statement format i.e. we will be preparing a statement of profit or loss and other comprehensive income.

Test Yourself 2

Below is the information for Matrix & Co for the year ended 31 December 20X9:

	Tshs
Opening inventory	500
Purchases	2,600
Closing inventory	400
Revenue	4,000
Distribution costs	240
Other income	110
Administration expenses	150
Income tax expenses	300
Gain on Freehold property revaluation	600
Tax on revaluation surplus	180

Required:

Prepare the statement of profit or loss and other comprehensive income for the year to 31 December 20X9.

---

2. Prepare a statement of profit or loss and other comprehensive income from the given information.
Identify items requiring separate disclosure on the face of the statement of profit or loss and other comprehensive income.

[Learning Outcomes a and f]

Information to be presented on the face of the statement of profit or loss

The information in the financial statements may be provided for on the face of the statement or in the notes to the financial statements. Certain information, which is important for the users of an entity's financial statements, is required to be presented on the face of the financial statements.

IAS 1, Presentation of Financial Statements, requires particular information to be presented on the face of the statement of profit or loss or the profit or loss section.

Definition

The statement of profit or loss shall include line items that present the following amounts for the period:

(a) revenue;
(b) finance costs;
(c) share of profit of the associates and associates accounted for the period;
(d) tax expense;
(e) profit or loss

As Paper T05 is a basic paper, other minimum presentation requirements are not mentioned here.

An entity shall present **additional line items, headings and subtotals** in the statements presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance.

IAS 1, Para 82 and 85

There are other disclosure requirements according to IAS 1 regarding profit or loss of discontinued operations. However, these do not form a part of your syllabus, and hence they have not been discussed here.

Unlike the statement of financial position, IAS 1 does not specify many line items to be disclosed on the face of the statement of profit or loss. The probable reason is that reporting entities deal in a wide variety of businesses, and one set of line items may not be applicable to all.
In order to enable understanding of the basics of the preparation of the financial statements, some simple problems are discussed here.

Example

Preparation of financial statements from a trial balance

Malcolm Chisholm, a sole trader provides you with the following trial balance for the year ended 31 May 20X9.

Trial Balance as at 31 May 20X9

	Dr	Cr
	Tshs	**Tshs**
Sales Purchase		241,320
Discounts allowed	150,000	
Discounts received	10,800	
Provisions for depreciation (as at 1 June 20X8)		2,880
on property		
on equipment		12,000
Inventory, as at 1 June 20X8		22,800
Capital, as at 1 June 20X8	30,000	
17% long-term loan		72,780
Irrecoverable debts		18,000
Returns out	2,760	
Wages and salaries		9,000
Drawings	35,280	
Loan interest	14,400	
Other operating expenses	3,060	
Trade payables	10,620	
Trade receivables		21,600
Cash in hand	22,800	
Bank	180	
Property, at cost	780	
Equipment, at cost	72,000	
Allowance for receivables	48,000	
		300
	400,680	**400,680**

Malcolm provides you with the following information as at 31 May 20X9:

(i) Inventory as at 31 May 20X9 has been valued at cost, at Tshs25,200.

(ii) Accruals required for wages and salaries are Tshs480.

(iii) Other operating expenses are pre-paid by Tshs180.

(iv) The allowance for receivables is required to be maintained at 2% of trade receivables.

(v) Depreciation for the year ended 31 May 20X9 is still to be provided for, as follows:
Property: 1.5% per annum using the straight line method and
Equipment: 25% per annum using the reducing balance method.

Required:

Prepare a statement of profit or loss and a statement of financial position for the year the year ended 31 May 20X9.

Continued on the next page

Answer

Malcolm Chisholm – Statement of profit or loss for the year to 31 May 20X9

	Tshs	Tshs
Sales		241,320
Cost of sales		
Opening inventory	30,000	
Purchase	150,000	
Purchase returns	(9,000)	
	171,000	
Closing inventory	(25,200)	(145,800)
Gross profit		**95,520**
Other income - discounts received		2,880
		98,400
Expenses		
Operating expenses		
Wages and salaries (Tshs35,280 + Tshs480)	35,760	
Discounts allowed	10,800	
Irrecoverable debts (W1)	2,916	
Loan interest (18,000 x 17%)	3,060	
Depreciation (W2)	7,380	
Other operating expenses (Tshs10,620 - Tshs180)	10,440	(70,356)
Profit for the year		**28,044**

Malcolm Chisholm - Statement of financial position as at 31 May 20X9

	Tshs	Tshs
Non-current assets		
Property (cost)	72,000	
Less: Accumulated depreciation	(13,080)	58,920
Equipment (cost)	48,000	
Less: Accumulated depreciation	(29,100)	18,900
		77,820
Current assets		
Inventory	25,200	
Trade receivables net of allowance for receivables (Tshs22,800 - 456 (W1)	22,344	
Prepayments	180	
Bank	780	
Cash in hand	180	48,684
		126,504
Capital		
Balance at 1 June 20X8		72,780
Add: Profit for the year	28,044	
Less: Drawings	(14,400)	13,644
Current liabilities		
Trade payables	21,600	
Accruals	480	22,080
Long-term liabilities		
17% loan		18,000
		126,504

Continued on the next page

Workings

W1 Irrecoverable debts

	Tshs
Previous allowance	300
New allowance (2% x 22,800)	(456)
Increase	156
According to trial balance	2,760
Income	**2,916**

W2 Depreciation on property

	Tshs
Opening provision	12,000
Provision for the year (1.5% x Tshs72,000)	**1,080**
Closing provision	**13,080**

Calculated on cost

W3 Depreciation on equipment

	Tshs
Opening provision	22,800
Provision for the year (25% x Tshs25,200)	6,300
Closing provision	**29,100**

Calculated on cost

Total depreciation charge in the statement of profit or loss = Tshs1,080 + Tshs6,300 = Tshs7,380

Test Yourself 3

The owner of Chemidrum Traders gives you the following information:

Inventory	Tshs
1 January 20X9	15,700
31 December 20X9	12,300

Transactions during 20X9 are as follows:

	Tshs
Purchases at list price	80,000
Trade discount was received at 2.5% of list price	
Early settlement discount earned at 3% on a payment of Tshs50,000	
Sales	104,250
Cash payments	
Salaries	3,000
Electricity	900
Telephone	400
Printing and stationery	500
Refreshments	300
Unpaid expenses related to 20X9	
Telephone	50
Electricity	100
Salary	500

Required:

Prepare a statement of profit or loss for the year to 31 December 20X9

3. Disclose items of income and expenditure in the statement of profit or loss.
Describe the usefulness of statement of profit or loss and statement of comprehensive income to users of accounting information

[Learning Outcomes d and g]

3.1 Disclosure of income and expenditure in the statement of profit or loss

The following main headings are usually given in the statement of profit or loss, when the classification of expenses method is used. The expenses below each heading are the main expenses which usually make up the heading. However, it is possible to classify the expenses differently than what is shown here; if a good enough reason can be shown.

1. **Revenue** (Sales)

2. **Cost of sales**

3. **Income from other sources** i.e. income derived from activities which are not the main activities of the entity.

   (a) Interest and dividends
   (b) Fees and royalties
   (c) Rent
   (d) Profit or loss on sale of non-current assets
   (e) Bad debts recovered after being written off earlier

4. **Selling and distribution expenses**

   (a) Salaries of sales staff and managers
   (b) Travelling and entertainment of sales people
   (c) Advertising and sales promotion
   (d) Cost of running and maintenance of delivery vehicles
   (e) Bad debts: the debts that become irrecoverable
   (f) Discount allowed to customers.

5. **Administration expenses**

   (a) Salaries of office staff and managers,
   (b) Insurance of assets
   (c) Rent and property taxes
   (d) Telephone
   (e) Postage and courier
   (f) Printing and stationery
   (g) Heating and lighting

6. **Finance expenses**

   (a) Interest on bank overdraft
   (b) Interest on loans

Example

Classify the following expenses under selling and distribution expenses, administration expenses, cost of goods, and finance expenses:

Salesmen's salaries	Tshs20,000
Repairs to office premises	Tshs10,000
Interest on term loan	Tshs15,000
Telephone	Tshs12,000
Power for the factory	Tshs23,000
Wages for manufacturing the goods	Tshs50,000
Additional allowance for bad debts	Tshs14,000
Interest on debentures	Tshs34,000

Continued on the next page

Answer

Expenses	Tshs	Classification
Salesmen's salaries	20,000	Selling and distribution expense
Additional allowance for bad debts	14,000	Selling and distribution expense
Repairs to office premises	10,000	Administration expenses
Telephone	12,000	Administration expenses
Power for the factory	23,000	Cost of goods
Wages for manufacturing the goods	50,000	Cost of goods
Interest on term loan	15,000	Finance expenses
Interest on debentures	34,000	Finance expenses

Example

Flora, a florist, gives you the following information:

Sales during the year: Cash sales Tshs9,800
Credit sales Tshs3,200

Total purchases during the year are Tshs10,500 of which Tshs2,400 are still outstanding.
Salary paid to an assistant Tshs400.
She hired a shop for Tshs120 per month. 2 months' rent has not yet been paid by Flora.
She rented a part of the shop for Tshs50 per month.
The cost of travelling between her home and the shop is Tshs900 for the year.
Other shop expenses: Tshs85
Being of perishable nature, she purchases flowers only according to demand, therefore there is no opening or closing inventory.

From the above information prepare the statement of profit or loss for the year to 31 December 20X7.

Answer

Flora florist – Statement of profit or loss for the year to 31 December 20X7

	Tshs	Tshs
Sales		
Cash sales	9,80	
Credit sales	0	13,00
Less: Cost of goods sold		0
Gross profit		**2,500**
Add: Other income – rent (Tshs50 x 12 months)		600
		3,100
Less: Expenses		
Salary Rent	400	
Conveyance	1,440	
Shop expenses	900	
Profit for the year	85	(2,825)
		27

Note:

In accordance with the **concept of the matching principle**:

1. Outstanding purchases of Tshs2,400 should be included in the total purchases, as the outstanding amount will be shown as trade payables in the statement of financial position.
2. Rent of a hired shop is paid for only 10 months. However, total rent should be charged to the statement of profit or loss for 12 months. Rent payable of 2 months should be shown as a provision for rent in the statement of financial position.

Test Yourself 4

Which of the following expenses are administrative expenses?

(i) Salary paid to employees
(ii) Telephone expenses
(iii) Interest on loan taken for office premises
(iv) Advertisement expenses
(v) Cost of running and maintenance of delivery vehicles
(vi) Bad debts

A (i) and (ii)
B (iii) and (iv)
C (i), (ii), (iii) and (iv)
D (i), (ii), (v), (vi)

3.2 Usefulness of statement of profit or loss to the users

(i) A statement of profit or loss depicts whether an entity has made a profit or loss in an accounting period.

(ii) To describe how the profit or loss arose e.g. it differentiates costs between operating costs and cost of sales.

(iii) The analysis of statement of profit or loss gives much more information than a company's earnings.

(iv) It provides important information about management's efficiency in controlling expenses, amount of income, and taxes paid.

(v) Investors can use the statement of profit or loss to calculate financial ratios that will ultimately give the rate of return.

(vi) To compare a company's profits with that of its competitors by examining various profit margins e.g. the operating profit margin, gross profit margin and net profit margin.

4. Explain in non-complex cases how generally accepted accounting practice applies to revenue and expenses.

[Learning Outcome b]

4.1 Statement of profit or loss is a period statement

The statement of profit or loss is a statement for a period, typically one year. Revenue, expenses and profits for the period for which the statement of profit or loss is prepared are to be included in the statement of profit or loss. Most of the principles to be discussed now stem from this fundamental fact. The statement of profit or loss is like a video recording of all the transactions that occur in the period!

Example

A statement of profit or loss for the year to 31 December 20X9 covers the period between 1 January and 31 December 20X9. Income and expense occurring during this period are included in the statement of profit or loss.

4.2 Meaning of revenue and expenses

(a) Revenue

Discussed in Learning Outcome 1 of this Study Guide

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity.

Revenue refers to the **earnings** on account of the ordinary activities that are undertaken with a profit motive.

Example

The amount received as professional fees is a revenue item, since it is a receipt on account of the ordinary activities of the profession. On the contrary, the proceeds from the sale of furniture are revenue items only for a dealer or manufacturer of furniture items. For all other businesses – proceeds from the sale of furniture are not revenue items (considered to be capital income).

(b) Expenses

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

Example

A loss, by theft is an item of expense.

Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, wages and depreciation. They usually lead to **an outflow of cash or cash equivalent,** or a **depletion of assets** such as inventory, property, plant and equipment.

Example

When rent of Tshs1,000,000 is paid, it is an expense represented by an outflow of cash. When a plant is used for one year, and depreciation of Tshs20,000,000 is charged, it is a non-cash expense represented by depletion of an asset.

4.3 Difference between capital and revenue expenditure

This concept has been discussed in detail in Study Guide F1. To summarise, it can be said that:

The expenditure that is for the **maintenance of an asset is revenue expenditure** and is recognised in the statement of profit or loss**.**

The expenditure that is incurred for **enhancing the life or the utility of an asset is capital expenditure** and is recognised in the statement of financial position**.**

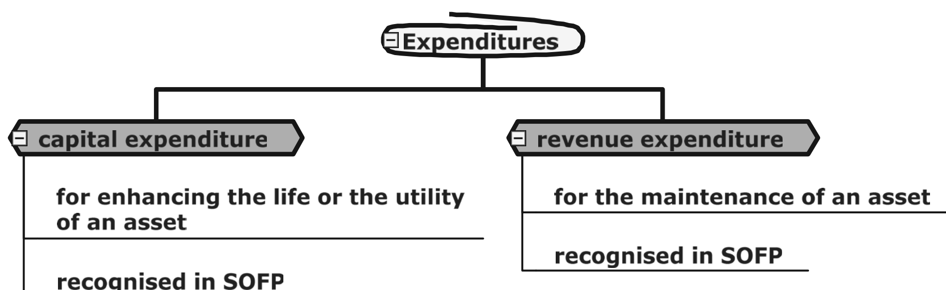
Example

Popular Cinemas spent Tshs65 million on expanding the seating capacity of one theatre and Tshs5 million on painting another theatre.

The Tshs65 million spent on expanding the seating capacity is capital expenditure as it is incurred to enhance the life or the utility of an asset. It will be recognised in the statement of financial position.

The Tshs5 million spent on painting the other theatre is revenue expenditure, as it is incurred for maintenance of an asset. It is recognised in the statement of profit or loss.

SUMMARY



4.4 Revenue recognition principles

Definition

Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants.

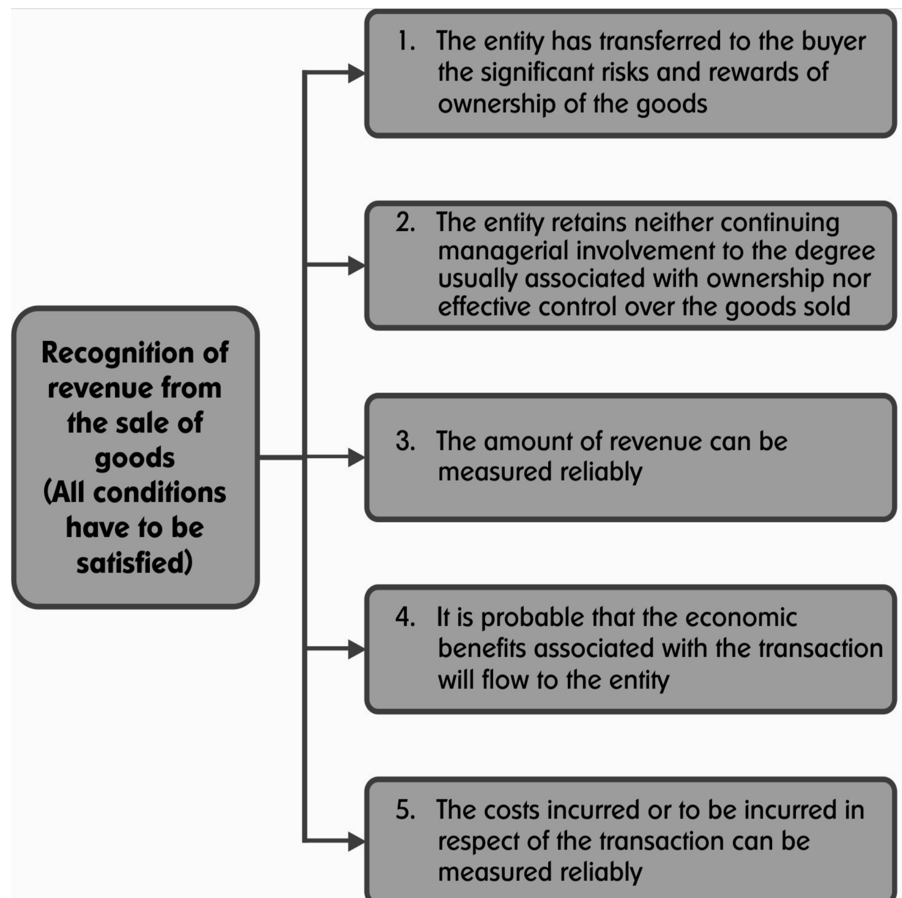
IAS 18 Para 7

Sales revenue includes revenue from:
- the sale of goods; or
- the rendering of services; or
- the use by others of entity assets yielding interest, royalties and dividends.

The amounts collected on behalf of others (e.g. sales taxes, value added tax and money collected on behalf of a principal in an agency relationship) are **excluded** from revenue. To keep it simple, we will be discussing revenue from sale of goods and services.

1. Measurement of revenue from sale of goods

Diagram 1: Recognition of revenue from the sale of goods



Generally, the amount of revenue is the amount **of cash or cash equivalents** received or receivable. However, sometimes, the inflow of cash or cash equivalents is deferred. In such cases, the fair value of the consideration may be less than the nominal amount of cash received or receivable. **Such arrangements are regarded as financing transactions and the fair value of the consideration is determined by discounting all future receipts using an imputed rate of interest**

Example

On 31 March 20X7, Delta sold goods for a price of Tshs12·1 million. The terms of the sale allowed the customer to extend the credit and the price was payable by the customer in cash on 31 March 20X9. A discount rate that is appropriate for the risks in this transaction is 10%.

Answer

In this case, on 31 March 20X7, Delta should recognise only Tshs10 million i.e. Tshs12.1 million/$(1 + 10\%)^2$ as revenue and receivables. On 31 March 20X8, it should recognise Tshs1 (Tshs10 million x 10%) as finance cost and increase the receivables. On 31 March 20X9, finance cost (income) will be recognised for Tshs1.1 (Tshs11 million x 10%) and also the receivables.

---

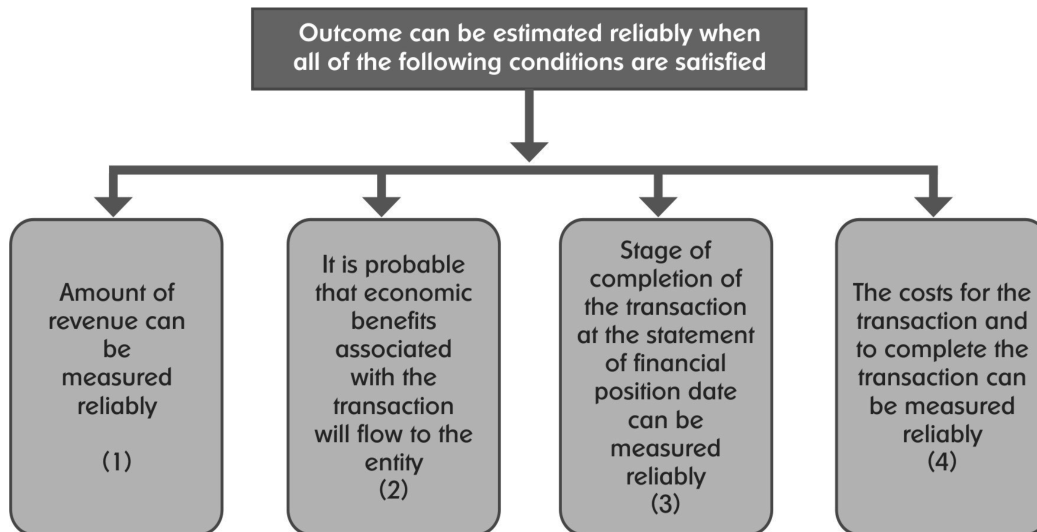
2. Measurement of revenue from sale of services

1. If **outcome can be estimated reliably**: revenue is recognised using the stage of completion method.
2. If **outcome cannot be estimated reliably**: revenue is recognised only to the extent of the recoverable expenses.

In the early stages of rendering services when the **outcome of a transaction is not certain, revenue will be recognised only to the extent of costs incurred** because it is assumed that these costs will be recovered from the client. If it is not probable that the costs will be recovered, no revenue is recognised and all costs are expensed.

In order to estimate the outcome reliably, all of the necessary conditions outlined in the following diagram must be satisfied.

Diagram 2: Criteria to measure whether outcome can be reliably estimated



Test Yourself 5

Square Co has assembled and installed a machine at the premises of Circle Co. The total cost of this machine is Tshs24,500. Circle Co has paid the amount but on the condition that, if the machine breaks down within a period of one year, it will have to be dismantled and taken back by Square Co.

Required:

When can this amount received by Square Co be recognised as sales revenue?

4.5 Financial statements of a company

An example containing financial statements is given here, in order to give an idea about the financial statements of a company.

Example

The following trial balance has been extracted from the books of Zodiac Ltd as at 30 September 20X9

	Tshs'000	Tshs'000
Administrative expenses	500	
Share capital (3,500 ordinary shares of Tshs1,000 each)		3,500
Cash at bank and in hand	75	
Tax (over payment last year)		25
Distribution costs	750	
Dividends received (on 31/03/20X9)		311
Freehold property:		
- at cost	3,375	
- accumulated depreciation (at 01/10/20X8)		325
Plant and machinery:		
- at cost	6,500	
- accumulated depreciation (at 01/10/20X8)		4,500
Interim dividend (paid on 30/06/20X9)	45	
Investments	2,500	
Retained earnings at 01/10/20X8		3,428
Purchases	20,000	
Research expenditure	94	
Inventory (at 01/10/20X8)	2,875	
Trade payables		3,625
Trade receivables	3,375	
Sales revenue		24,375
Total	**40,089**	**40,089**

Additional information:

(i) The company was incorporated in 20X2.

(ii) Depreciation for the year to 30 September 20X9 is to be charged on the historic cost of the non-current assets as follows: Plant and machinery: 15 per cent and Freehold property: 5 per cent

(iii) Research expenditure should be included under administrative expenses.

(iv) The inventory at 30 September 20X9 was valued at Tshs4,500,000.

(v) On 30 September 20X9, the directors proposed a final dividend of Tshs750 per share

(vi) Tax based on the profits for the year was estimated to be Tshs1,062,500

Required:

Prepare the statement of profit or loss and other comprehensive income, statement of changes in equity and statement of financial position of Zodiac for the year ended 30 September 20X9 in accordance with IAS 1 "Presentation of Financial Statements".

Continued on the next page

Answer

Zodiac Ltd – Statement of profit or loss and other comprehensive income for the year ended 30 September 20X9

	Tshs'000	Tshs'000
Sales revenue		24,375
Less: Cost of sales (W1)		(18,375)
Gross profit		**6,000**
Distribution costs	750	
Administrative expenses (W2)	1,738	(2,488)
		3,512
Other operating income (W3)		311
Profit before taxation		**3,823**
Income tax expense (W4)		(1,038)
Profit for the financial year		**2,785**

Zodiac Ltd – Statement of changes in equity for the year ended 30 September 20X9

	Share capital	Retained earnings	Total
	Tshs'000	Tshs'000	Tshs'000
Balance as on 01 October 20X8	3,500	3,428	6,928
Add: For the year (30/09/20X9)		2,785	2,785
Less: Dividend (W5)		(2,670)	(2,670)
Balance as on 30 September 20X9	**3,500**	**3,543**	**7,043**

Zodiac Ltd – Statement of financial position as on 30 September 20X9

	Tshs'000	Tshs'000
Non-current assets		
Land and buildings(W6)	2,881	
Plant and machinery (W7)	1,025	
Investments	2,500	6,406
Current assets		
Inventory	4,500	
Trade receivables	3,375	
Cash at bank	75	7,950
Total assets		**14,356**
Capital and reserves		
Share capital	3,500	
Retained earnings	3,543	7,043
Current liabilities		
Trade payables	3,625	
Tax	1,063	
Proposed dividend	2,625	7,313
Total liabilities		**14,356**

Continued on the next page

Workings

W1 Cost of sales

	Tshs'000
Opening inventory	2,875
Add: Purchases	20,000
	22,875
Less: Closing inventory	(4,500)
	18,375

W2 Administrative expenses

	Tshs'000	Tshs'000
Per trial balance		500
Add: Research		94
		594
Add: Depreciation		
- Property (5% x 3375)	169	
- Plant (15% x 6,500)	975	1,144
		1,738

W3 Dividends received

Dividends received - Tshs311,000

W4 Tax

	Tshs'000
Tax	1,063
Less: Overpayment last year	(25)
	1,038

W5 Dividend paid

	Tshs'000
Interim	45
Final (3,500 x Tshs750)	2,625
	2,670

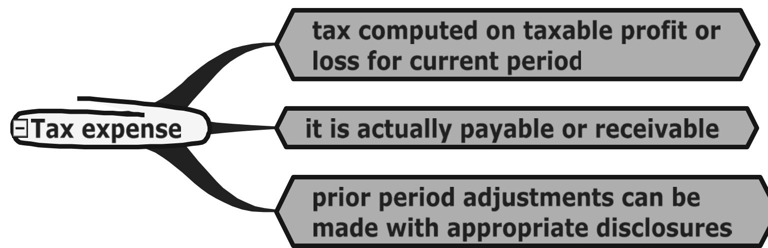
W6 Freehold property

	Tshs'000
Cost	3,375
Less: Accumulated depreciation	(325)
Less: Depreciation for the year (W2)	(169)
	2,881

W7 Plant and machinery

	Tshs'000
Cost	6,500
Less: Accumulated depreciation	(4,500)
Less: Depreciation for the year (W2)	(975)
	1,025

SUMMARY



Test Yourself 6

During 20X7, Choice Ltd earned a profit of Tshs32,500 before tax. The income tax payable for the year is Tshs3,600.

Required:

Show the treatment in the books of Choice Ltd.

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5. Explain the inter-relationship between the statement of financial position, statement of profit or loss and other comprehensive income.

[Learning Outcome e]

The relationship between the statement of profit or loss part and other comprehensive income part of the income statement has been explained in the previous Learning Outcomes.

Profit for the year as shown by the statement of profit or loss is added to the capital of the owner in the case of a sole trading firm or a partnership firm. In the case of a company, the amount of profit is added (loss deducted from) to the statement of financial position as '**Retained Earnings'**. The components of other comprehensive income are taken to the suitable account under the 'Equity' group. The equity group of accounts consists of the accounts representing capital and other reserves belonging to the owners (shareholders).

Example

According to the statement of profit or loss and other comprehensive income, profit for the year is Tshs1,400,000, other comprehensive income is Tshs120,000 (net revaluation gain) and therefore, the total comprehensive income is Tshs1,520,000.

Tshs1,400,000 representing profits will be added to the retained earnings. The revaluation gain is added to the revaluation surplus in the statement of financial position.

The accounting equation is:

Assets = Liabilities + Owners' capital
i.e. Owners' capital = Assets - Liabilties

Example

The existing Capital of Troy Co is Tshs60,000, represented by assets worth Tshs100,000 less liabilities worth Tshs40,000.

To put it in an equation form,

Capital = Assets – Liabilities
i.e. Tshs60,000 = Tshs100,000 - 40,000
i.e. Tshs60,000 = Tshs60,000

Profits earned by Troy Co for the year to 31 December 20X6 are Tshs25,000.

Continued on the next page

This profit is added to capital in the statement of financial position. Revised capital is Tshs85,000 (Tshs60,000 + Tshs25,000). The statement of financial position shows that trade receivables have increased by Tshs35,000 and loans have increased by Tshs10,000.

The revised equation is:

Capital = Assets – Liabilities

i.e. Tshs60,000 + Tshs25,000 = (Tshs100,000 + Tshs35,000) - (Tshs40,000 + Tshs10,000)
i.e. Tshs85,000 = Tshs135,000 - Tshs50,000
i.e. Tshs85,000 = Tshs85,000

The loss made during a period (determined by the statement of profit or loss is deducted from the owners' capital.

When the owners' capital decreases, the net assets of the business are decreased by an amount equal to the loss. This is how the accounting equation is maintained.

Example

To continue the previous example of Troy,

If there was a loss of Tshs20,000 during the year, there would then be a reduction in the capital by this amount. The net assets will also decrease by an amount equal to the loss. Assuming there is an increase in the liabilities, the new equation would be:

Capital = Assets – Liabilities

i.e. Tshs60,000 - Tshs20,000 = Tshs100,000 – (Tshs40,000 + Tshs20,000)
i.e. Tshs40,000 = Tshs40,000

Business expenses are disclosed in the statement of profit or loss whereas personal expenses paid are treated as drawings, and reduced from the capital in the statement of financial position. For example rent of Tshs20,000 paid for the business premises, is charged as a business expense. However, rent worth Tshs6,000 paid for the residence of the owner is a drawing and reduced from the capital.

Accrued expenses that are not paid at the end of the reporting date are added to the relevant expenses in the statement of profit or loss and recorded as a liability in the statement of financial position. For example if there is a rent of Tshs500 accrued but not paid, it is added to rent expense and shown as a current liability.

Accrued income that is not received by the reporting date is added to the relevant income in the statement of profit or loss, and as an asset in the statement of financial position. For example if there is an interest of Tshs200 accrued but not received, it is added to the other income in the statement of profit or loss and shown as a current asset in the statement of financial position.

An expense paid but not yet recognised in the statement of profit or loss (because it has not accrued) is reduced from the concerned expense in the statement of profit or loss and recognised as an asset in the statement of financial position.

Example

Insurance of Tshs1,000,000 is paid for the year commencing 1 April 20X6. The reporting date is 31 December 20X6. At this date, 9 months have passed since the insurance was paid. The correct insurance expense to recognise is Tshs750,000 (Tshs1,000,000 x 9/12). The insurance for 3 months is paid but not yet used. It is reduced from the insurance expense in the statement of profit or loss and shown as an asset in the statement of financial position.as a pre-paid expense.

Income received but not yet recognised in the statement of profit or loss (because it was received in advance) is deducted from the income in the statement of profit or loss and recognised as a liability in the statement of financial position (deferred income). For example if the commission received includes an amount of Tshs600 received in advance, it is deducted from commission income and shown as a liability in the statement of financial position.

Test Yourself 7

How will you treat an expense paid but not yet recognised in the statement of profit or loss?

A Recognise it as an asset
B Recognise it as a liability
C It's not related to the business, hence no adjustment is required.
D It's not related to the current year, therefore no adjustment is required.

Answers to Test Yourself

Answer to TY 1

Cost of goods sold = Opening inventory + Purchases – Closing inventory
= Tshs16,400 + Tshs87,200 – Tshs14,560
= Tshs89,040

Sales = Cost of goods sold + Gross profit

Let us assume sales as x, therefore gross profit will be 0.20x
x = Tshs89,040 + 0.20x
x – 0.20x = Tshs89,040
x = Tshs89,040/0.80
x = Tshs111,300

Answer to TY 2

Matrix Ltd- Statement of profit or loss for the year to 31 December 20X9

	Tshs	Tshs
Revenue		4,000
Opening inventory	500	
Purchases	2,600	
Closing inventory	(400)	(2,700)
Gross profit		**1,300**
Other income		110
Distribution expenses	240	
Administration expenses	150	(390)
Profit before tax		**1,020**
Income tax expenses		(300)
Profit for the year		**720**
Other comprehensive income		
Gains on property revaluation		600
Income tax relating to revaluation surplus		(180)
Other comprehensive income for the year, net of tax		**420**
Total comprehensive income for the year		**1,140**

Answer to TY 3

Statement of profit or loss for the year to 31 December 20X9

	Tshs	Tshs
Revenue Cost of sales Opening inventory		104,250
	15,700	
Purchases (W1)	76,500	
	92,200	
Less: Closing inventory	(12,300)	
Cost of goods sold		79,900
Gross profit		**24,350**
Expenses		
Salaries (3,000 + 500)	3,500	
Electricity (900 + 100)	1,000	
Telephone (400 + 50)	450	
Printing and stationery	500	
Refreshments	300	(5,750)
Profit for the year		**18,600**

W1 Purchases

	Tshs	Tshs
List price of purchases	80,000	
Less: Trade discount at 2.5% X80,000	(2,000)	78,000
Less: Settlement discount (50,000 x 3%)		(1,500)
Net purchases		**76,500**

Answer to TY 4

The correct option is **A**

Only (i) and (ii) - are administrative expenses.
(iii) - is a finance expense.
(iv), (v) and (vi) - are selling expenses.

Answer to TY 5

In this case, the legal form of the transaction suggests that this is a sale transaction as the title of ownership has passed to Square Co.

A proper assessment of this transaction reveals that the seller has retained the significant risks of ownership, as Square Co is entitled to return the machine, if it breaks down before the end of the first year of installation. Perhaps at the time of return, a reasonable amount may be recovered for the period it was used by Circle Co. However, it cannot be calculated with reasonable accuracy and cannot be recognised.

Hence, it will be recognised as sale revenue only at the end of one year from the date of installation.

Answer to TY 6

Choice Ltd – Statement of profit or loss

	Tshs
Profit before tax	32,500
Less: Income tax	(3,600)
Profit after tax	**28,900**

Also, in the statement of financial position, income tax payable of Tshs3,600 will be shown under the head current liabilities.

Answer to TY 7

The correct option is **A**.

Recognise it as an asset. It is a pre-paid expense and not related to the current year. It is treated as a current asset.

Self Examination Questions

Question 1

An increase in profit will have another effect, such as:

(i) Increase in any asset
(ii) Increase in any liability
(iii) Decrease in any asset
(iv) Decrease in any liability

A (i) and (ii)
B (ii) and (iii)
C (iii) and (iv)
D (i) and (iv)

Question 2

State which of the following statements is incorrect:

A Personal expenses paid out of the business cash should not be recorded in the books of the business.
B Income received but not yet recognised in the statement of profit or loss is recognised as a liability in the statement of financial position.
C Accrued incomes that have not been received by the reporting date are added to the relevant income shown in the statement of profit or loss and shown as an asset in the statement of financial position.
D Income tax is treated as an expense to calculate the profit for the period.

Question 3

Which of the following is not selling and distribution expenditure?

A Running and maintenance cost of the delivery vehicle.
B Salary paid to the people in the sales department.
C Advertisement expenditure.
D Cost of primary packing.

Question 4

Profex purchased 5,000 units at Tshs6. Out of this, 4,500 units were sold at Tshs7.

Considering the matching principle, how much should be considered as cost of sales?

A Tshs30,000
B Tshs35,000
C Tshs27,000
D Tshs31,500

Question 5

Which of the following is incorrect?

A Expenditure that is incurred for the maintenance of an asset is revenue expenditure.
B Expenditure that is incurred to enhance the life or the utility of an asset is capital expenditure.
C Income tax expense should be treated as an expense when calculating the profit for the period.
D Depreciation on a delivery van is an administration expense.

Important

The questions given below do not specifically address this Study Guide. However these questions test your understanding regarding the knowledge gained in Sections D, E, F, G and H of this Paper.

Question 6

Harbinger Ltd is preparing its financial statements for the year ended 31 October 20X8. The accountant of Harbinger Ltd requires your assistance with regard to the below mentioned queries.

	Item Account	Tshs'000	Tshs'000
A	Buildings at cost	1160	
B	Buildings accumulated depreciation, 1 November 20X7		95
C	Plant at cost	250	
D	Plant accumulated depreciation, 1 November 20X7		175
E	Bank balance		110
F	Sales		2820
G	Sales return	150	
H	Purchases	1780	
I	Purchases returns		100
J	Inventory at 1 November 20X7	250	
K	Cash	35	
L	Trade payables Trade		390
M	receivables	500	
N	Administrative expenses	510	
O	Allowance for receivables at 1 November 20X7		15
P	Retained earnings at 1 November 20X7		205
Q	Equity shares		650
R	Share premium account		125
		4,635	**4,685**

(i) For each of the items listed below (A to R), determine whether they belong to the statement of financial position as at 31 October 20X8. Indicate 'Yes' if the item account appears in the statement of financial position and 'No' where it does not belong to the statement of financial position.

Item Ref	Item Account	YES/NO
A	Buildings at cost	
B	Buildings accumulated depreciation, 1 November 20X7	
C	Plant at cost	
D	Plant accumulated depreciation, 1 November 20X7	
E	Bank balance	
F	Sales	
G	Sales return	
H	Purchases	
I	Purchases returns	
J	Inventory at 1 November 20X7	
K	Cash	
L	Trade payables Trade	
M	receivables	
N	Administrative expenses	
O	Allowance for receivables at 1 November 20X7	
P	Retained earnings at 1 November 20X7	
Q	Equity shares	
R	Share premium account	

(ii) The inventory as at 31 October 20X8 is Tshs60,000. Calculate the gross profit for the period. Ignore depreciation.

Additional information:

The building had an estimated life of 40 years when it was acquired. Depreciation is on a straight-line basis. Plant and equipment is depreciated at 20% per annum on the reducing balance basis.

Calculate the depreciation charge for the year.

(iii) Calculate the amount appearing under the head non-current asset for the year ended 31 October 20X8.

(iv) After preparing trial balance, it is learnt that a customer has become insolvent and, therefore, the entire amount of Tshs20,000 due from him was irrecoverable.

The allowance for receivables is to be increased to 5% of trade receivables.

The allowance for receivables and bad debts are treated as an administrative expense.

Calculate the amount of trade receivable to be shown in the statement of financial position as at 31 October 20X8.

(v) What is the double entry to record the bad debts

Item ref	Ledger account	Debit	Credit	No Debit/Credit
		Tshs'000	Tshs'000	
M	Trade receivable			
N	Administrative Expenses			
O	Allowance for trade receivables			
F	Sales			

Question 7

	Item Account	Debit	Credit
		Tshs	Tshs
A	Plant and machinery – cost at 1 November 20X7	480,000	
B	Plant and machinery - accumulated depreciation at 1 November 20X7		95,000
C	Land	2,350,000	
D	Cash		150,000
E	Bank balance		110,000
F	Sales		4,250,000
G	Purchases	1,780,000	
H	Inventory at 1 November 20X7	250,000	
I	Discount received	14,000	
J	Discount allowed		12,000
K	Trade payables		390,000
L	Trade receivables	500,000	
M	Administrative expenses	510,000	
N	Finance costs	120,000	
O	Allowance for receivables at 1 November 20X7		15,000
P	Retained earnings at 1 November 20X7		205,000
Q	Equity shares		650,000
R	Share premium account		125,000
S	Suspense		2,000
		6,004,000	**6,004,000**

(i) For each of the items listed above (A to S), determine whether they belong to the statement of financial position as at 31 October 20X8. Indicate 'Yes' if the item account appears in the statement of financial position and 'No' where it does not belong to the statement of financial position.

(ii) During posting of ledger balances to the trial balance the accountant of Baxter Ltd noticed a difference in the trial balance. On investigation the following errors were found:

Discount allowed of Tshs9,000 were credited to the discount received account

Discount received of Tshs10,000 were debited to discount allowed account

What is the double entry to rectify the error?

Item ref	Ledger account	Debit	Credit	No Debit/Credit
L	Trade receivable			
K	Trade Payable			
I	Discount received			
J	Discount allowed			
S	Suspense account			

(iii) The details of the plant and machinery (cost), for the year ended 31 October 20X8 are given below

Plant and machinery – cost

Dr **Cr**

		Tshs'000			Tshs'000
01/11/20X7	Balance b/d	480,000	31/01/20X8	Transfer disposal account	120,000
01/01/20X8	Cash – purchase of plant	320,000	31/10/20X8	Balance c/f	680,000
		800,000			**800,000**

The company's policy is to charge depreciation at 20% per year on the straight line basis, with proportionate depreciation in the years of purchase and disposal.

What should be the depreciation charge for the year ended 31 October 20X8?

(iv) Here is some additional information:
Closing inventory is valued at Tshs200,000
Income tax expenses has been estimated at Tshs50,000 for the year ended

(a) What is the value of inventory disclosed in statement of financial position?
(b) Which account is debited and credited for the year end adjustment for income tax?

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **D**.

An increase in profit indicates an increase in capital, therefore the corresponding effect could be either an increase in any asset or a decrease in any liability, in order to satisfy the accounting equation.

Answer to SEQ 2

The correct option is **A**.

Personal expenses paid out of the business cash are treated as drawings, and should be deducted from the capital.

Answer to SEQ 3

The correct option is **D**.

The cost of primary packing is not a selling expenditure. Secondary packing is a selling expenditure.

Answer to SEQ 4

The correct option is **C**.

Under the matching principle, revenues and expenses are recognised only to the extent they are related when they result directly and jointly from the same transaction. In this case, only 4,500 units are sold, therefore expenditure to that extent should be recognised i.e. 4,500 units x Tshs6 = Tshs27,000.

Answer to SEQ 5

The correct option is **D**.

Depreciation on a delivery van is a selling and distribution expense, and not an administration expense.

Answer to SEQ 6

(i) The correct answer is

Item Ref	Yes/No
A	Yes
B	No
C	Yes
D	No
E	Yes
F	No
G	No
H	No
I	No
J	No
K	Yes
L	Yes
M	Yes
N	No
O	No
P	Yes
Q	Yes
R	Yes

(ii) The correct answer is

Non-current assets	Calculation	Tshs'000
Building	Tshs1,160 / 40 years	29
Plant	(Tshs250 -Tshs175) X 20%	15
Depreciation charge		**44**

(iii) The correct answer is

	Building	Plant
Cost	1,160	250
Less: Accumulated depreciation	(95)	(175)
Less: Charge for the year	(29)	(15)
Total	**1,036**	**60**

Total non-current assets = Tshs1,036 + Tshs60 = Tshs1,096

(iv) The correct answer is

	Tshs'000
Trade receivable per trial balance	500
Less: Bad debts	(20)
Total	**480**
Less: Allowance for trade receivable	(24)
Trade receivable as at 31 October 20X8	**456**

(v) The correct answer is

The journal entry to record bad debts is as follows:

.

Item ref	Ledger account	Debit	Credit	No Debit/Credit
		Tshs'000	**Tshs'000**	
M	Trade receivable Administrative		20	
N	Expenses Allowance for trade	20		
O	receivables Sales			NO
F				NO

Answer to SEQ 7

(i) The correct answer is

	Item Account	Yes / No
A	Plant and machinery - cost	Yes
B	Plant and machinery - accumulated depreciation, 1 November 20X7	No
C	Land	Yes
D	Cash	Yes
E	Bank balance	Yes
F	Sales	No
G	Purchases	No
H	Inventory at 1 November 20X7	No
I	Discount received	No
J	Discount allowed	No
K	Trade payables	Yes
L	Trade receivables	Yes
M	Administrative expenses	No
N	Finance costs	No
O	Allowance for receivables at 1 November 20X7	
P	Retained earnings at 1 November 20X7	Yes
Q	Equity shares	Yes
R	Share premium account	Yes
S	Suspense	No

(ii) The correct answer is

Item ref	Ledger account	Debit	Credit	No Debit/Credit
L	Trade receivable			NO
K	Trade Payable			NO
I	Discount received		500	
J	Discount allowed		500	
S	Suspense account	1,000		

Correct entry	Wrong entry	Rectification entry
Dr Discount allowed Tshs4,500 Cr TR account Tshs4,500	No Debit Cr Discount received Tshs4,500 Cr TR account Tshs4,500	Dr Discount allowed Tshs9,000 Dr Discount received Tshs9,000 Cr Suspense A/c Tshs18,000 Being rectification entry passed
Dr Supplier account Tshs5,000 Cr Discount received Tshs5,000	Dr Supplier account Tshs5,000 Dr Discount allowed Tshs5,000 No Credit	Dr Suspense account Tshs20,000 Cr Discount received Tshs10,000 Cr Discount allowed Tshs10,000 Being rectification entry passed

Combined entry

Dr Suspense account	Tshs2,000
Cr Discount allowed	Tshs1,000
Cr Discount received	Tshs1,000

(iii) The correct answer is **Tshs131,333**

	Tshs
Depreciation on disposals	
(Tshs120,000 x 20% x 3/12)	6,000
On old plant and machinery still in hand balance Tshs360,000 x 20%	72,000
On newly purchased plant and machinery	
(Tshs320,000 x 20% x 10/12)	53,333
	131,333

(iv)

(a) The correct answer is Tshs200,000

(b) The income tax expense account is debited and the provision for tax account is credited for the year end adjustment for income tax.

SECTION F

PREPARING BASIC FINANCIAL STATEMENTS

F2

STUDY GUIDE F2: STATEMENTS OF FINANCIAL POSITION

Get Through Intro

The process of accounting ends with the preparation of the financial statements. The financial statements of an entity consist of a number of reports / statements – one such statement is the statement of financial position (SOFP).

The SOFP is a statement which reflects the financial position of an entity as at a particular date. An SOFP when presented correctly shows the health or the state of affairs of a business. The SOFP (along with its companions - the statement of profit or loss and the statement of changes in equity, function like a thermometer – they depict whether the company is ailing or flourishing.

The accounting effect of any transaction necessarily satisfies the accounting equation. A series of these transactions leads to an accumulation of figures which is called an SOFP. The accounting equation and business entity convention form the basis of any SOFP.

In this Study Guide, we will learn these concepts and also the method of preparing the SOFP. The importance of this Study Guide stems from the fact that the entire accounting exercise is undertaken in order to prepare financial statements.

Learning Outcomes

a) Understand the nature of and main types of reserves including retained earnings, revaluation surplus and share premium account.
b) Prepare a statement of financial position from given information.
c) Explain the difference between capital and revenue reserves.
d) Describe the usefulness of statement of financial position to users of accounting information.

1. Understand the nature of and main types of reserves including retained earnings, revaluation surplus and share premium account.
Explain the difference between capital and revenue reserves.
[Learning Outcomes a and c]

1.1 The nature of reserves

Usually, the profits earned are available for distribution of dividends. However, sometimes profits are 'reserved' for certain purposes. Such profits are transferred from profits to the credit of the specified reserve. Transfers to reserves are appropriations of retained earnings.

These reserves may be:

1. **Statutory reserves**: these are the reserves which are mandated by law and are not available for distribution of dividends.

(a) Sometimes the law requires entities to transfer a part of their profits to certain reserves in order to protect the entity and its creditors from the effects of losses e.g. requirements for banks to transfer a certain percentage of profits to a Statutory Reserve Fund.

(b) Taxation laws may give concessions from tax, subject to a condition that a specific reserve is created and maintained for a specified number of years. For example, an investment allowance reserve related to the allowance for new investments in plant and machinery.

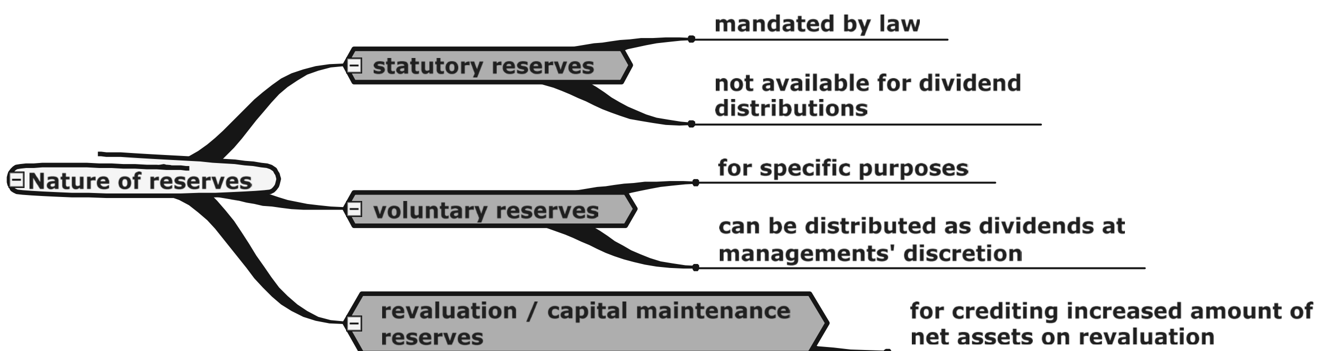
2. **Voluntary reserves**: these are of the following types:

(a) Reserves for a specific purpose e.g. an asset replacement reserve or
(b) Non-specific reserves e.g. a general reserve

Voluntary reserves are available for the distribution of dividends if the management so wishes.

3. **Revaluation or capital maintenance reserves**: revaluation or restatement of assets and liabilities give rise to an increase or decrease in capital. Such an increase in the value of net assets due to revaluation is credited to the revaluation surplus account. The laws of many countries do not allow dividends to be distributed out of revaluation reserve.

SUMMARY



Test Yourself 1

The following reserves are available for the distribution of dividends:

i Statutory reserves
ii Voluntary reserves
iii Revaluation or capital maintenance reserves

A i
B ii
C iii
D i and ii

1.2 Reserves in a company SOFP

A company SOFP usually contains the following types of reserves:

(a) Revaluation surplus: as explained above, this is a reserve created because of an increase in the value of net assets after revaluation of assets and liabilities.

(b) Share premium: the Companies Act of some countries requires share premium to be disclosed under the group reserves and surplus. Share premium is the excess of the issue price of shares over their nominal or par value.

A company issued ordinary shares of Tshs100,000 for cash at Tshs125,000. The entry is:

Dr	Cash	Tshs125,000	
Cr	Ordinary shares		Tshs100,000
Cr	Share premium account		Tshs25,000

Being issue of ordinary shares at a premium

Share premium is not available for distribution of dividends.

(c) Assets replacement reserve (e.g. plant and machinery replacement reserve): sometimes companies create an asset replacement reserve and invest an equivalent amount outside the business. When the life of an asset is over, it is expected that funds for replacement will be generated by selling the investments.

(d) Dividend equalisation reserve: this is a reserve created to ensure that a stable rate of dividend is maintained even in the lean periods. If retained earnings are not sufficient to pay dividend, amounts are withdrawn from the dividend equalisation reserve.

The retained earnings of Nebula Ltd are Tshs200,000. The dividend equalisation reserve balance is Tshs75,000.

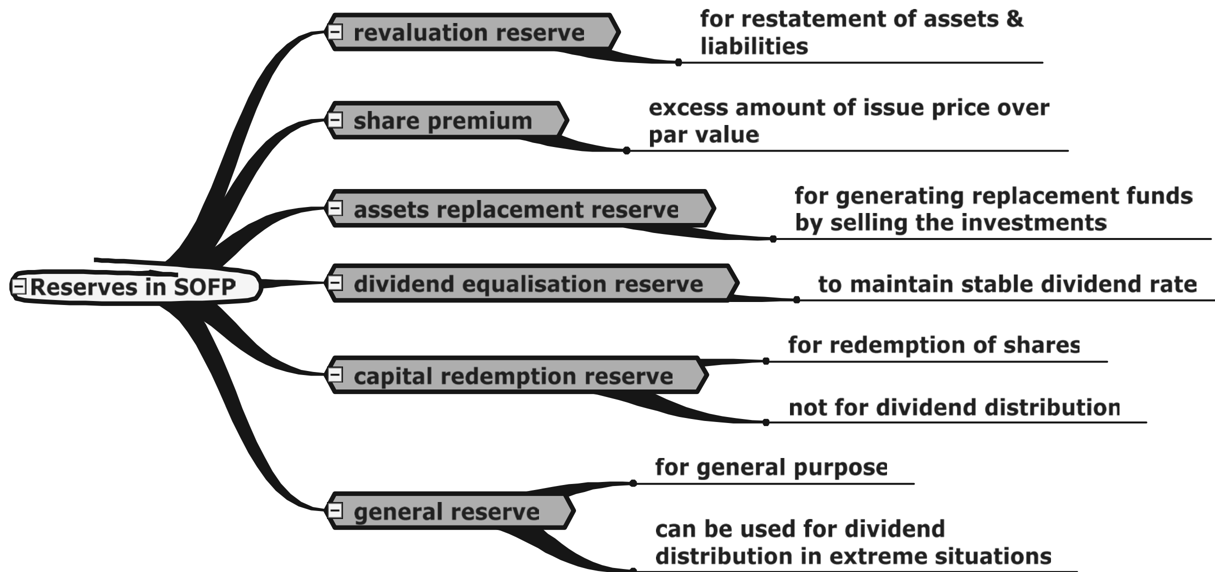
Nebula has to distribute dividends of Tshs250,000 if it wants to maintain the rate of dividend which it declared in the past years. It can use the full retained earnings of Tshs200,000 and Tshs50,000 from the dividend equalisation reserve. After the distribution of dividends, the balance of dividend equalisation reserve will be Tshs25,000.

(e) Capital redemption reserve: local company law usually enforces some controls on capital redemption. If the company redeems the preference share capital, the assets of the company will be reduced due to repayment of capital. This may hurt the interests of creditors.

In order to protect the creditors' interests, Company Law usually lays down that the redemption should be either out of a fresh issue or out of profits available for dividends. When the shares are redeemed out of profits, the company is usually required to transfer an amount equal to the nominal value of capital redeemed to the capital redemption reserve. This reserve is not available for distribution of dividends.

(f) General reserve: this is a general purpose voluntary reserve. Generally it is not used for distribution of dividends. However, in extreme situations, amounts are drawn from this reserve for the purpose of dividends.

SUMMARY



Test Yourself 2

Which of the following statements is correct?

A A dividend equalisation reserve is a reserve to maintain the rate of dividend even in a lean period.
B A general reserve is a voluntary reserve and can not be used for dividend distribution.
C Asset replacement reserves are the reserves created when, as a result of revaluation, the value of assets increases.
D A share premium is available for distribution of dividends, as it is collected only from the shareholders.

1.3 The reason why the heading retained earnings appears in a company Statement of financial position (SOFP)

Meaning of retained earnings

Retained earnings are the profits earned by a company that are retained in the business and not distributed as dividends. As seen earlier, when profits are earned, retained earnings on the liabilities side of an SOFP are increased and, simultaneously, the net assets of a company are increased, since the assets generated by way of the profit earned are retained in the business. Conversely, when profits are distributed by way of dividends, retained earnings are reduced and on the opposite side, net assets are also reduced, as dividends would mean an outflow of assets.

Consider the following two statements of financial position:

Statement of financial position at 1/1/20X7

	Tshs
Assets	
Non-current assets	100,000
Current Assets	50,000
	150,000
Ordinary shares	125,000
Loans	25,000
	150,000

Statement of financial position as at 31/3/20X7

	Tshs
Non-current assets	100,000
Current Assets	80,000
	180,000
Ordinary shares	125,000
Retained earnings	30,000
Loans	25,000
	180,000

A profit of Tshs30,000 was earned in the period. Current assets (say, cash) have increased by a corresponding amount. Since dividends have not been distributed out of this amount, Tshs30,000 will be called 'retained earnings'.

Why the heading, 'retained earnings', appears only in a company SOFP (and not in sole proprietorship / partnership SOFP)

For a sole trader or a partnership, the statement of profit or loss is closed by transferring the profit to the credit of the proprietor's capital account. In the SOFP, the profits for the year are usually not disclosed separately but included in the capital account in the following manner.

	Tshs'000
Opening capital	X
Add: Profits during the period	X
Less: Drawings during the period	(X)
Closing capital	**X**

For a partnership firm, the same principle is followed, except that the balance of profit after appropriations is transferred to partners' current accounts (for fixed capital) or capital accounts (for fluctuating capital accounts). Here too, the profit for the year is usually fully appropriated; no balance carried forward.

The following example explains this. Between 1 January 20X7 to 31 March 20X7, a profit of Tshs30,000 was earned, and is added to the capital account. There are no retained earnings shown separately.

Statement of financial position as at 1/1/20X7

	Tshs
Assets	
Non current assets	100,000
Current Assets	50,000
	150,000
Capital	125,000
Loans	25,000
	150,000

Statement of financial position as at 31/3/20X7

	Tshs
Non current assets	100,000
Current Assets	80,000
	180,000
Capital	
Opening balance 125,000	
Add profit 30,000	155,000
Loans	25,000
	180,000

For a company, the nominal value of the share capital is disclosed in the share capital account. This total nominal value usually remains fixed and an accountant cannot change it with the amount of profits. As a result, the accountant is compelled to carry forward the balance of profit or loss for the year, in a separate account which is known as the **retained earnings** account. This balance in the retained earnings account is reduced to the extent that it is used for the distribution of dividends.

Example

Lambert started a business with a capital of Tshs200,000 on 01 January 20X7.
He earned profits of Tshs90,000 from 20X7 to 20X9.
He withdrew Tshs50,000 out of these profits.

What will be the balance of capital on 31 December 20X9?

What difference would there be if the business was run by Lambert Co Ltd and if it distributed dividends worth Tshs50,000?

Answer

If the business was run as a sole trader:

Capital account

	Tshs
Capital introduced	200,000
Add: profits earned	90,000
Less: drawings	(50,000)
Balance of capital on 31 December 20X9	**240,000**

If the business was run as a limited company:

	Tshs
Share capital issued	200,000
Retained earnings	
Add: profits earned	90,000
Less: dividends distributed	(50,000)
Retained earnings on 31 December 20X9	**40,000**

Total capital = Tshs200,000 + Tshs40,000 = Tshs240,000

Test Yourself 3

Retained earnings appear in the SOFP of the following business entities:

i Sole proprietor
ii Partnership firm
iii Company

A Only i
B Only ii
C Only iii
D i and ii

1.4 Differences between capital and revenue reserves

Capital reserves are reserves which comprise capital profit. These reserves are created out of the profits of certain specific transactions of capital nature and are not available for distribution. Following are the items of capital profit from which capital reserves are created:

Profit on revaluation of assets and liabilities
Profit on sale of shares and debentures
Profit on forfeiture of shares
Profit on redemption of debentures

Examples of capital reserve include share premium, revaluation reserve, capital redemption reserve etc.

Revenue reserves are reserves which comprise revenue profit earned in the normal course of the business. These reserves can be distributed as dividend to the shareholders and strengthen the financial position of the company. Examples of revenue reserves include general reserve, dividend equalization fund, sinking fund, etc.

	Revenue reserves	Capital reserves
Source	Revenue profit is the source of revenue reserve.	Capital profit is the source of capital reserve.
Use	Revenue reserve is used to strengthen the financial position, distribute dividend, replace fixed assets and redeem liabilities	Capital reserve is used to meet capital losses, write off preliminary expenses or issue bonus shares to the shareholders.
Indication	Revenue reserve indicates the operating efficiency of the business.	Capital reserve does not indicate the operating efficiency of the business.

Test Yourself 4

Which of the following is not a capital reserve?

A General reserve
B Share premium
C Revaluation
D Capital redemption

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2. Prepare a statement of financial position from the given information.
Describe the usefulness of statement of financial position to users of accounting information.

[Learning Outcomes b and d]

2.1 Accounting equation

We know that the total of assets in the statement of financial position equals the total of capital plus liabilities. This tests the arithmetical accuracy of the double entry accounting system. This has been explained in Study Guide C1. This relationship can be converted into an equation.

Accounting equation:

Assets = Liabilities + Owners' capital

This equation can also be rearranged as:

Owners' capital = Assets - Liabilities

At each stage, A =C + L, in the double entry book keeping system.

Example

Jerry started a business with cash Tshs5,000,000 and goods Tshs10,000,000.

Dr Cash Tshs5,000,000
Dr Inventory Tshs10,000,000
Cr Capital Tshs15,000,000
Being business incorporated

Here,

Assets (cash and inventory) = Capital
= Tshs15,000,000

Jerry has taken a bank loan of Tshs3,000,000
Dr Cash Tshs3,000,000
Cr Bank loan Tshs3,000,000
Being bank loan taken

Assets (cash and inventory) = Capital + Liabilities (bank loan)
i.e. (Tshs5,000,000+ Tshs3,000,000) + Tshs10,000,000 = Tshs15,000,000 + Tshs3,000,000 = Tshs18,000,000

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1. Nature of an statement of financial position

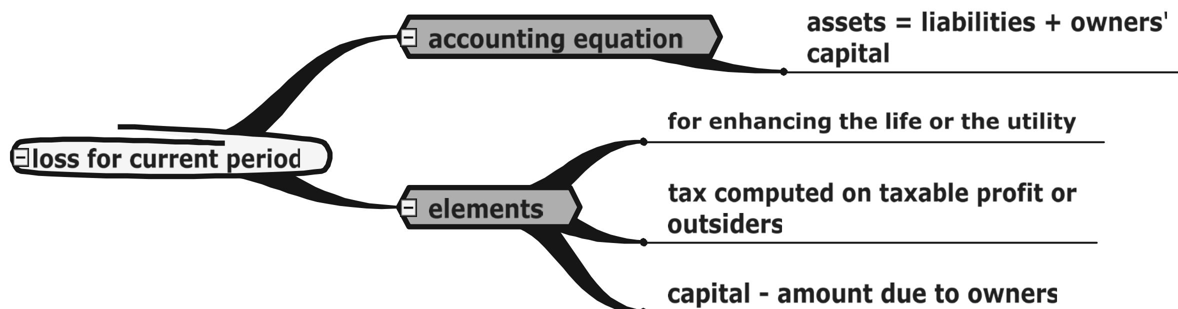
The SOFP reflects the state of affairs of an entity at a given date.

The elements of an SOFP are:

Assets include what the entity **owns** or what it **has to receive** in the future.
Liabilities indicate the **amounts due** from the entity to outsiders.
Capital represents the **amount that was invested** by the owners into the business, and the amount of **profit** retained in the business (i.e. to the extent it is not withdrawn by the owners).

Any transaction or event has an effect on these three categories.

SUMMARY



Example

See how the following transactions have an effect on the statement of financial position equation.

	Tshs'000
a) Issued shares for cash	50,000
b) Purchased a machine on credit	30,000
c) Purchased 500 kg of merchandise for credit	10,000
d) Sold 400 kg on credit	12,000
e) Paid rent Tshs700 and salaries Tshs2,000 in	2,700
f) Recorded unpaid rent	140
g) Paid to machine supplier	30,000

Continued on the next page

Effect of transactions or events

Sr.		Assets	Liabilities	Equity
		Tshs'000	**Tshs'000**	**Tshs'000**
(a)	Increase in asset - cash	50,000		
	Increase in equity			50,000
(b)	Increase in asset – machinery	30,000		
	Increase in liability – payables		30,000	
(c)	Increase in asset – inventory#	10,000		
	Increase in liability – payables		10,000	
(d)	Increase in asset - receivables	12,000		
	Decrease in asset – inventory	(8000)		
	Increase in equity (due to profit) see working*			4,000
(e)	Decrease in equity (due to expenses – which			(2,700)
	Decrease in asset – cash	(2,700)		
(f)	Decrease in equity (due to expenses)			(140)
	Increase in liabilities - payables		140	
(g)	Decrease in asset - cash	(30,000)		
	Decrease in liability - payables		(30,000)	
		61,300	**10,140**	**51,160**

The accounting equation is

Assets = Liabilities + Capital
i.e. Tshs61,300,000 = Tshs10,140,000 + Tshs51,160,000

* Working

	Tshs
Profit on sale	12,000,000
Sales- 400 kg Cost- 400 kg (Tshs10,000,000 x 400/500)	8,000,000
	4,000,000

While studying the accounting entries, we stated that goods purchased are debited from the purchases account because they are an expense. The unsold inventory is usually brought into the financial statements as an asset, by way of reduction from the cost of purchases, at the end of the period. However, for the purpose of an accounting equation, since we have to crystallise the position after each transaction, purchases are added to the inventory, as they constitute unsold inventory at that moment.

As seen above, each transaction affects one or more components of the accounting equation. Whatever detailed rules of accounting you may follow, your SOFP MUST follow this equation. Therefore, we can conclude that the accounting equation and business entity convention underlie the SOFP.

Test Yourself 5

Which of the following sentences is incorrect?

A The business entity convention means that, for the purpose of accounting, a business is treated as a separate entity from the owners
B The SOFP reflects the state of affairs of an entity on a given date
C The accounting equation is: Assets + Capital = Liabilities
D The SOFP is always balanced

2.2 Proforma of statement of financial position

An SOFP is a statement of assets, liabilities and capital of a business at a given moment.

It discloses the state of affairs of the entity at that moment. Usually, an SOFP is prepared at the end of the accounting year. As seen in the first Learning Outcome of this Study Guide, an SOFP is based on an equation. This equation can be presented in a manner where the total of capital and liabilities is equal to the total of assets, or where:

Capital = Assets - Liabilities

The only difference between the SOFP and the accounting equation is that an SOFP has a detailed format. It contains the assets and liabilities of the entity, grouped in a suitable manner.

The Companies Act or similar legislations of different countries lay down the format of the SOFP and the companies have to adhere to that format. Other entities do not have a format fixed by the law. The format of the SOFP as **suggested** in IAS 1, Presentation of Financial Statements is as follows:

A proforma of the SOFP, **with imaginary figures:**

XYZ Co's - Statement of financial position as on 31 December 20X7

	Tshs'000	Tshs'000
Assets		
Non-current assets		
Property, plant and equipment	1,000	
Goodwill	200	
Other intangible assets	500	**1,700**
Current assets		
Inventories	500	
Trade receivables	600	
Other current assets	200	
Cash and cash equivalents	100	**1,400**
Total assets		**3,100**
Equity and Liabilities		
Equity		
Share capital	500	
Other reserves	350	
Retained earnings	450	
Total equity (as explained earlier, for sole traders and		**1,300**
Non-current liabilities		
Long-term borrowings	600	
Other long term payables	200	
Total non-current liabilities		**800**
Current liabilities		
Trade and other payables	500	
Short-term borrowings	250	
Current portion of long-term borrowings	120	
Current tax payable	80	
Short-term provisions	50	
Total current liabilities		**1,000**
Total liabilities		**1,800**
Total equity and liabilities		**3,100**

2.3 Usefulness of SOFP to the users of accounting information

The statement of financial position is one of the fundamental reports included in the company's annual reports. The SOFP serves a variety of purpose to the various users. Let us discuss the usefulness of SOFP from the point of view of management, potential lenders, investors and the regulatory agencies.

Management

The SOFP serves as a report card of what the management has done over the year. By evaluating the SOFP management can plan, evaluate and control operations within the company. Along with SOFP they may use other analytical tools to take important decision to amalgamate, sell the business operations, expand business, acquire assets, etc.

Potential lenders and investors

The SOFP will give potential lenders and investors the information required by them before they take decisions to invest money or lend their money to the entity. The SOFP will help them analyse business assets, liabilities and net worth, and they can then compare the SOFP with the previous year's SOFP. They are keen to know whether the entity is able to pay investors back.

Regulatory agencies

Public limited companies have to publish their SOFP on an annual basis. Also they have to file the SOFP with the tax authorities, the various stock exchanges where they are listed, and the respective authority under the companies act. This is to report to the regulatory authorities whether the company is adhering to the various rules and legislation framed.

2.4 Current and non-current distinction

We have already explained earlier in Study Guide F1, the difference between current assets and non-current assets. This is also true for current liabilities and non-current liabilities. Let us now understand each of the groups of assets and liabilities in detail:

(a) Current assets

Current assets include:

cash (including money in the bank) and

assets that are expected to be converted into cash within twelve months or

assets that are part of an entity's operating cycle

The following are examples of current assets:

(i) Inventory: it may consist of raw material, work in progress and finished goods for a manufacturer and trading goods for a trader.

(ii) Trade receivables: these are receivables against the sales made.

(iii) Cash in the bank: this is the amount of bank balance in the books.

(iv) Short-term investments: if a business has a temporary cash surplus, it may invest in government securities, or shares and debentures. When cash is needed, these will be sold off.

(v) Expenses paid in advance: certain expenses such as insurance are paid in advance i.e. they are paid in the current period but pertain to the next period. The amount which pertains to the next period is carried forward as an asset in the SOFP.

Example

Fire insurance premium paid on 1 October 20X6 for one year was Tshs10,000. At the date of the SOFP, i.e. 31 December 20X6, 3 months premium had accrued. However, premium for 9 months which relates to the next financial year is, therefore, prepaid. Prepaid insurance is = 10,000/12 x 9 = Tshs7,500

(vi) Other receivables: at times, amounts may be receivable from persons other than the customer, e.g. a temporary advance given to an employee.

(b) Non-current assets

All business assets which are not current assets are called non-current assets. They are not part of the operating cycle. The following are examples of non-current assets:

(i) Property, plant and equipment: These assets are used for:

producing the goods which are to be sold or

used as a part of the administrative set-up

Example

Premises used for the office, machine used at the factory and a car used by the CEO.

(ii) Intangible non-current assets: intangible non-current assets are the assets that do not have a physical existence e.g. goodwill, patent etc.

(iii) Non-current investments: investments that are expected to be kept for more than 12 months are long-term investments e.g. long-term investments by company L in the shares of company M.

(c) Current Liabilities

Current liabilities are the liabilities that are to be paid within 12 months from the reporting date, or form a part of the operating cycle.

Example

Examples of current liabilities:

i. Trade payables, including bills of exchange payable
ii. Bank overdraft that is normally payable on demand
iii. Current tax payable
iv. Accrued expenses, these are the expenses already incurred by the entity but not yet actually paid, e.g. unpaid electricity, unpaid rent etc

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(d) Non-current liabilities

Non-current liabilities are the liabilities that are payable after more than 12 months.

Example

Examples of non-current liabilities:

i. Long-term loan taken from a bank, repayable after more than a year.
ii. Debentures: debentures are the securities issued by a limited company, repayable after the specified term. The holders of debentures are the creditors (i.e. lenders of money) of the company.

(e) Non-current assets and depreciation

Non-current assets like a building or machine are used by the entity for a number of years. They have a finite life. The cost of these non-current assets is allocated over their economic life, in order to calculate depreciation or amortisation. Every year, the depreciation is charged to the statement of profit or loss as an expense, and an equal amount is reduced from the carrying value of related non-current assets.

Example

The following is information provided by Pearl Beauty Salon. You are required to prepare an SOFP as at 31 March 20X7.

	Tshs
Equipment	8,800
Accumulated depreciation on equipments	1,400
Furniture and fixtures	8,400
Accumulated depreciation on furniture and fixtures	2,800
Computers	11,100
Accumulated depreciation on computers	4,600
Long-term loan from bank	30,000
Capital as at 1 April 20X6	44,260
Drawings during the year	6,000
Inventory	8,300
Trade receivable	800
Bank overdraft	1,500
Cash in hand	2,110
Bills payable	6,000
Profit for the year	9,200
Tax payable	2,350
Trade payable	1,150
Shop rent outstanding	680
Prepaid insurance	430
Investment in Peer Ltd	58,000

Answer

Pearl Beauty Salon - SOFP for the year ended 31 March 20X7

	Tshs	Tshs
Assets		
Non-current assets		
Equipments (Tshs8,800 -Tshs1,400)	7,400	
Furniture and fixtures (Tshs8,400 - Tshs2,800)	5,600	
Computers (Tshs11,100 - Tshs4,600)	6,500	
		19,500
Long-term investment –Peer Ltd		58,000
Current assets		
Inventories	8,300	
Trade receivable	800	
Prepaid insurance	430	
Cash	2,110	11,640
Total assets		**89,140**

Continued on the next page

	Tshs	Tshs
Capital and liabilities		
Capital		
As at 1 April 20X6	44,260	
Add: Profit for the year	9,200	
Less: Drawings	(6,000)	
As at 31 March 20X7		47,460
Non-current liabilities		
Bank loan		30,000
Current liabilities		
Bank overdraft	1,500	
Trade payable	1,150	
Bills payable Tax	6,000	
payable Outstanding	2,350	
shop rent	680	11,680
Total capital and liabilities		**89,140**

Test Yourself 6

Which of the following are current assets?

(i) Inventory held for more than 12 months.
(ii) A deposit made of Tshs500,000 for 11 months.
(iii) Another deposit made of Tshs50,000 for 13 months
(iv) A car held by a car trader for the purpose of reselling.
(v) Purchase of a computer by a professional.

A (i),(ii), (iii), and (iv)
B (i),(ii), (iv), and (v)
C (i), (ii), and (iv)
D (i), (ii), (iii), and (v)

Answers to Test Yourself

Answer to TY 1

The correct option is **B**.

Statutory and revaluation reserves are not available for distribution. The management can utilise only voluntary reserves for the distribution of dividends.

Answer to TY 2

The correct option is **A**.

General reserves is a voluntary reserve but can sometimes be used for dividend distribution.

The asset replacement reserve is a reserve created and invested outside the company so as to generate sufficient funds for asset replacement.

Share premium, even if created by amounts paid by the shareholders, is not available for dividend distribution.

Answer to TY 3

The correct option is **C**.

Retained earnings appear only in the books of companies. In the case of sole proprietors, profit is added to the capital, and in the case of partnerships; profit is distributed amongst the partners.

Answer to TY 4

The correct option is **A**.

General reserve is available freely for distribution to the shareholders.

Answer to TY 5

The correct option is **C**.

The accounting equation is: Liabilities + Capital = Assets

Answer to TY 6

The correct option is **C**.

Inventory is always a current asset as it can be realised at any time. Investments that are expected to be kept for more than 12 months are long-term investments. For a car trader, a car is inventory and therefore it is a current asset, otherwise it is a non-current asset. For a professional, a computer is a non-current asset but for a person dealing in computers it is current asset.

Self Examination Questions

Question 1

Explain the effect of the following transactions on the accounting equation.

	Tshs
Cash sales	50,000
Credit sales	250,000
Credit purchase	210,000
Drawings	45,000
Payment of advance for purchase of machinery	120,000
Payment to creditor	215,000
Gross profit ratio is 20%	

Question 2

Categorise the following into current assets, non-current assets, current liabilities and non-current liabilities:

(a) Purchase of vehicle by a transport company.
(b) Prepaid insurance Tshs520.
(c) A loan that has a 5 year repayment period, of which only 5 monthly instalments are pending.
(d) Income tax payable
(e) Bank overdraft
(f) Purchase of plot by a property dealer.
(g) Purchase of machinery by a manufacturing company
(h) Purchase of a computer and Microsoft office by a clothing shop
(i) Debentures
(j) Equity shares

Question 3

From the following information provided by Pretty Cosmetics, prepare the SOFP as at 31 March, 20X7.

	Tshs
Building	90,000
Accumulated depreciation on building	12,000
Computers	17,250
Accumulated depreciation on computer	7,500
Vehicle	15,000
Depreciation on vehicle	3,900
Furniture and fixtures	14,200
Depreciation on furniture and fixtures	5,800
Inventory	12,450
Trade receivable	3,165
Cash in hand	1,200
Advance given to employees	5,000
Capital as at 1 April 20X6	73,640
Loan from bank Profit for	45,000
the year Drawings during	13,800
the year Trade payable	9,000
Tax payable	1,725
Prepaid insurance	3,525
Electricity expenses payable	645
	1,020

Question 4

State which of the following is correct

A In the case of sole proprietorship, the business entity convention is not applicable.
B Retained earnings do not appear in the books of a sole proprietor or in the books of partnership firms.
C In the SOFP, assets are always equal to liabilities.
D The general reserve is a statutory reserve created for dividend distribution. It is not for specific use and therefore an amount can be drawn whenever required and can be used for any purpose, including distribution of dividends.

Answers to Self Examination Questions

Answer to SEQ 1

Details	Assets	Liabilities	Capital
	Tshs	**Tshs**	**Tshs**
Increase in cash	50,000		
Decrease in inventory (50,000 x 80%)	(40,000)		
Increase in capital (due to profit) (50,000 x 20%)			*10,000
Increase in receivable	250,000		
Decrease in inventory (250,000 x 80%)	(200,000)		
Increase in capital (due to profit) (250,000 x 20%)			*50,000
Increase in payables		210,000	
Increase in inventory	210,000		
Decrease in capital due to withdrawal			(45,000)
Decrease in cash	(45,000)		
Decrease in cash	(120,000)		
Increase in asset (advance)	120,000		
Decrease in payables		(215,000)	
Decrease in cash	(215,000)		
	10,000	**(5,000)**	**15,000**

Note: opening balances are not given in this question. The above is only the net result of transactions.

The accounting equation is: Assets = Liability + Capital
Tshs10,000 = (Tshs5,000) + Tshs15,000

Answer to SEQ 2

i	Purchase of vehicle by a transport company.	Non-current assets
ii	Prepaid insurance Tshs520	Current assets
iii	A loan with a 5 year repayment period, of which only 5 monthly installments are payable, as on reporting date	Current liability
iv	Income tax payable	Current liability
v	Bank overdraft (it is usually repayable on demand, although banks may renew the overdraft every year)	Current liability
vi	Purchase of plot by a property dealer.	Current assets
vii	Purchase of machinery by a manufacturing company	Non-current assets
viii	Purchase of a computer and Microsoft office by a clothing shop	Non-current assets
ix	Debentures	Non-current liability
x	Equity shares	**None of the above (it is a part of capital)**

Equity shares are the capital of the company, and not the asset or liability.

Answer to SEQ 3

Pretty Cosmetics - SOFP for the year ended 31 March 20X7

	Tshs	Tshs
Assets		
Non-current assets		
Building (Tshs90,000 – Tshs12,000)	78,000	
Furniture and fixtures (Tshs14,200 - Tshs5,800)	8,400	
Vehicles (Tshs15,000 - Tshs3,900)	11,100	
Computers (Tshs17,250 - Tshs7,500)	9,750	107,250
Current assets		
Inventories	12,450	
Trade receivable	3,165	
Prepaid insurance	645	
Advance to employees	5,000	
Cash in hand	1,200	22,460
Total assets		**129,710**
Capital and liabilities		
Capital		
As at 1 April 20X6	73,640	
Add: Profit for the year	13,800	
Less: Drawings	(9,000)	
At 31 March 20X7		78,440
Non-current liabilities		
Bank loan		45,000
Current liabilities		
Trade payable	1,725	
Tax payable	3,525	
Electricity expenses payable	1,020	6,270
Total capital and liabilities		**129,710**

Answer to SEQ 4

The correct option is **B**.

Retained earnings appear only in the case of companies. The business entity convention is applicable to all the businesses including sole proprietorship and partnerships. In the SOFP, assets are equal to liabilities and capital. An amount from the general reserves can be drawn only under extreme situations and not for any general reason as it is not a statutory reserve.

SECTION F

PREPARING BASIC FINANCIAL STATEMENTS

F3

STUDY GUIDE F3: INCOMPLETE RECORDS

Get Through Intro

When a full set of records is maintained, it is easy to prepare financial statements. A readily available trial balance is used, certain year end procedures are performed and the financial statements are ready.

However, at times a full set of records may not be available and the accountant may still be asked to prepare the financial statements. This may happen when part of the records has been lost or destroyed. Similarly, the proprietor may not maintain full records, but when he approaches a bank for a loan, the bank may insist on a full set of financial statements.

At times, a single missing figure may be needed, rather than the full financial statements. For example a cashier has absconded and we have to determine the amount of missing cash.

Whatever the reason, occasionally a professional accountant does have to become a detective and hunt for missing figures. Each situation may be different and the accountant has to use his judgement to decide ways of finding out the missing information. Sometimes cash and bank summaries may help. At other times, ledger accounts or profit percentages may have to be used.

We try to understand these techniques in this Study Guide.

Learning Outcomes

a) Explain and apply techniques used in incomplete record situations:
   i. Accounting equation and comparison of net worth method
   ii. Ledger accounts to calculate missing figures
   iii. Cash and / or bank summaries
   iv. Profit percentages to calculate missing figures.

1. Explain and apply techniques used in incomplete record situations:
i. Accounting equation and comparison of net worth method
ii. Ledger accounts to calculate missing figures
iii. Cash and / or bank summaries
iv. Profit percentages to calculate missing figures

[Learning Outcome a]

Incomplete records: meaning

Whenever a business does not have a full set of accounting records to prepare financial statements, the records are said to be incomplete records.

This may happen due to one of the following reasons:

(a) the owner of the business does not keep a complete set of records
(b) the owner of the business may be ignorant of double entry accounting principles
(c) a complete set of records is maintained but part of it has been accidentally lost or destroyed.

Limitations of incomplete records

(i) Arithmetical accuracy of accounts cannot be checked

(ii) Difficult to:
Carry out audit procedures
Operate internal control system and internal check system
Detect fraud
Ascertain the financial position of the business

(iii) If a set of financial statements, i.e. the statement of profit or loss and the statement of financial position, is to be prepared when the records are incomplete, then the accountant does not have the luxury of a ready trial balance from which he can prepare them.

(iv) Various methods have to be used to calculate the missing information in order to prepare the financial statements. The methods used vary with the nature of information that is incomplete.

(v) The accountant's approach also depends upon whether both the statement of profit or loss and the statement of financial position are to be prepared or whether only the statement of financial position is to be prepared.

1.1 Use of accounting equation and comparison of net worth method

We have learnt the following accounting equation in Study Guide C1:

Capital = Net assets or Net worth

= Assets - Liabilities

The values of variables in the above accounting equation are affected by a business transaction. Any increase or decrease in assets, liabilities and capital can be calculated using this accounting equation.

We also know that:

profits increase capital and
losses decrease capital

Hence if we know the other transactions in the capital account, (for example, capital introduced and drawings) we can calculate the amount of profit earned or loss incurred during the period by using the following equation:

Profit (loss) = Increase / (decrease) in net assets – Capital introduced + Drawings.

Samuel had the following assets and liabilities.

	31/12/20X8 Tshs'000	31/12/20X9 Tshs'000
Assets		
Property plant and equipment	500	600
Inventories	200	250
Accounts receivable	300	350
Total assets	**1,000**	**1,200**
Liabilities		
Bank loan	400	380
Accounts payable	250	300
Total liabilities	**650**	**680**
Net assets (assets – liabilities)	350	520
(1,000 – 650) (1,200 – 680)		

He introduced Tshs100,000 as capital during the year and his drawings amounted to Tshs60,000.

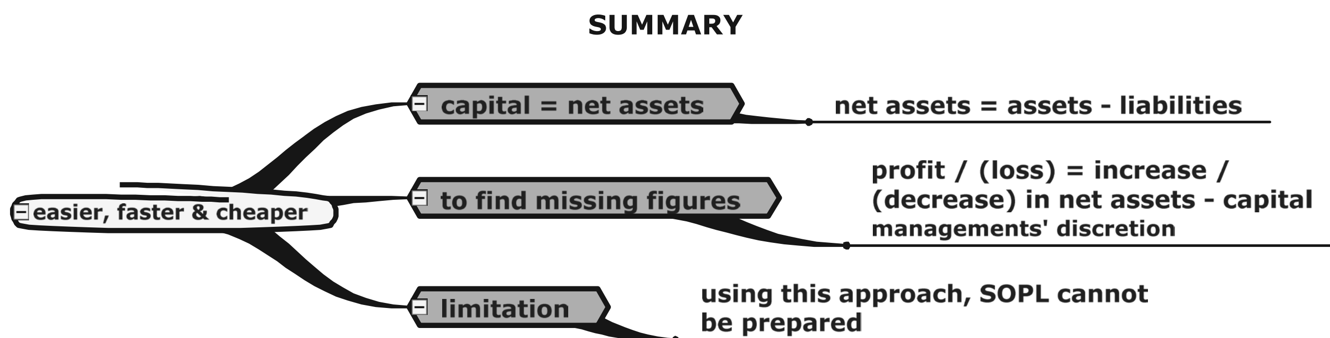
Calculate the profit or loss earned by Samuel

Profit (loss) = Increase / (decrease) in net assets – Capital introduced + Drawings
= (520 - 350) – 100 + 60
=170 – 100 + 60
=130 i.e. Tshs130,000

Limitation of this approach

We cannot prepare a statement of profit or loss using this approach. Therefore even though we can determine **how much profit** has been earned, in the absence of the statement of profit or loss, we cannot determine **how** it has been earned.

SUMMARY



Which of the following is a reason for a decrease in capital when figures from two years are compared?

A Introduction of capital
B Profit earned during the year
C Drawings
D All of the above

1.2 Use of ledger accounts to calculate missing figures

Accountants know from their experience that certain accounts have a specific pattern. If all known amounts affecting that account have been entered in ledger accounts, then accountants can say that the balancing figures in these accounts are the missing amounts of that account. The following are the examples of such accounts:

1. Accounts receivable
2. Accounts payable
3. Inventory account / trading account
4. Expenses and income accounts incorporating accruals and prepayments
5. Capital and drawing accounts

In practical situations, the missing amounts derived from one account may have to be entered in another account to find out its missing figure and so on. However, initially we will practise simple questions involving one missing figure in one account at a time.

While learning this topic we also learn about the interrelationship of various segments of accounts e.g. sales and accounts receivable, purchases and accounts payable and inventory, cost of sales and gross profits.

Let us now consider these accounts, in turn;

1. Accounts receivable

The pattern of a typical accounts receivable account is as follows:

Accounts receivable account

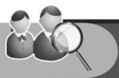
Dr **Cr**

	Tshs		Tshs
Balance b/d	X	**Cash / Cheque received**	X
Credit sales	X	Sales returns	X
Dishonoured cheque	X	Discount allowed	X
		Bad debts	X
		Balance c/d	X
Total	**X**	**Total**	**X**

All the items mentioned in this account may not be present all the time. The highlighted items are invariably present in this account. The others may or may not be present. Hence if they are not mentioned in the question, we can assume that they need not be considered.

This process has been followed for all the accounts discussed in this Learning Outcome.

If we know the amounts of all the items except one, then the **balancing figure** can be considered to be the amount of that item.



Example

From the following information of Princeton calculate the missing figure and explain what entry it must be

	Tshs
Opening balance of the trade receivables	25,000
Credit sales	170,000
Closing balance of the trade receivables	17,000

Answer

Let us prepare a trade receivables account and fill in the available figures.

Accounts receivable account

Dr **Cr**

	Tshs		Tshs
Balance b/d	25,000	**Cash received (balancing figure)**	*178,000
Credit sales	170,000	Balance c/f	17,000
Total	**195,000**	**Total**	**195,000**

Continued on the next page

* We now have to decide what this must be. We have already accounted for sales in the year and we also know the final balance of how much we are owed from our receivables. Therefore this figure must represent the cash received during the year.
Cash received = Opening balance + Credit sales – Closing balance
= Tshs25,000 + Tshs170,000 - Tshs17,000
= Tshs178,000

The cash entry in trade receivables account is on the credit side. The debit effect would be in the cash at bank account.

This method can be used to find out any other missing figure.
E.g. Credit sales = Closing balance + Cash received – Opening balance

---

Test Yourself 2

First Lady, a ladies' clothes shop does not keep proper books of accounts. It can give you the following information.

	Tshs
Opening balance of the trade receivables	23,000
Credit sales	172,000
Cash received	175,000
Closing balance of the trade receivables	15,000

You are required to calculate the discount allowed in the year.

A Tshs5,000
B Tshs8,000
C Tshs2,000
D Tshs15,000

---

2. Accounts payable

A typical trade payables account is as follows:

Accounts payable account

Dr **Cr**

	Tshs		Tshs
Cash paid	X	**Balance b/d**	X
Purchase returns	X	**Credit purchases**	X
Discount received	X		
Balance c/d	X		
Total	**X**	**Total**	**X**

Example

Dilbert had opening trade payables of Tshs25,000 and closing trade payables of Tshs45,000. Cash paid to the suppliers during the period was Tshs235,000. What is the amount of credit purchases?

Answer

Accounts payable account

Dr **Cr**

	Tshs		Tshs
Cash paid	235,000	Balance b/d	25,000
Balance c/f	45,000	Credit purchases (balancing figure) (235,000 + 45000 — 25,000)	**255,000**
Total	**280,000**	**Total**	**280,000**

Test Yourself 3

Jen-Z gives the following information:

	Tshs
Opening trade payables	63,000
Closing trade payables	54,000
Credit purchases during the period	352,000
Discount received	4,200
Purchase returns	35,000

What is the amount of cash paid?

A Tshs325,000
B Tshs321,800
C Tshs312,800
D Tshs318,200

---

3. Inventory account

Typically, small businesses debit the value of goods purchased to the purchases account and not the inventory account. Inventory at the end of the period is recognised as an asset by reducing its value from the total of opening inventory and purchases. However, some companies do prepare an inventory account. Even when this account is not maintained regularly, it may be prepared for the limited purpose of finding out balancing figures.

A typical inventory account is as follows:

Inventory account

Dr **Cr**

	Tshs		Tshs
Opening inventory b/d	X	**Cost of goods sold**	X
Goods purchased	X	Goods stolen	X
		Goods destroyed	X
		Closing inventory c/d	X
Total	**X**	**Total**	**X**

Frequently, the amount of cost of goods sold or purchases is calculated using profit percentages. This is discussed in paragraph 1.4 of this Study Guide. Here we will take the figures as given.

Example

Morris gives the following information:

	Tshs
Opening inventory	100,000
Closing inventory	120,000
Goods purchased	600,000
Cost of goods sold	575,000

Some goods were stolen during the period. Calculate the value of the stolen goods.

Answer

Inventory account

Dr **Cr**

	Tshs		Tshs
Opening inventory b/d	100,000	Cost of goods sold	575,000
Goods purchased	600,000	Goods stolen (balancing figure) (100,000 + 600,000 - 575,000 - 120,000)	**5,000**
		Closing inventory c/f	120,000
Total	**700,000**	**Total**	**700,000**

Accounting for goods stolen or destroyed

Continued on the next page

If the goods are not covered by insurance

Dr	Loss by theft (SOPL)	X	
Cr	Inventory account (if maintained) or trading account		X

Being loss of goods debited to the statement of profit or loss

If the goods are covered by insurance

Dr	Insurance claim receivable account (to the extent covered by the insurance)	X	
Dr	Loss by theft (SOPL - to the extent not covered)		X
Cr	Inventory account (if maintained) or trading account		

Being the loss of goods due to theft, not fully covered by insurance

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4. Expenses and income accounts incorporating accruals and prepayments

Individual accounts usually have either prepaid or accrued expenses.
Depending upon whether it has prepaid or accrued expenses, the presentation of an account will change.

A typical expense account showing accruals is as follows:

This amount relates to current year but not paid for – debited here

Expense incurred last year but not paid for last year so brought forward as a credit

Expense Accrual account

Dr **Cr**

	Tshs		Tshs
Cash paid during year	X	**Balance b/d (accruals)**	X
Balance c/d (accruals)	X	________ **Expense a/c (**amount to be shown in SOPL)	X
Total	**X**	**Total**	**X**

A typical expense account showing prepayments is as follows:

Money paid last year – but expense relates to current year, so b/d as a debit

Money paid this year but relates to expenses for following year. – Hence credited here

Expense prepayment account

Dr **Cr**

	Tshs		Tshs
Balance b/d (Prepayments)	X	_______**Expense a/c**	X
Cash paid	X	**Balance c/d (Prepayments)**	X
Total	**X**	**Total**	**X**

Example

Transco uses electricity in its manufacturing process. Expenses accrued at 1 January 20X7 and 31 December 20X7 were Tshs18,000 and Tshs22,000 respectively. The amount paid during the year is Tshs210,000. Calculate the electricity expense in the statement of profit or loss.

Answer

Electricity expenses accrual account

Dr **Cr**

	Tshs		Tshs
Cash paid	210,000	Balance b/d (accruals)	18,000
Balance c/d (accruals)	22,000	Electricity expense a/c **(balancing figure)** (amount to be shown in SOPL (Tshs210,000 + Tshs22,000 - Tshs18,000)	**214,000**
Total	**232,000**	**Total**	**232,000**

Let's take another example of prepayments.

Example

Stross Co conducts its business in a rented office. It has to pay rent in advance. The rent paid in advance on 1 January 20X7 and 31December 20X7 was Tshs11,000 and Tshs12,000 respectively. The amount paid during the year is Tshs139,000. Calculate the rent expense in the statement of profit or loss.

Answer

Rent prepayment account

Dr **Cr**

	Tshs		**Tshs**
Balance b/d (prepayments)	11,000	Rent expense a/c **(balancing figure)** (to be shown in SOPL) (Tshs11,000 + Tshs139,000 - Tshs12,000)	**138,000**
Cash paid	139,000	Balance c/d (prepayments)	12,000
Total	**150,000**	**Total**	**150,000**

Test Yourself 4

Protext, a perfumery, provides you with the following information:

Telephone expenses accrued at 1 January 20X6 were Tshs110. Electricity expenses outstanding on that date were Tshs294. Telephone expenses accrued at 31 December 20X6 were Tshs105. Electricity expenses outstanding on that date were Tshs329.

During the year, Tshs1,295 is recorded as telephone expenses and Tshs2,456 as electricity expenses in the statement of profit or loss.

Calculate the amount paid for the telephone and electricity expenses.

	Telephone Expenses	**Electricity Expenses**
A	Tshs1200	Tshs2,421
B	Tshs1300	Tshs2,231
C	Tshs1300	Tshs2,421
D	Tshs1200	Tshs2,231

5. Capital and drawing accounts

A typical capital account is as follows:

Capital account

Dr **Cr**

	Tshs		**Tshs**
Drawings (in cash and kind)	X	Balance b/d	X
Loss for the period	X	Additional capital introduced	X
Balance c/d	X	Profit for the period	X
Total	**X**	**Total**	**X**

Personal drawings mean

the cash drawn,
goods taken for personal use by the proprietor or
proprietor's personal expenses paid out of business cash

If the question states that the drawings were "approximately" __Tshs per month, you should multiply that amount by 12 to get annual drawings. However, if the question states a range of, for example, 100 - 120 per week, then you should not use these figures but calculate the drawings as one of the missing figures.

Capital introduced may be by way of an amount actually brought into the business from personal resources or cheques related to personal income deposited into a business bank account.

Samuels gives the following details:

	Tshs
Opening balance of capital	50,000
Closing balance of capital	260,000
Profit earned during the year	300,000

There was no fresh capital introduced.

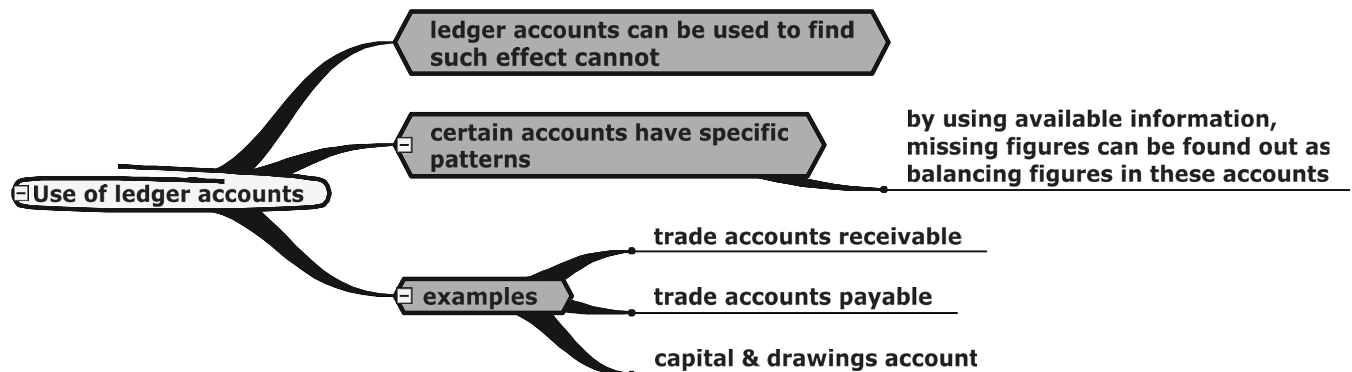
Calculate drawings.

Capital account

Dr **Cr**

	Tshs		Tshs
Drawings (balancing figure) (50,000 + 300,000 - 260,000)	**90,000**	Balance b/d	50,000
Balance c/f	260,000	Profit for the period	300,000
Total	**350,000**	**Total**	**350,000**

SUMMARY



Sara boutique gives you the following information:

	Tshs
Opening balance of capital	120,000
Closing balance of capital	180,000
Capital introduced	20,000
Drawings	50,000

Calculate profit earned in the year.

A Tshs150,000
B Tshs50,000
C Tshs30,000
D Tshs90000

1.3 Use of cash and / or bank summaries

The principles specified above in connection with the use of ledger accounts also apply to the cash and bank summaries. These summaries are, in fact, total cash or bank accounts. The normal items are known. All the available information is filled in and a missing item is found as the balancing figure.

A typical cash / bank summary with two columns will appear like this

Cash book or cash / bank summaries

Dr	Cash	Bank		Cash	Bank Cr
Balance b/d (if positive bank balance)	X	X	Balance b/d (if overdraft - possible only for bank column)	------	X
Cash sales	X	------	Cash receipts banked (contra)	X	-----
Cash receipts banked (contra)	------	X	**Cash paid to trade payables**	X	X X
Cash received from trade receivables	X	X	**Sundry expenses**	X	X
Cash withdrawn from bank (contra)	X	------	**Personal drawings**	X	X
Balance c/ f (if overdraft- possible only for bank column)	------	X	Cash withdrawn from bank (contra)	------	X
			Balance c/f (if positive balance)	X	
Total	**X**	**X**	**Total**	**X**	**X**

Most of the information required in order to prepare this summary can be picked up from bank statements. The missing amounts (you will most likely be asked to find in your examination) that can be found out with the help of the available information are:

(a) Amounts paid to suppliers
(b) Personal drawings
(c) Amounts received from customers
(d) Opening or closing balances of cash or bank.

Example

From the following information you are asked to **prepare the cash book for the year ended 31 December 20X7**

Opening balances	**Tshs**
Cash in bank	5,000
Cash in hand	350
Transactions during the year	
Credit sales	36,000
Cash sales	10,000
An **extract from the bank account** is as follows:	
Cash deposited in the bank	35,000
Bank receipts from accounts receivable	54,000
Payments towards accounts payable	57,000
Other expenses paid	4,000
Closing balances	
Cash in bank	5,400

Continued on the next page

You are required to **calculate the missing figures in the cash and bank accounts**.

Cash book or cash/ bank summaries

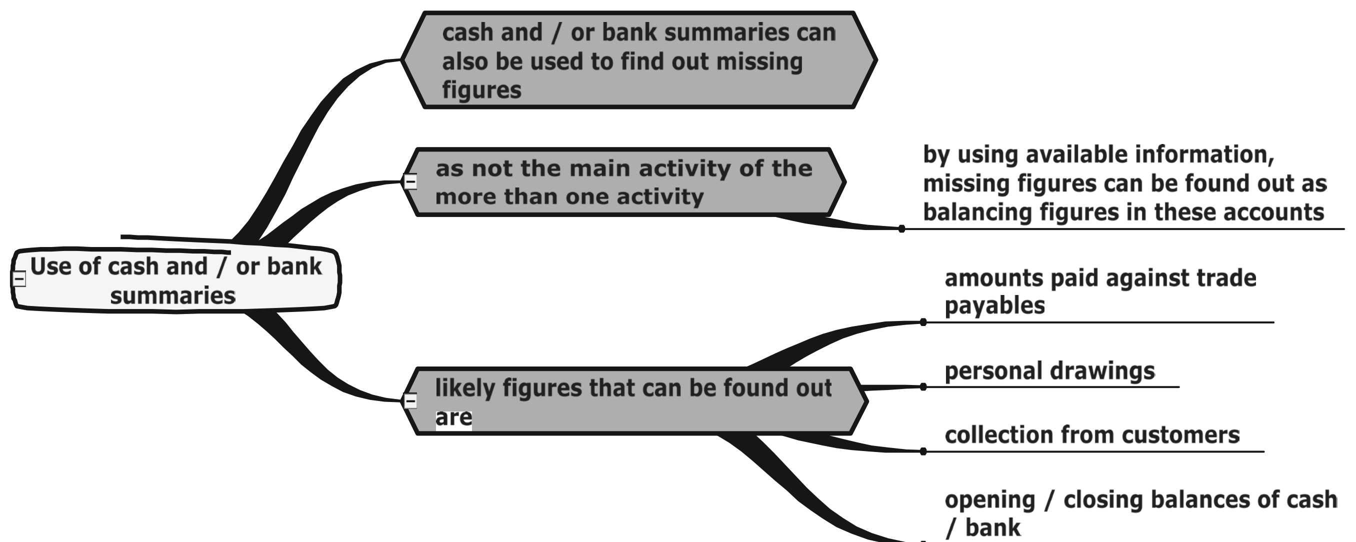
Dr **Cr**

	Cash	**Bank**		**Cash**	**Bank**
	Tshs	**Tshs**		**Tshs**	**Tshs**
Balance b/d	350	5,000	Cash receipts banked (contra)	35,000	------
Cash receipts banked (contra)	---------	35,000	Cash paid to trade payables	------	57,000
Amounts received from trade receivables	----------	54,000	Sundry expenses	------	4,000
Cash withdrawn from bank (contra)	27,600	-----------	Cash withdrawn from bank (contra) **(balancing figure) (94,000-57,000-4,000-5400)**	------	**27,600**
Cash sales	10,000		**Balance c/f (balancing figure) (37,950-35,000)**	**2,950**	5400
Total	**37,950**	**94,000**	**Total**	**37,950**	**94,000**

Since the opening and closing bank balances are given, we will first calculate the missing figure from the bank column.

Here, the balancing figure is a cash withdrawal therefore its second effect will come in the cash column. After this figure has been entered we can now calculate the closing balance of cash.

SUMMARY



1.4 Use of profit percentages to calculate missing figures

The relationship between sales cost of sales and gross profit is expected to remain stable over a period. These relationships are expressed as percentages and used for the purpose of finding missing figures. These percentages will be used in combination with the inventory account mentioned earlier for this purpose.

Remember the following terms:

Gross profit percentage is the gross profit as a **percentage of sales**.

Example

Gross profit = Tshs250,000
Sales = Tshs1,000,000
Gross profit percentage = Tshs250,000/Tshs1,000,000 x 100
= 25%

Mark up percentage is the gross profit as a **percentage of cost of goods sold.**

Example

Continuing with the previous example,

Cost = Sales – Gross profit
= Tshs1,000,000 - Tshs250,000
= Tshs750,000

Mark up = Gross profit/Cost of goods sold x 100
= Tshs250,000/Tshs750,000 x 100
= 33.33%

Example

Richardson earns a gross profit of 25%. Sales during the year 20X7 were Tshs500,000. The opening inventory was Tshs40,000 and the closing inventory, Tshs60,000. What is the value of purchases?

Answer

Step 1

	Tshs
Sales	500,000
Less: gross profit at 25%	125,000
Cost of goods sold	**375,000**

Step 2

Now, the value of purchases can be found out by preparing an inventory account:

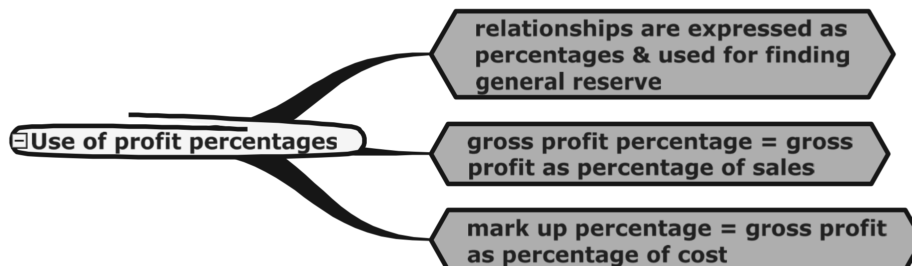
Inventory account

Dr **Cr**

	Tshs		Tshs
Opening inventory b/d	40,000	Cost of goods sold	375,000
Goods purchased **(balancing figure)**	**395,000**	Closing inventory c/f	60,000
Total	**435,000**	**Total**	**435,000**

It may also be the other way round. The cost of sales may be calculated as a missing figure and then sales can be found out based on percentage of mark up.

SUMMARY



Test Yourself 6

Sam has a proprietary business which trades in cosmetics. During the year ended 31 December 20X7, he earned gross profit at a rate of 22%.

You are given the following figures and asked to find out the opening inventory.

	Tshs
Sales during the year 20X7	250,000
Total purchases during the year	215,000
Closing inventory	60,000

1.5 Preparation of the opening statement of financial position

Usually, all the opening balances should be readily available. However, at times we may have to calculate the opening capital. Opening capital is equal to net assets of the company i.e. the total assets minus the total liabilities.

In order to find the opening capital, an opening statement of financial position will be prepared in which all the assets and liabilities are entered. The balancing figure in this statement of financial position will be the opening capital.

Example

Information provided by the Flexibond Inc for the year ended 31 December 20X9 is as follows:

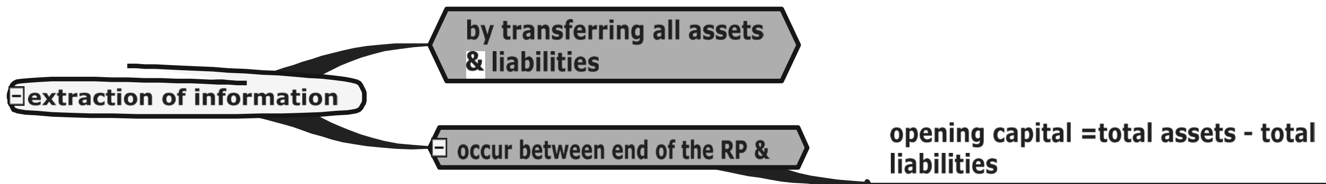
	Tshs
Land and building	15,000
Depreciation on building	2,500
Furniture and fixtures	19,750
Depreciation on furniture and fixtures	10500
Vehicles	34,000
Depreciation on vehicles	16,900
Inventory	12,375
Accounts receivable	4,330
Investment	10,000
Accounts payable	10,175
Cash balances	5,000
Bank overdraft	10,200

You are asked to prepare the statement of financial position for the year ended 31 December 20X9. Assume that there are no accruals and no prepayments.

Statement of financial position as at 31 December 20X9

	Tshs	Tshs
Non-current assets		
Land and building (15,000 - 2,500)	12,500	
Furniture and fixtures (Tshs19,750 - Tshs10,500)	9,250	
Vehicles (Tshs34,000 - Tshs16,900)	17,100	38,850
Investments		10,000
Current Assets		
Inventory	12,375	
Accounts receivable	4,330	
Cash in hand	5,000	21,705
Total assets		**70,555**
Capital and liabilities		
Capital **(balancing figure)**		**50,180**
(Tshs70,555 - Tshs20,375)		
Current liabilities		
Account payables	10,175	
Bank overdraft	10,200	20,375
Total capital and liabilities		**70,555**

SUMMARY



Answers to Test Yourself

Answer to TY 1

The correct option is **C**.

Introduction of capital and profit increases the capital. On the other hand, loss or drawings decreases the capital.

Answer to TY 2

The correct option is **A**.

Accounts receivable account

Dr **Cr**

	Tshs		**Tshs**
Balance b/d	23,000	Cash received	175,000
Credit sales	172,000	**Discount allowed (balancing figure) 195,000 - 175,000 - 15,000)**	**5,000**
		Balance c/d	15,000
	195,000		**195,000**

Answer to TY 3

The correct option is **B**.

Accounts payable account

Dr **Cr**

	Tshs		**Tshs**
Cash paid (balancing figure) 415,000 - 35,000 - 4,200 - 54,000)	**321,800**	Balance b/d	63,000
Purchase returns	35,000	Credit purchases	352,000
Discount received	4,200		
Balance c/d	54,000		
	415,000		**415,000**

Answer to TY 4

The correct option is **C**.

Telephone expenses accrual account

Dr **Cr**

	Tshs		**Tshs**
Cash paid (balancing figure)	**1,300**	Balance b/d (accruals)	110
Balance c/d (accruals)	105	Telephone expense a/c	1,295
	1,405		**1,405**

Electricity Expenses accrual account

Dr **Cr**

	Tshs		**Tshs**
Cash paid (balancing figure)	**2,421**	Balance b/d (accruals)	294
Balance c/d (accruals)	329	Electricity expense a/c	2,456
	2,750		**2,750**

Answer to TY 5

The correct option is **D**.

Capital account

Dr	Tshs		Tshs Cr
Drawings	50,000	Balance b/d	120,000
Balance c/f	180,000	Additional capital introduced	20,000
		Profit for the period (Bal. fig.)	**90,000**
	230,000		**230,000**

Answer to TY 6

	Tshs
Total sales	250,000
Less: gross profit (W1)	(55,000)
Cost of goods sold	**195,000**

Putting the value of cost of goods sold in the inventory account, we will get the opening inventory.

Inventory account

Dr	Tshs		Tshs Cr
Opening inventory b/d **(balancing figure)**	**40,000**	Cost of goods sold	195,000
Goods purchased	215,000		
		Closing inventory c/d	60,000
	255,000		**255,000**

Workings

W1 Gross profit = Gross profit ratio x Sales
= 22% x 250,000
= Tshs55,000

Self Examination Questions

Question 1

Big Bight, a shopping mall, had a fire last year. The accountant could not save his books of accounts. From whatever was saved he gave the following information:

	Tshs
Opening balance of trade receivables	53,000
Cash received	315,000
Discount allowed	3,000
Bad debts	1,500
Closing balance of trade receivables	51,000

You are required to calculate credit sales in the year.

Question 2

Continuing the above case of Big Bight, some of the goods were destroyed in the fire. It has a fire insurance policy. In order to claim the policy amount, Big Bight Ltd wanted to know the value of the goods destroyed.

	Tshs
Opening inventory	21,500
Closing inventory	20,200
Goods purchased	210,000
Cost of goods sold	180,000

Question 3

(a) From the following information prepare the cash book for the year ended 31 December 20X7

Opening balances	**Tshs**
Inventory	10,000
Accounts receivable	15,000
Cash at bank	7,500
Cash in hand	500
Non-current assets	50,000
Accounts payable	3,000
Transactions during the year –	
Credit sales	50,000
Cash deposited in the bank	40,000
Bank receipts from accounts receivable	45,000
Bank payments towards accounts payable	75,000
Sundry expenses made through bank	4,000
Cash withdrawals from bank	9,100
Closing balances -	
Cash balance	600
Accounts payables	3,500

There were no accruals and prepayments.
All payments except petty cash expenses are made by cheque.
All the customers pay by cheque except cash sales.
Depreciation for the year is Tshs2250 (not recorded in the books)
Mark up is 20% on cost.
No other information is available

(b) You are also required to find out the missing figures and prepare the statement of profit or loss and the statement of financial position as at 31 December 20X7.

Question 4

Fresh n Juicy Plc is a proprietary firm belonging to Margaret. She does not keep full accounting records. However, from the records she does maintain, we can extract the following information:

Opening balances	**Tshs**
Accounts payable	8,225
Accounts receivable	12,810
Telephone expenses (accrued)	350
Inventory	8,575
Insurance prepaid	280
Cash and bank account	18,800

Transactions during the year	**Tshs**
Receipts from account receivables	168,000
Payments to suppliers	106,000
Telephone expenses paid	4,550
Salaries	15,100
Office expenses	5,863
Postage and stationery	2,380
Conveyance	1,138
Discount allowed to customers	1,000
Insurance paid	1,400
Purchase of furniture	22,750
Sale of old furniture (carrying value Tshs750)	3,675

Closing balances	Tshs
Accounts payable	4,530
Accounts receivable	16,625
Telephone expenses (accrued)	455
Inventory	10,325
Insurance prepaid	350
Cash and bank	15,194

It is the policy of Fresh n Juicy to charge depreciation for the full year for purchases before 1 September. Furniture is purchased on 31 August 20X6. The depreciation charge for furniture is 10%.

Required

(a) Prepare the statement of profit or loss for the year ended 31 March 20X7.
(b) Prepare the statement of financial position as at 31 March 20X7.

Answers to Self Examination Questions

Answer to SEQ 1

Accounts receivable account

Dr **Cr**

	Tshs		Tshs
Balance b/d	53,000	Cash received	315,000
Credit sales (370,500 - 53,000)	**317,500**	Discount allowed	3,000
		Bad debts	1,500
		Balance c/d	51,000
	370,500		**370,500**

Answer to SEQ 2

Inventory account

Dr **Cr**

	Tshs		Tshs
Opening inventory b/f	21,500	Cost of goods sold	180,000
Goods purchased	210,000	**Goods destroyed** (231,500 - 180,000 - 20,200)	**31,300**
		Closing inventory c/d	20,200
	231,500		**231,500**

Answer to SEQ 3

(a)

Cash book or cash / bank summaries

Dr **Cr**

	Cash Tshs	Bank Tshs		Cash Tshs	Bank Tshs
Balance b/d	500	7,500	Cash receipts banked (contra)	40,000	-
Cash receipts banked (contra)		40,000	Trade account payables	-	75,000
Collection against trade receivables		45,000	Sundry expenses	-	4,000
Cash withdrawn from bank (contra)	9,100	-	Cash withdrawn from bank (contra)	-	9,100
Cash sales (balancing figure) (40,600 – 500 - 9,100)	**31,000**		**Balance c/f (92,500 - 75,000 - 4,000 - 9,100)**	600	**4,400**
	40,600	**92,500**		**40,600**	**92,500**

The balancing figure in the cash column is of cash sales and in the bank column is of closing balance.

(b) Statement of profit or loss for the period to 31 December 20X7

	Tshs	Tshs
Sales (W1)		81,000
Less: cost of goods sold		
Opening inventory Goods	10,000	
purchased (W2) **Less:**	75,500	
closing inventory (W3) Gross	(18,000)	(67,500)
profit		13,500
Expenses		
Other expenses	4,000	
Depreciation	2,250	(6,250)
Net profit		**7,250**

Statement of financial position as at 31 December 20X7

	Tshs	Tshs
Current Assets		
Inventory (W3)		18,000
Accounts receivable (W4)		20,000
Cash in hand	600	
Cash at bank	4,400	5,000
Net non-current assets (50,000 – 2,250)		47,750
Total assets		**90,750**
Capital and liabilities		
Capital (balancing figure)	80,000	
Net profit for the year	7,250	87,250
Current liabilities		
Account payables		3,500
Total capital and liabilities		**90,750**

Workings

W1 From total sales we can calculate the cost of goods sold using the profit formula.

	Tshs
Total sales	
Credit sales	50,000
Cash sales	31,000
	81,000
Cost of goods sold	
Total sales (120%)	81,000
Less: profit (20% on cost)	13,500
Cost of goods sold	**67,500**

W2

Accounts payable account

Dr	Tshs		Cr Tshs
Paid	75,000	**Balance b/d**	3,000
Purchase returns		**Credit purchases**	**75,500**
Discount received		(78,500 - 3,000)	
Balance c/d	3,500		
	78,500		**78,500**

By putting the value of cost of goods sold in the inventory account and the credit purchases calculated above in the trade payables account, we will get the closing inventory.

W3

Inventory account

Dr **Cr**

	Tshs		**Tshs**
Opening inventory b/d	10,000	Cost of goods sold (W1)	67,500
Goods purchased (W2)	75,500		
		Closing inventory c/d (85,500 - 67,500)	**18,000**
	85,500		**85,500**

W4

Trade receivables account

Dr **Cr**

	Tshs		**Tshs**
Balance b/d	15,000	**Cash received**	45,000
Credit sales	50,000		
		Balance c/d (balancing figure) (65,000 - 60,000)	**20,000**
	65,000		**65,000**

Answer to SEQ 4

Statement of profit or loss for the year to 31 March 20X7

	Tshs	**Tshs**
Sales (W1)		172,815
Less: Cost of goods sold		
Opening inventory	8,575	
Goods purchased (W2)	102,305	
Less: Closing inventory	(10,325)	(100,555)
Gross profit		**72,260**
Other incomes		
Profit on sale of furniture (W5)		2,925
		75,185
Expenses		
Telephone expenses (W3)	4,655	
Salaries	15,100	
Office expenses	5,863	
Postage and stationery	2,380	
Conveyance	1,138	
Insurance (W4)	1,330	
Discount allowed	1,000	
Depreciation on furniture 10%	2,275	(33,741)
Net profit		**41,444**

Statement of financial position as at 31 March 20X7

	Tshs	Tshs
Current Assets		
Inventory	10,325	
Accounts receivable	16,625	
Cash in bank	15,194	
Prepaid insurance	350	42,494
Net non-current assets		
Furniture (22750 - 2275)		20,475
Total assets		**62,969**
Capital and liabilities		
Capital (W6)	32,640	
Less: Drawings (W7)	(16,100)	
Net profit for the year	41,444	57,984
Current liabilities		
Account payables	4,530	
Accrued telephone expenses	455	4,985
Total capital and liabilities		**62,969**

Workings

W1

Accounts receivable account

Dr **Cr**

	Tshs		Tshs
Balance b/d	12,810	Cash received	168,000
Credit sales (185,625 - 12,810)	**172,815**	Discount allowed	1,000
		Balance c/d	16,625
	185,625		**185,625**

W2

Accounts payable account

Dr **Cr**

	Tshs		Tshs
Cash account - paid	106,000	Balance b/d	8,225
Balance c/d	4,530	**Credit purchases (balancing figure)** (110,530 - 8,225)	**102,305**
	110,530		**110,530**

W3

Telephone expenses accrual account

Dr **Cr**

	Tshs		Tshs
Paid	4,550	Balance b/d (accruals)	350
Balance c/d (accruals)	455	**Telephone expenses a/c (to be shown in SOPL) (5,005 - 350)**	**4,655**
	5,005		**5,005**

W4

Insurance prepayment account

Dr **Cr**

	Tshs		Tshs
Balance b/d	280	**Insurance expenses a/c (to be shown in SOPL) (1680 - 350)**	**1,330**
Cash account - paid	1,400	Balance c/d (accruals)	350
	1,680		**1,680**

W5

Profit on sale of furniture	**Tshs**
Sale of furniture	3,675
Furniture carrying value	750
Profit on sale of furniture	2,925

W6 Opening capital

Opening Statement of financial position

	Tshs
Liabilities	
Accounts payable	8,225
Accrued telephone expenses	350
Opening capital (Balancing figure)	**32,640**
Total liabilities	**41,215**
Assets	
Accounts receivable	12,810
Inventory	8,575
Prepaid insurance	280
Cash and bank	18,800
Furniture	750
Total assets	**41,215**

W7

Cash/bank account

Dr **Cr**

	Tshs		**Tshs**
Balance b/d	18,800	Accounts payable	106,000
Accounts receivable	168,000	Telephone expenses	4,550
Sale of furniture	3,675	Salaries	15,100
		Office expenses	5,863
		Postage and stationery	2,380
		Conveyance	1,138
		Insurance	1,400
		Purchase of furniture	22,750
		Drawings	**16,100**
		Balance c/d	15,194
	190,475		**190,475**

STUDY GUIDE F4: PREPARATION OF MANUFACTURING ACCOUNTS

Get Through Intro

You have already studied the preparation of major financial statements, e.g. statement of profit or loss and statement of financial position, earlier in Section I. However, in the case of a manufacturing entity, a statement referred to as the manufacturing account needs to be prepared in addition. The purpose of a manufacturing account is to present a picture of the contents of the manufacturing activity of the entity.

If you are working with a manufacturing entity in the future and you need to determine the cost of goods sold for this entity, you need to know the difference between production and non-production costs.

This Study Guide helps you to understand the basic concepts relating to manufacturing accounts and how various costs are classified into production and non-production activities.

Learning Outcomes

a) Define, explain and calculate:
   i. Direct cost
   ii. Indirect cost
   iii. Prime cost
   iv. Production cost
   v. Total cost
   vi. Inventory (Finished goods and work in progress).
b) Explain and prepare for a manufacturing entity:
   i. Manufacturing account
   ii. Statement of income and expenditure
   iii. Statement of financial position

1. Define, explain and calculate:
- **i. Direct cost**
- **ii. Indirect cost**
- **iii. Prime cost**
- **iv. Production cost**
- **v. Total cost**
- **vi. Inventory (Finished goods and work in progress)**

[Learning Outcome a]

Important terminologies

Definition

(a) Direct cost: costs which can be traceable to units of production, like direct materials, direct labour and direct expenses.

(b) Indirect costs: cost which cannot be easily or perfectly traceable to each unit of production, like overheads (production, administration and selling and distribution).

(c) Prime cost: also referred to as 'direct costs', these are directly related to the product and vary directly with output.

For example, if an automobile manufacturer doubles the output of cars, more material and wages will be required to generate the output.

(d) Production costs: production cost is the total of prime costs and factory overheads.

(e) Total cost: total costs refers to the total of production costs and non-production costs

(f) Inventories: inventories are assets:

> Inventories are explained in detail in Study Guide E1

held for sale in the ordinary course of business (finished products);
in the process of production for such sale (work in progress); or
in the form of materials or supplies to be consumed in the production process or in the rendering of services (raw materials).

There are three broad elements of cost:

Material
Labour
Expenses

These three broad elements can be further classified into:

Production and non-production costs
Direct costs and indirect costs

1.1 Production and non-production costs

The purpose of preparing a manufacturing account is to determine the production costs. A manufacturing account is divided into two sections:

The Prime Cost Section and
The Factory Overheads Section

Production costs form part of the manufacturing accounts, whereas the non-production costs are included in the statement of income.

(a) Production costs

Materials
Labour
Overheads

(b) Non-production costs

Administration costs
Selling and distribution costs
Finance costs

Let us understand the above costs in detail.

1. Production costs

The total of direct costs and indirect costs incurred for manufacturing goods to get them ready for sale is production cost.

Example

Johnson Plc manufactures soft toys. The following is the related cost.

Direct materials	Tshs2,000,000
Indirect materials	Tshs1,200,000
Direct labour	Tshs1,600,000
Indirect labour	Tshs1,000,000
Production overheads	Tshs600,000
Advertisement expenses	Tshs500,000

Production costs will be
Tshs2,000,000 + Tshs1,200,000 + Tshs1,600,000 + Tshs1,000,000 + Tshs600,000 = Tshs6,400,000

Note: advertisement expenses are not directly related to the production of soft toys, hence they will not be considered in the production costs.

Definition

Costs incurred in relation to the operation of a manufacturing process are **production costs**.

The production process generally involves processing raw materials into the final product. All the costs incurred in a factory, directly or indirectly, until the stage when the goods can be marketed as final products are considered production or manufacturing costs.

Example

In the production of glassware (glasses, glass plates etc.), the costs incurred for the glass, wages paid to labour and the cost of fuel used in making the glassware will all qualify as production costs.

Packing costs, where the products require primary packaging in order to sell the goods, are a part of production costs. In these cases, the product is incomplete unless it is packed, e.g. milk packed in bottles / cartons or hair shampoo bottled in plastic containers.

Production costs are sub-classified as:

(a) Direct material
(b) Direct labour
(c) Production overheads

Materials, labour and overheads are discussed in detail below in this Learning Outcome

Production or manufacturing costs incurred in the manufacture of a product are also termed product costs. Manufacturing costs are also known as inventorial costs. This is because until the time the product is actually sold on the market, these costs are recorded in the finished goods inventory account. This account eventually forms a part of current assets in the statement of financial position.

2. Non-production costs

Definition

All the costs incurred from the conceptualisation to the sale of a product other than those attributable to production activity, inclusive of administration costs, selling costs, distribution costs, finance costs and research and development costs, are the **non-production costs**.

Example

Salaries paid to office staff of the finance department are non-production costs. These are not spent on actual production, but are essential for the running of the organisation.

Non-production or non-manufacturing costs are also known as period costs. These are costs incurred in relation to a period and not in relation to a product.

(a) Administration costs

Definition

Any cost incurred for the management or administration of the business that includes planning and controlling its operations, is an **administrative cost**.

Normally, administration costs are fixed in nature. They do not change due to variations in output / input.

Example

Office rent
Salary of office staff – cleaners, clerks
Electricity and telephone costs of the office
Legal fees, audit fees, insurance expense of office

Administrative costs of an organisation include the costs incurred in formulating policy, directing the organisation and controlling its activities. In a big organisation, administrative costs are split into two types:

Costs incurred at the factory level to provide the staff with administrative support
Costs incurred at head office level that are allocated to the factory

(b) Selling and distribution costs

To sell the produced goods, the company has to bear some costs relating to sales. They are termed sales and distribution costs. These are the costs incurred both to get the finished items to the point where customers can buy them and to actually persuade the customers to buy them.

(i) Selling costs

Definition

Costs incurred in relation to the sale of a product or rendering of a service and allied activities are known as **selling costs**.

A product needs to be marketed and advertised so that the customers are aware of it, thereby creating a demand for the product in the market. Selling costs are incurred by all kinds of organisations, whether manufacturing or trading, as both of these have to sell products in the market. Selling costs include all costs that help the sale of the product in the marketplace.

Example

Sales promotion expenses, showroom expenses
Advertising costs such as catalogues, banners, brochures
Salaries of sales and marketing personnel, commission paid to salesmen

---

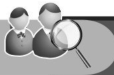
(ii) Distribution costs

Definition

Costs incurred for the transport of goods from the factory or depot to the customer and / or the costs incurred for maintaining the channel of distribution are known as **distribution costs**.

This cost also covers the cost of recovering and reconditioning empty containers for reuse.

Once the goods are ready for sale, they need to be transported to the place of sale. The costs incurred in the transportation of the finished goods to the customers' place are known as distribution costs. While maintaining distribution channels, an organisation needs to incur costs in the form of allowing discounts to **stock**ists, distributors and retailers, etc.



Example

The transportation cost of goods between two points, namely the receipt point of goods from production and the delivery point to the customer
The insurance cost of the goods between this period
Depreciation on vehicles used for the distribution of goods
Fuel used by vehicles in the distribution department
Repairs and maintenance cost of the above vehicles
Any cost incurred for the secondary packing

(c) Finance costs

Definition

Costs incurred in relation to the provision of finance to the business, mainly interest costs, are known as **finance costs**.

To incur all the previously discussed costs, the business needs a constant flow of money. This includes initial start-up costs – capital investment, working capital and costs required for the day-to-day running of the business, expansion costs – capital investment required for the expansion of the existing activities.

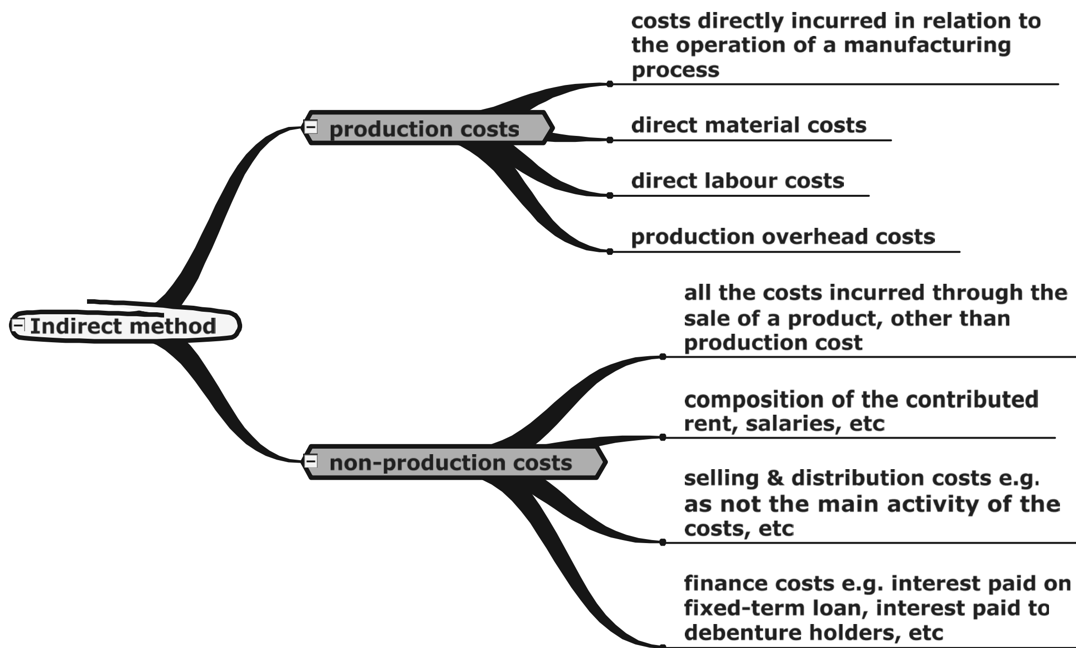
These costs are funded by obtaining a loan from the bank or raising capital from the market by issue of shares and debentures. Finance costs are incurred to meet the working capital as well as long term finance needs of the organisation. This cost cannot be traced to the individual products, but will have to be allocated using a suitable base.

Example

Interest paid on a fixed-term loan taken for the construction of a building
Interest paid on a fixed-term loan taken for the purchase of plant and machinery
Interest paid to debenture holders

The various types of costs make up the total cost of a product.

SUMMARY



1.2 Direct and indirect costs

The distinction of costs into direct and indirect is necessary because they need different treatments for cost computation and control. All direct costs are part of prime costs, whereas indirect costs are split into production and non-production costs.

1. Classification of costs as direct or indirect

The functional classification of costs into production and non-production costs was seen in the earlier discussion of this Learning Outcome. The same category of costs can be differently classified into direct and indirect costs.

This classification is based on the principle of traceability of costs into the final product or service. Let us revise these definitions of direct and indirect costs again.

Definition

Cost that can be specifically identified or traced in full, to the product or service in an economically feasible manner is a **direct cost.**

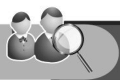
Definition

A cost that cannot be specifically **identified** with a product or a service is an **indirect cost.**

Example

Potatoes and salt are the direct ingredients in the preparation of potato chips. Costs incurred on these will be direct costs.

Apart from being easily traceable to the products, the traceability of costs should also be economically feasible for the costs to be classified as direct. If the traceability is not cost beneficial, a cost that is direct by nature will be classified as indirect.



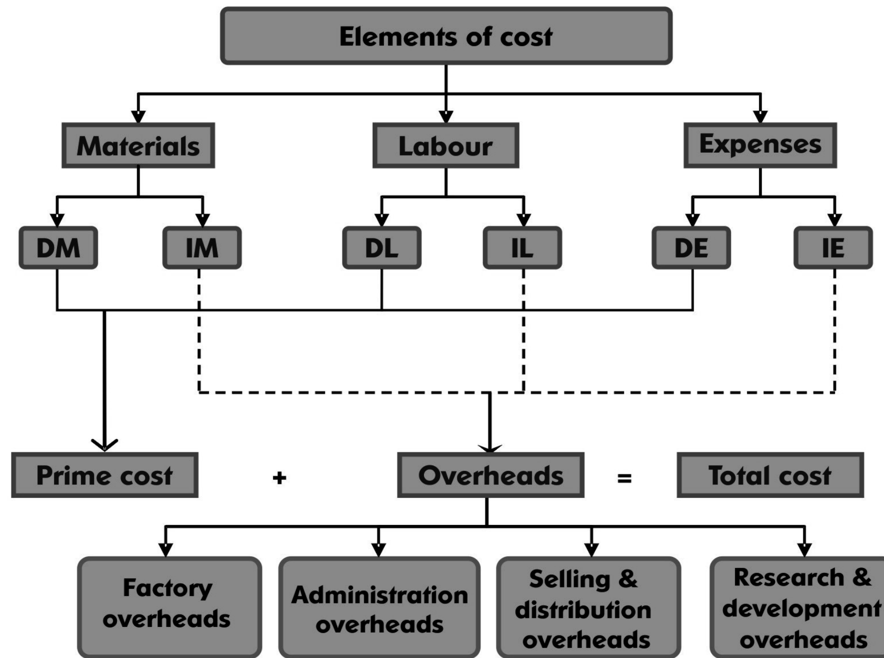
Example

In the above example of potato chips, it is a difficult and a costly affair to trace the amount of oil consumed by each pack of chips and so it will be treated as an indirect cost. Oil is easily traceable to the chips but still is classified as indirect cost.

Direct costs consist of direct materials, direct labour and direct expenses. These form part of the **prime costs**.

Indirect costs comprise indirect materials, indirect labour and indirect expenses. These are collectively also termed overheads. As explained above, **factory overheads** form part of **production costs** and other overheads such as **administrative overheads, selling and distribution overheads and research and development overheads** form part of **non-production costs**.

Diagram 1: Elements of cost



Note:

DM = Direct materials

IM = Indirect materials

DL = Direct labour

IL = Indirect labour

DE = Direct expenses

IE = Indirect expenses

Threads used in manufacturing cloth are direct materials for the end product of rolls of cloth. However, in stitching clothing, thread is an indirect cost as the amount of thread used for each unit of clothing stitched cannot be economically traced to each item of clothing.

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2. Direct costs in manufacturing industries

Manufacturing industries use inputs, process them and produce output. Non-manufacturing industries mainly consist of trading and service providing entities.

A manufacturing organisation: an organisation engaged in the manufacture of clothing.

A non-manufacturing organisation: an advertising agency engaged in the marketing and publicity of the clothing brand.

A financial consultancy company engaged in the preparation of various tax related reports and accounting work for its clients.

Direct costs consist of costs incurred on

- Direct materials
- Direct labour
- Direct expenses

(a) Direct Material

Definition

Materials that can be **physically identified** with or **traced to a particular product or service easily** or conveniently in a cost beneficial manner are known as **direct materials.**

Materials are considered to be direct materials when:

- A direct relationship can be established between the input and the output.
- These are physically identifiable in the product.
- The materials can be easily traced to the product without any clerical effort or extra cost or time.

In manufacturing organisations, all materials that are used to produce the product are the direct material costs. The fact that the materials should be traceable to the products in a cost beneficial manner is very important. If materials cannot be traced to the product in a cost beneficial manner then they are not classified as direct materials even if they form a part of the final product.

Example

Sheet steel and spares used in the manufacture of automobiles in an automobile company.

Output of one production process may be used as input materials by yet another process for further processing.

Example

In a shoe manufacturing factory, the shoe sole produced by one department will be a direct material for the department which stitches together the entire shoe.

(b) Direct labour

Definition

Labour that is directly identifiable with and easily traceable to a product or service in an economically feasible manner is **direct labour.**

Labour cost can be considered a part of total direct cost when:

- a direct relationship exists between labour cost and the product or process;
- labour cost can be measured in the light of this direct relationship;
- labour cost is significant enough; and
- it is economically feasible to identify it as a direct cost.

In a manufacturing organisation, the wages of workers who are directly involved in the manufacturing activity are direct labour costs.

Example

Wages paid to the labourers engaged in construction work on a building site will constitute direct labour cost.

(c) Direct expenses

Apart from direct material and direct labour costs, some other costs may also be traced directly to a product or a service. These are categorised as direct expenses.

Direct expenses include all expenses other than direct material or direct labour that are specifically incurred for a particular product or process. These expenses can sometimes be hard to trace to the final products and hence are sometimes treated as indirect expenses.

Example

In a manufacturing organisation, direct expenses may include costs such as the cost of hiring a hot mix plant (cement mixer) for the construction of concrete roads. This is a direct cost incurred in relation to concrete roads.

Test Yourself 1

Direct material cost means a material cost that can be:

A Specifically, easily, or conveniently identified with a cost objective
B Attributed to, or allocated to, a cost objective on a rational or logical basis
C Associated with a cost objective as it relates to the production process in general
D All of the above

Test Yourself 2

Which of the following are direct labour costs?

A Cutting, shaping and polishing of a raw material as part of production
B Remuneration of supervisor or shop foreman who oversees the production process
C Wages paid to assistants who help in setting up the production process
D All of the above

Test Yourself 3

Direct expenses are those which:

A Can be included in direct material or direct labour
B Are the same as direct material and direct labour
C Are incurred specifically in connection with a product or service
D All of the above

3. Indirect costs in manufacturing industries

Costs other than direct material and direct labour costs that cannot be specifically identified with a product in an economically feasible manner are indirect costs. These costs need to be assigned to the entire volume of production using a suitable base.

Indirect costs are all the overhead expenses - manufacturing overheads, administration overheads, selling and distribution overheads and research and development overheads. Manufacturing overheads are generally incurred in manufacturing organisations.

(a) Manufacturing overheads

These consist of the costs incurred on:

(i) Indirect materials

Definition

Materials of minor importance in comparison to direct materials are known as **indirect materials**. They are not identifiable easily with the final product.

In a manufacturing organisation, indirect materials are those that cannot be easily and precisely traced to any individual product or service. These are materials that are essential, but used in negligible quantities or are used to bring the product in existence but are not traceable to it.

Example

Glue used in the production of wooden tables. It is used in negligible quantity but is essential for the production of tables. The cost of the glue cannot be traced down to each table as it is used in very small quantities. Glue will therefore be classified as an indirect material and the cost incurred on this will be an indirect material cost.

Gas or fuel used in the preparation of food in hotels is an indirect ingredient in food items sold. It is essential for the preparation of food but is not physically traceable to it.

Test Yourself 4

Indirect materials include which of the following?

A Tools, jigs, dyes used to make the finished product
B Wooden shafts used in construction of buildings
C Oil, grease, lubricants, adhesives, cleaning solutions for material maintenance
D Options B and C

(ii) Indirect labour

Definition

Labour costs that **cannot be traced** to the production of specific goods or provision of services are **indirect labour costs.**

Certain direct labour costs are also sometimes treated as indirect costs as it is more appropriate to classify them in this way e.g. overtime premiums, shift differentials (extra payment for working in odd hours like night shifts) and holiday pay. This is done because these payments are made only during abnormal conditions and hence it is convenient to classify them as indirect costs rather than direct labour costs.

In a manufacturing organisation, indirect labour costs consist of labour costs in service departments such as purchasing or engineering. The labour cost of certain workers in the production departments will be considered indirect labour, such as foremen and supervisors, as their time is split between many items produced and cannot be apportioned easily.

Example

Wages paid to labour working in the storeroom or factory office and maintenance staff in the factory will be the indirect labour costs.

Test Yourself 5

Indirect labour:

A Is synonymous with direct labour; that is, exhibits the characteristic traits of direct labour
B Means cost of labour directly engaged in production or service providing activities
C Consists of labour costs incurred in departments such as purchasing, engineering and stores
D None of the above

(iii) Indirect expenses

Indirect expenses include costs that might be incurred for the overall production or service in order to ensure that operations are carried out smoothly. In a manufacturing organisation, indirect expenses will include rent and rates for factory premises and insurance charges to be paid, if any.

(b) Non-manufacturing overheads

These include administration, research and development, selling and distribution overheads.

Administrative costs such as costs of book keeping, selling costs such as salesmen commission and distribution costs of the products from the factory to the market place are non-manufacturing overheads.

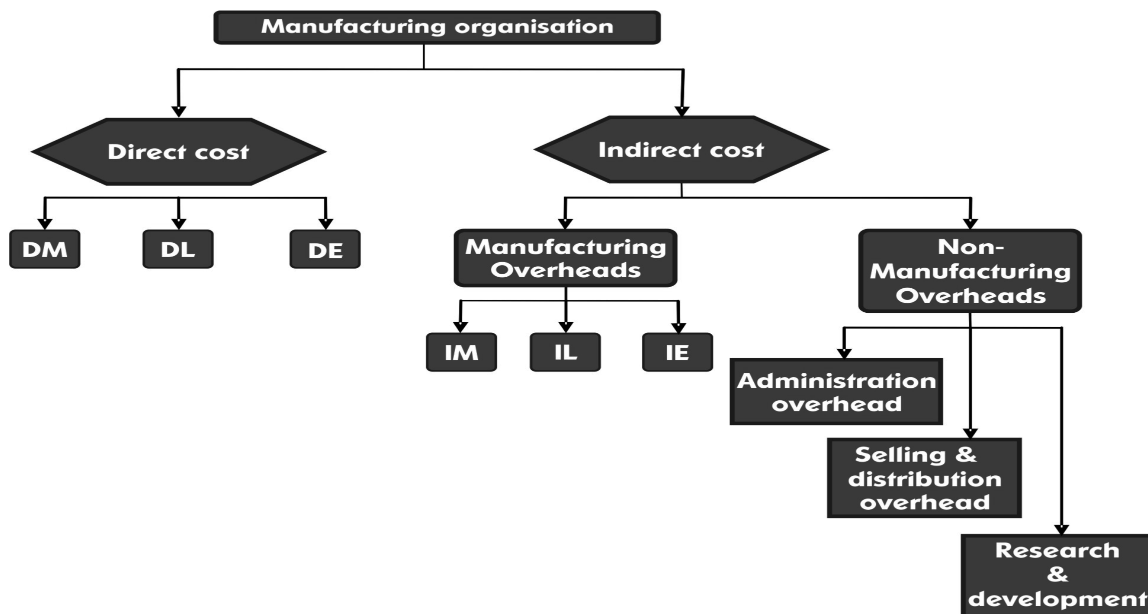
In a non-manufacturing organisation, the proportion of support costs as a percentage of total costs is higher than in manufacturing organisations.

Administrative overhead costs are much higher as office maintenance is vital for non-manufacturing organisations. The office is where all work takes place as there is no factory or production floor.

Selling and distribution costs, which include marketing and promotion costs, are usually higher in service providers.

Business development costs (costs on advertising, meeting clients etc.) incurred by a legal consultancy firm for creating a network base of potential clients are selling overhead costs.

Diagram 2: Direct and indirect cost classification in a manufacturing organisation



Given below is an illustrative list of examples for direct and indirect costs.

Example

Elements of direct costs	Elements of indirect costs
Direct material: cost of dough and sugar used in the preparation of biscuits, the cost of sheet steel used in the body of a car. **Direct labour:** salary of a baker baking biscuits in a bakery, salary of the worker who assembles the body of a car in a car manufacturing company. **Direct expenses:** costs of repairs and maintenance to the oven in which the cake is baked	**Indirect materials:** electricity consumed by the oven, spray paint used to paint the body of the car. **Indirect labour:** salary of the kitchen cleaner in a bakery. **Indirect expenses:** rent of the premises of the bakery. **Administrative overheads:** salary of the general manager of the car manufacturing company. **Selling overheads:** commission paid to the door to door salesmen to market the bakery products. **Distribution overheads:** charges paid to the delivery man for delivering the biscuits to the retail shop.

2. Explain and prepare for a manufacturing entity:

i. Manufacturing account

ii. Statement of income and expenditure

iii. Statement of financial position

[Learning Outcome b]

In the earlier Learning Outcomes, we have studied the different types of costs. In this Learning Outcome, we will prepare the manufacturing account, statement of income and statement of financial position for a manufacturing entity. First let us have a look at the proformas.

Proforma of manufacturing account

	Tshs'000
Raw materials (Opening)	XX
Add: Purchases of raw materials	XX
Less: Raw materials (Closing)	(XX)
Raw material used	**XXX**
Add: Direct labour	XX
Prime cost	**XXX**
Factory overheads	
Factory overheads (direct and indirect)	XX
Depreciation on plant used for production	XX
	XXX
Add: Work-in-progress (Opening)	XX
	XXX
Less: Work-in-progress (Closing)	(XX)
Production costs or cost of goods manufactured	**XXX**

Important

The proforma of a manufacturing account is similar to a cost sheet. Students are advised to refer to Paper T06 and understand how a cost sheet is prepared.

Proforma of statement of income

	Tshs'000	Tshs'000
Sales		XX
Less: Cost of sales		
Finished goods (Opening)	XX	
Add: Production costs (from manufacturing account)	XX	
Less: Finished goods (Closing)	(XX)	(XX)
Gross profit on trading		**XXX**
Less: Administrative expenses:		
- Rent & rates	XX	
- Heat & light	XX	
- Stationery and postage	XX	
- Administrative staff salaries	XX	(XX)
Less: Selling and distribution expenses:		
Advertising expenses	XX	
Delivery van expenses	XX	
Depreciation of delivery van	XX	(XX)
Less: Research and development expense		
Research expenses	XX	
Research and development staff salaries	XX	(XX)
Profit for the year		**XXX**

Proforma of statement of financial position

	Tshs'000	Tshs'000
Non-current assets		
Plant and machinery	XX	
Motor vehicles	XX	XX
Current assets		
Inventory		
- Raw materials	XX	
- Work in progress	XX	
- Finished goods	XX	
Trade receivables	XX	
Bank balance	XX	
Prepaid rent	XX	XX
		XXX
Equity and liabilities		
Equity		
Capital	XX	
Less: Drawings	(XX)	
Add: Profit for the year	XX	XX
Non-current liabilities		
Bank loan	XX	XX
Current liabilities		
Payables	XX	
Accrued expenses	XX	XX
		XXX

Let us understand the preparation of the manufacturing accounts with the help of a comprehensive example.

Example

The following balances as at 31 October 2011 have been extracted from the books of Hasara Co, operating a manufacturing set-up in Arusha.

	Tshs'000
Inventory at November 1 October 2010	
Raw materials	17,500
Work in progress	12,500
Finished goods	17,250
Purchases of raw materials	95,000
Direct labour	70,000
Factory overheads	62,500
Administrative expenses:	
Rent and rates Heat	47,500
and light Stationery	15,000
and postage Staff	5,000
salaries	48,450
Sales	480,000
Plant and machinery at cost	75,000
Motor vehicles at cost (for sales deliveries)	40,000
Provision for depreciation:	
Plant and Machinery	30,000
Motor vehicles	10,000
Trade payables	17,200
Trade receivables	70,000
Drawings	27,750
Bank balance	41,500
Capital at 1 November 2010	120,000
Motor vehicle running expenses	11,250

Additional information:

(a) Inventory as at 31 October 2011 were as follows:

	Tshs
Raw materials	22,500,000
Work in progress	20,000,000
Finished goods	25,875,000

(b) Depreciation is provided annually at the following percentages of the original cost of non-current assets held at the end of each financial year:

Plant and machinery 10%
Motor vehicles 25%

(c) Amounts accrued at 31 October 2011 for direct labour amounted to Tshs9,500,000

(d) Rent and rates prepaid at 31 October 2011 amounted to Tshs4,000,000

Required:

Prepare for the year ended 31 October 2011

Manufacturing account
Statement of income
Statement of financial position

(Adapted from May 2012)

Continued on the next page

Answer

Hasara Co. Ltd - Manufacturing Account for the year to 31 October 2011

	Tshs'000	Tshs'000
Raw materials 1.11.2010		17,500
Add: Purchases of raw materials		95,000
		112,500
Less: Raw materials 31.10.2011		(22,500)
Raw material used		90,000
Add: Direct labour (70,000 + 9,500)		79,500
Prime cost		**169,500**
Factory overheads		
Factory overheads	62,500	
Depreciation on plant	7,500	70,000
		239,500
Add: Work-in-progress 1 Nov 2010		12,500
		252,000
Less: Work-in-progress 31 Nov 2011		(20,000)
Cost of goods manufactured		**232,000**

Hasara Co. Ltd - Statement of Income for the year to 31 October 2011

	Tshs'000	Tshs'000
Sales		480,000
Less: Cost of sales:		
Finished goods 01 Nov 2010	17,250	
Add: Market value of goods completed	232,000	
Less: Finished goods 31 Oct 2011	(25,875)	(223,375)
Gross profit on trading		**256,625**
Less: Administrative expenses:		
- Rent & rates (Tshs47,500 – Tshs4,000)	43,500	
- Heat & light	15,000	
- Stationery and postage	5,000	
- Staff salaries	48,450	(111,950)
Less: Selling and distribution expenses:		
Motor vehicle running expenses	11,250	
Depreciation of motor vehicle (25% of Tshs40,000)	10,000	(22,250)
Profit for the year		**122,425**

Tip

Finished goods are always part of the statement of income, and raw material and work in progress are recorded in the manufacturing account.

Continued on the next page

Hasara Co. Ltd - Statement of financial position for the year ended 31 October 2011

	Tshs'000	Tshs'000
Non-current assets		
Plant and machinery (Tshs75,000 – Tshs30,000 – Tshs10,000)	35,000	
Motor vehicles ((Tshs40,000 – Tshs10,000 – Tshs7,500)	22,500	**57,500**
Current assets		
Inventory		
Raw materials	22,500	
Work in progress	20,000	
Finished goods	25,875	
Trade receivables	70,000	
Bank balance	41,500	
Prepaid rent	4,000	183,875
		241,375
Equity and liabilities		
Equity		
Capital	120,000	
Less: Drawings	(27,750)	
Add: Profit for the year	122,425	214,675
Non-current liabilities		-
Current liabilities		
Trade payables	17,200	
Accrued expenses	9,500	26,700
		241,375

Test Yourself 6

Tipton Co is in the textile industry. It manufactures cotton shirts. The following are the details of their estimated annual expenses for the next financial year. Determine the cost per unit. The annual production of Tipton Co is 10,000 units.

	Tshs'00
Purchase of raw materials	500
Wages paid (80% direct wages)	600
Expenses related to purchases	70
Overheads	
Factory (20% are fixed)	750
Administration	400
Selling and distribution (20% are variable)	50

Required:

Calculate the cost of sales for Tipton Co.

Answers to Test Yourself

Answer to TY 1

The correct option is **A.**

Direct cost is specifically and easily identifiable with the cost object. Direct material cost is not allocable; it is identifiable with a cost objective or cost unit. Direct material cost is not related to the production process in general, but is specifically identifiable in the production process.

Answer to TY 2

The correct option is **A.**

There is a direct measurable relationship between labour cost and the product / process / output. Also, this forms a major part of total direct cost. Remuneration of supervisor or shop foreman who oversees the production process is not directly identifiable with any particular job, product or process. Wages paid to assistants who help in setting up the production process is also not directly identifiable with any particular job, product or process.

Answer to TY 3

The correct option is **C.**

These are called direct expenses because they are directly attributable to production or service provision i.e. incurred in such a way that their benefit can be easily visualised in the product and form a substantial part of total direct cost. Direct expenses are separately charged to the product or process and cannot be included in direct material and direct labour. Direct expenses can be distinguished from direct material and direct labour; they are not the same.

Answer to TY 4

The correct option is **D.**

Temporary wooden shafts, used in construction of buildings, are not a part of the final structure but are required for the construction process. Oil, grease, lubricants, adhesives, and cleaning solutions are all required for material maintenance. Tools, jigs, dyes etc. used to make the finished product are the store items and not indirect material.

Answer to TY 5

The correct option is **C.**

Indirect labour is not directly involved in production or service providing activities and can include labour costs of ancillary departments like purchasing and stores. Therefore, it is distinct from direct labour.

Answer to TY 6

The cost of sales can be calculated as follows:

	Tshs'000	Tshs'000	Per unit cost (Tshs)
Direct materials (purchase of raw materials)	500		
Direct wages (Tshs600 x 80%)	480		
Direct expenses (purchase related)	70		
Prime cost		**1,050**	**105.00**
Production overheads			
Factory overheads			
Variable (Tshs750 x 80%)	600		
Fixed (Tshs750 x 20%)	150		
Indirect wages (Tshs600 x 20%)	120	870	
Production cost		**1,920**	**192.00**
Administration overheads		400	
Administration costs		**2,320**	**232.00**
Selling and distribution costs			
Variable (Tshs50 x 20%)	10		
Fixed (Tshs50 x 80%)	40	50	
Cost of sales / Total costs		**2,370**	**237.00**

Self Examination Questions

Question 1

The following are three types of costs:

(i) CD for the general office computer.
(ii) Maintenance contract for the office photocopying machine.
(iii) The cost of painting advertising slogans on delivery vans.

Which of the following statements is true with regard to the above costs?

A (i) and (ii) are administrative overhead costs.
B (ii) and (iii) are administrative overhead costs.
C (iii) and (i) are selling and distribution costs.
D (i), (ii) and (iii) are selling and distribution costs.

Question 2

Which of the following is an administrative overhead cost?

A Cost of fuel for machinery
B Legal charges
C Salary of a sales manager
D Cost of printing price list

Question 3

Motor vehicle licences for lorries are:

A Production overhead
B Administration overhead
C Finance overhead
D Selling and distribution overhead

Question 4

Which of the following is / are not an example of fixed cost?

A Insurance cost incurred by an organisation
B Monthly machine fuel charges
C Interest on borrowed money for business
D Raw materials cost

Question 5

(i) Costs incurred to improve an existing product are classified as selling costs.

A True
B False

(ii) Salaries of office staff, sales and marketing personnel are classified as administrative and selling **costs.**

A True
B False

Question 6

Jogoo Ltd is a company which mills maize flour. The following balances were extracted from the company's trial balance as at 30 September 2012.

	Tshs'000
Purchases of new materials	2,800,000
Returns of raw materials	10,000
Direct labour	1,250,000
Administration costs	350,000
Sales	7,850,000
General factory expenses	150,000
Plant and machinery at cost	1,400,000
Delivery van at cost	2,100,000
Selling and distribution expenses	200,000
Indirect factory labour	240,000
Stock 01 October 2011: Raw materials	380,000
Work in progress	980,000
Finished goods	180,000
Rent	420,000

The following additional information is available:

(i) Rent was paid for the year up to 31 December 2012 and was to be apportioned between the factory and general administration on the basis of 2:1.

(ii) Indirect factory labour of Tshs60,000,000 were accrued on 30 September 2012.

(iii) Plant and machinery were depreciated at 20% per annum and delivery van at 30% on book value. Usage of the delivery van is apportioned at: 50% factory and 50% administration.

(iv) Stock at 30 September 2012 were:

Raw materials	480,000,000
Work in progress	880,000,000
Finished goods	280,000,000

Required:

Prepare the Manufacturing Account and Statement of Income for the year ended 30 September 2012.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **A.**

CD for general office use and maintenance contracts for office photocopying machines are administrative expenses incurred for office purposes.

Option B – (ii) is an administrative expense but (iii) is a selling and administrative expense for market promotion.
Option C – (iii) is selling and distribution expense but (i) is administration expense
Option D – (i) and (ii) are administration expenses and (iii) is selling and distribution expense.

Answer to SEQ 2

The correct option is **B.**

Legal charges are an administrative overhead cost.

Option A - Cost of fuel for machinery is a factory overhead cost.
Options C and D - Salary of a sales manager and the cost of printing the price list are selling overhead costs.

Answer to SEQ 3

The correct option is **D.**

Motor vehicle licences for lorries is a selling and distribution overhead as lorries are used to transport goods from one place to another.

Option A – Production overheads must be incurred in relation to the manufacture of a product.
Option B – Administration overheads are the overheads incurred in relation to maintaining an office.
Option C – Finance costs are the interest costs relating to the capital borrowed for business.

Answer to SEQ 4

The correct options are **A** and **C**.

Insurance cost is a fixed cost. It does not have any relationship with the production activity. Interest on borrowed money for business bears a fixed rate of interest. Both of these costs do not change according to change in the volume of production.

On the other hand, machine fuel charges and raw material requirements change in accordance with changes in production – therefore they are variable costs.

Answer to SEQ 5

(i) The correct option is **B.**

Costs incurred to improve an existing product are classified as research and development costs.

(ii) The correct option is **B**.

Salaries of office staff and sales and marketing personnel are classified as administrative and selling costs. This is because they include the costs of salary of office staff (administrative costs) and the salary of sales and marketing personnel (selling costs).

Answer to SEQ 6

Manufacturing account for the year to 30 September 2012

	Tshs'000	**Tshs'000**	**Tshs'000**
Opening Stock		380,000	
Add: Purchases	2,800,000		
Less: Returns	(10,000)	2,790,000	
Available for use		3,170,000	
Less: Closing stock		(480,000)	2,690,000
Direct labour			1,250,000
Prime cost			3,940,000
Factory overhead:			
General factory		150,000	
Indirect labour		300,000	
Rent		210,000	
Depreciation: Plant		280,000	
Motor Vehicle		315,000	1,255,000
Total Current Production cost			**5,195,000**
Add: Opening WIP			980,000
Total Production cost to date			**6,175,000**
Less: Closing WIP			(880,000)
Production cost			**5,295,000**

Statement of income for the year to 30 September 2012

	Tshs'000	**Tshs'000**
Sales		7,850,000
Cost of Sales:		
Opening Stock	180,000	
Add: Cost of Goods Manufactured	5,295,000	
Available for sale **Less:**	5,475,000	
Closing Stock **Gross**	(280,000)	(5,195,000)
Profit Administration		**2,655,000**
Expenses Selling &	350,000	
Distribution Rent	200,000	
Depreciation Motor Vehicle	105,000	
Net Profit	315,000	970,000
		1,685,000

SECTION G

PRINCIPLES OF AUDITING

G1

STUDY GUIDE G1: INTRODUCTION TO AUDITING: DEFINITIONS AND CONCEPTS IN AUDITING

Get Through Intro

To err is human. Man, in business and accounting, as well as in other aspects of life, is subject to ignorance, incompetence, inefficiency and various temptations. This may lead to the occurrence of errors and fraud. All these errors and fraud may be minimised, if not completely eliminated, when the accounts prepared by one person are checked by another on the basis of well-defined principles, standards and procedures. This idea led to the origin of audit.

Over different periods of time, audit has been constantly changing to meet the needs of the times. Auditing has undergone four distinct stages of development:

- The first stage was the mechanical verification of book-keeping details.
- The second stage was basically a verification audit. The role of the auditor in this stage was not merely to make a direct verification of the items of the Statement of Financial Position (SOFP) on the basis of internal records and information, but also to supplement their direct verification with an indirect verification from external evidence.
- The third stage was dominated by system-based audits. Here, the auditor actually went beyond the books by conducting an in-depth examination and collecting evidence from internal sources, as the major emphasis was on the need for internal control of the system.
- Auditing has now entered into the fourth stage the present period of specialised auditing. The mission of audit is not one of fault-finding alone. It must improve procedures so as to eliminate lapses and errors.

Now, the definition of auditing not only emphasises the verification of financial statements but also covers an examination of related matters, and aims to make auditing more useful in terms of objectives of ‘management policies’ or ‘stated requirements’.

In this Study Guide, you will understand the meaning of auditing, the objectives of auditing, the various types of audit and the differences between auditing and accounting.

Learning Outcomes

a) Define auditing.
b) Explain the differences between auditing and accounting.
c) Explain objectives of an audit.
d) State and explain types of audits
   i. Internal vs. External audit
   ii. Statutory vs. Non-statutory
   iii. Operational vs. Audit of Financial Statements
e) Explain professional ethics of an auditor
f) Describe the qualities of an auditor

1. Define auditing.
Explain objectives of an audit.
[Learning Outcomes a and c]

1.1 Definitions of audit

Each entity, irrespective of the size, should record all transactions and events occurred over a particular time period, appropriately classify them and prepare financial statements i.e. accounting reports from such information.

In the case of partnership firms and small entities, ownership lies with a small group of people. The same group generally manages the entity. However in the case of large entities, it becomes essential that professionals manage the business. Therefore, the managers are generally separate from the owners.

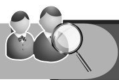
Since owners are not involved in the day to day operation of the entity, they are interested in knowing the financial position and performance of the entity. Apart from the owners, the following groups are interested in the financial position and performance of the entity:

- Suppliers
- Employees
- Banks and financial institutes
- Tax and other government authorities

They all want an assurance from an independent person as to the truth and fairness of the financial statements. Such independent and high level assurance can only be provided by an external auditor.

Definition

An **external audit** can be defined, in simple terms, as **an independent examination of financial information, with a view to expressing an opinion on this information**.



Example

Independent Auditor's Report

We have audited the financial statements of Red Co for the year ended October 31, 20X9. We conducted our audit in accordance with the International Standard on Auditing.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the supplementary information. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the information is free from material misstatements

The financial statements of Red Co have been prepared, in all material respects, in accordance with the financial reporting framework. In our opinion and based on the information available to us, the financial statements provide a true and fair view of the financial position of the company.

M. Alex
8 December 20X9

It is clear that the basic objective of auditing, i.e. the expression of an opinion on the financial statements, is constant irrespective of the nature, size or form of the entity.

An external audit is performed by external auditors, who are independent of the organisation and provide an independent opinion on the organisation's financial statements.

An **external audit** is primarily concerned with the verification of accounting data in order to determine the accuracy and reliability of financial statements. In other words, it **is a review and assessment of the financial records to form an overall conclusion as to whether:**

- The financial statements show a **true and fair** view.
- The financial statements have been prepared using acceptable accounting policies, which have been consistently applied.

The financial statements comply with all the relevant regulations and statutory requirements.
Adequate disclosure of all material matters relevant to the proper presentation of financial information has been made.

In most developed countries, all publicly quoted companies as well as all large companies are required by law to produce annual financial statements and have them audited by external auditors. Other organisations may also choose to get their accounts audited, even if there is no legal requirement.

True and fair view

The term "**true and fair**" is not defined in the Companies Act, but if the accounts of an entity are prepared in accordance with the facts, correct principles and applicable / accepted standards, the accounts are said to be true and fair.

In simple terms, we can say that truth means something factually correct and fair means just, equitable and not misleading. So, the auditor needs to ensure that the financial statements are not only factually correct but are also just, equitable presented so as to be open and understandable, and in accordance with accounting principles and standards.

Example

Old Co has had its accounts audited by its auditor. The truck has been depreciated over a period of ten years. Mathematically, the auditor has made the calculations correctly but the life of the truck has not been estimated correctly. The life of the truck cannot be more than five years. Therefore, the financial statements are true but are not fair: though arithmetically accurate they mislead users about the state of the trucks.

Definition

The most common definition of an audit is an evaluation of an organisation, system, process, project or product.

Audits are performed to ascertain the validity and reliability of information, and also to provide an assessment of a system's internal control.

Traditionally, audits were mainly associated with gaining information about the financial systems and financial records of a company or a business. However, recently, auditing has begun to cover other areas such as information about environmental performance. As a result, there is a growing need for professionals whose job is to conduct audits.

An audit is described as being an official examination of an organisation's accounting records. It is useful to an organisation as it provides an independent assurance of whether their reporting policies and procedures are accurately showing the relevant financial information of its operations and activities.

1.2 Objectives of audit

The **objective of the external audit** of the financial statements of a limited liability company is **to enable the auditors to express an opinion as to whether the financial statements are prepared in all material respects, in accordance with an identified reporting framework.**

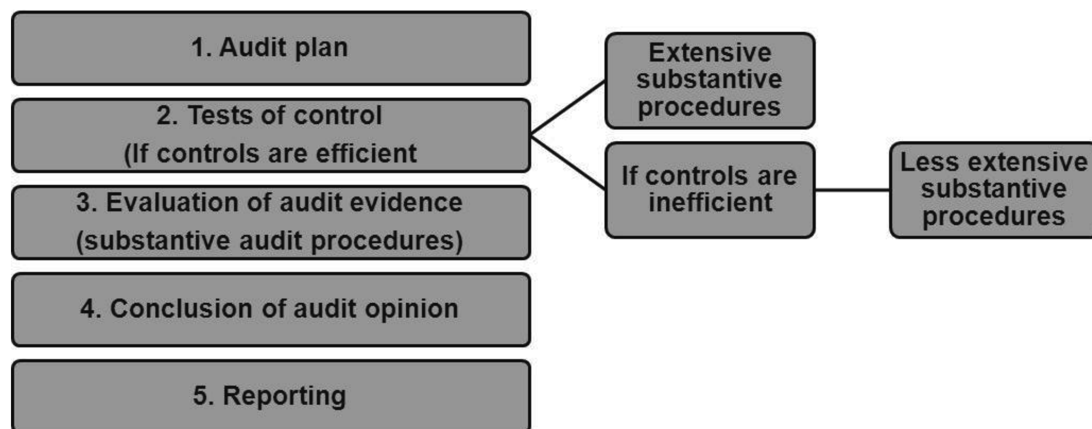
This means that the external auditor expresses a written opinion on the truth and fairness of the financial statements.

External audit adds creditability to the implied assertions given by the management of a company.

External audit also ensures that there is no material misstatement in the financial statements prepared.

Refer to the example of the independent auditor's (Mr. Alex) report, explained earlier!

Diagram 1: General stages of a typical audit



1.3 Advantages of Auditing

The fact that firms for which an audit is not compulsory also carry out an audit speaks highly of the direct advantages of auditing.

(i) In the complex business world, where there has been a complete separation between ownership and management, an audit is the only **effective source of crucial checks on directors or managers**.

(ii) Although auditing does not ensure complete absence of errors and frauds, these are **material misstatements should be found and corrected.**

(iii) Auditing **facilitates tax calculations** and makes them more reliable and acceptable to tax authorities.

(iv) Audited accounts are a **source of evidence in a court of law**.

(v) Auditing can **help a company** in:

settling disputes in the firm
obtaining or extending credit
obtaining loans
selling the business
converting it into another form of business organisation

The fact that more and more entities are introducing compulsory audits speaks of the various advantages of auditing.

1.4 Limitations of Auditing

Like any other art, auditing has limitations. Some of these are conceptual and others arise from the audit being conducted below standard.

(i) Auditors examine the prepared accounts. They may find themselves unable, despite their training and knowledge, to reveal any ingenious manipulation of accounts at the preparatory level. Hence, audited accounts **do not always disclose the complete facts**.

(ii) Auditing is normally **conducted on a test basis.**

(iii) Auditing **depends largely on judgement and opinion**. Any error made in matters involving judgement can lead to an incorrect opinion.

(iv) Auditing, to be real, must have an independent auditor. This **independence,** however, **can be compromised** in practical life despite safeguards.

(v) A real and purposeful audit demands a sense of judgment, understanding and application in various circumstances and difficult situations. This **judgment may vary** from one auditor to another.

Test Yourself 1

Why is there a need to have an audit?

2. Explain the differences between auditing and accounting.
[Learning Outcome b]

2.1 Meaning of accounting

Accounting is the **process of recording and reporting of financial transactions** including the origination of the transaction, its recognition, processing and summarisation in the financial statements**.**

Discussed in Study Guide A1

Thus, financial reporting is the process of **preparing and presenting the financial statements.**

2.2 Meaning of auditing (explained in detail in Learning Outcome 1)

An **external audit** can be defined, in simple terms, as **an independent examination of financial information, with a view to expressing an opinion on this information**.

2.3 Differences between auditing and accounting

1. Benefits

Accounting enables an organisation to:

- determine the organisation's profitability and cash flows
- take decisions relating to relocating of its internal resources, with a view to ensuring the financial stability of the company. For example, if an organisation wants to raise finance, it will carry out analysis of the financial statements before deciding whether to raise share capital or debt.

Auditing provides authenticity to financial statements as auditors are independent of the entity.

2. Timing

Accounting is required when organisations enter into transactions, however auditing starts only after accounting for a particular period is completed.

3. Relation with the organisation

The accountant is usually an employee of the organisation. However, the auditor is independent of the entity.

Hence the auditor is not a staff member of the organisation. The auditor is appointed by the shareholders of the organisation for the period of audit and is paid remuneration for carrying out the audit.

4. Accountability

The accountant is accountable to the management as they are appointed by the management. However, auditors are accountable to shareholders as they are appointed by the shareholders of the organisation.

5. Methodology of reporting

The accountant is required to provide accounting information to the management periodically according to the requirements of the management. However, auditors are required to prepare an audit report at the end of the audit.

Test Yourself 2

Identify the option containing a true statement relating to auditing:

A Auditing starts when an organisation enters into transactions.
B An external audit can be defined, in simple terms, as an independent examination of financial information, with a view to expressing an opinion on this information.
C Accounting enables an organisation to determine its profitability and cash flows
D During the accounting process, accountants identify record and analyse the financial dealings of a company.

3. State and explain types of audits i. Internal vs. External
ii. Statutory vs. Non-statutory
iii. Operational vs. Audit of Financial Statements

[Learning Outcome b]

3.4 Internal and external audit

Having discussed what an audit is, it is necessary to understand how an audit can be classified. An audit can be classified into two broad categories:

1. Internal audit

An internal audit is an audit on behalf of management to ensure that the existing internal controls are adequate and effective and each unit of the organisation follows the policies and procedures as laid down by top management. An internal audit is conducted by internal auditors, who are integral to the organisation and provide ongoing assessment of all activities.

With internal audit an assurance is given on the reliability and effectiveness of an organisation's risk management, internal control and corporate governance systems.

Definition

Internal audit function: a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management and internal control processes.

ISA 610(revised)

When setting their strategies almost all organisations need to:

- identify what their long term objectives will be;
- identify what activities must be conducted to achieve these objectives;
- identify what potential risks are involved when conducting these activities and
- establish a system of internal controls that when effectively implemented will help mitigate these risks.

Example

The Good Wood organisation is a Canadian company that is in the lumber trade. The organisation begins its operations by felling trees from a forest. The tree trunks are then cut into standard sizes and transported back to the organisation's warehouse.

The trunks are then categorised and stored in terms of size and quality (e.g. high, medium or low quality as well as large, medium or small sizes). The marketing team then sets about obtaining orders for various quantities of lumber from organisations across Europe. Once an order has been secured the corresponding lumber is then dispatched to a nearby shipyard and transported to the customer. Internal controls include:

ensuring a forward currency contract is booked each time an order is secured;

making sure that all lumber is insured whilst on the organisation's premises and whilst in transit to the customer;

weekly physical checks of the inventory on hand against inventory records;

monthly checks to ensure that all relevant taxes such as VAT have been paid and are current;

monthly checks on the number of trees being felled; and

weekly checks to ensure that lumber is being sold at the proper market rates and terms.

Internal auditing is the function of examining and testing whether these systems have been properly designed and are functioning properly. It is important to note here that internal auditors play a very different and distinct role from management. Management is responsible for identifying potential risks in the strategy / objective setting process.

Example

An internal audit for the GoodWood organisation would require the following activities to be performed:

examining a sample of past orders to see if a corresponding forward currency contract had been booked at the time of the sale;

examining all insurance policies for amounts insured for and dates, to ensure that they are accurate;

attending some of the weekly physical inventory checks and observing how staff conduct these checks in order to ensure accurate records on inventory are being maintained;

examining all tax records and corresponding receipts;

examining a sample of production reports against inventory records for the same period and

examining a sample of past sales records to determine if the sales had been made at the relevant market rates and terms for that time.

SUMMARY

Internal auditors are required to review the risks that have been identified by management as well as evaluating the controls they have put into place to mitigate those risks. At the end of their assessment, internal auditors provide an opinion on whether the organisation's controls are sufficient and working effectively.

Therefore it is vital that the internal audit function always remains separate from the rest of the organisation's management team and they should not have any operational responsibilities.

Example

For instance many corporations have their internal audit department report directly to either their board of directors or their audit committee. This helps ensure that their work remains free from the risk of interference from any senior managers / executives of the organisation.

From the above it can be summarised that internal auditing is an independent appraisal function. Its main objectives are to:

- assess whether management has **met** its **responsibilities** (in terms of effective and efficient operations);
- determine whether the organisation is in compliance with all **laws and regulations**;
- determine if all prescribed **internal control policies** and **procedures** are being complied with;
- determine that the **size** and **scop**e of the **internal control system** is sufficient;
- report any **unidentified risks** and **internal control weaknesses** as well as any instances of **non-compliance** with laws and regulations and
- recommend any **improvements / changes** that need to be made to the internal control system.

2. External audit

An external audit is performed by external auditors, who are independent of the organisation and provide an independent opinion on the organisation's financial statements.

If accounts are audited internally, the overall objective behind the audit is lost because the accounts and the financial statements prepared are not independently examined. An **external audit** is primarily concerned with the verification of accounting data in order to determine the accuracy and reliability of financial statements. In other words, it **is a review and assessment of the financial records to form an overall conclusion as to whether:**

- The financial statements show a **true and fair** view.
- The financial statements have been prepared using acceptable accounting policies, which have been consistently applied.
- The financial statements comply with all the relevant regulations and statutory requirements.
- Adequate disclosure of all material matters relevant to the proper presentation of financial information has been made.

In most developed countries, all publicly quoted companies as well as all large companies are required by law to produce annual financial statements and have them audited by external auditors. Other organisations may also choose to get their accounts audited, even if there is no legal requirement.

Example

An American Co, True Ltd has engaged a CPA, Fair, to prepare and audit the financial statements of the Co.
It is the duty of Fair:

- to express an opinion on the **truth and fairness** of the financial statements.
- to check whether the financial statements have been prepared using appropriate accounting policies.
- to see whether the financial statements comply with all the relevant regulations and statutory requirements as laid down by the US Government.
- to see whether adequate disclosure of all significant matters related to the proper presentation of financial information has been made.

The International Standard on Auditing (ISA) provides guidance on the objective and general principles governing an external audit engagement.

3. Internal versus external audit

Diagram 4: Internal versus external audit

Internal audit	External audit
• Conducted by internal auditors, who are employees of the organisation	• Conducted by professional practitioners, who are independent of the organisation
• Provides ongoing assessment of all activities of an entity i.e. risk management, internal control & corporate governance systems.	• Provides an independent opinion on the truth and fairness of an entity's Financial statements
• It serves primarily the need of management.	• It serves primarily the interest of owners & other stakeholders of the organisation.
• Review of operations is made primarily to identify improvements and confirm compliance with established policies & procedures.	• Review of operations is made primarily to determine scope of examination and reliability of financial data.
• It provides a continuing review of business activities.	• The work of audit is done periodically i.e. annually.
• The review of the internal auditor may be biased.	• The review of the external auditor is always unbiased.

3.5 Statutory versus non-statutory audit

1. Statutory audit

Statutory audit refers to external audit. As already discussed earlier, **the objective of an external audit engagement is to enable the auditor to express an opinion on whether all the financial statements have been prepared in all material respects, in accordance with the applicable financial reporting framework. The basic aim is to express an opinion on the truth and fairness of the financial statements**.

It is a reasonable assurance engagement where the practitioner:

gathers sufficient appropriate evidence,
concludes that the subject matter conforms with the relevant criteria,
ensures that the level of risk is acceptably low and
expresses the conclusion in a positive form

2. Non-statutory audit

Non-statutory audits refer to audits which are not statutory audits.

They could be of the following types:

Review engagement
Negative assurance engagements
Agreed upon procedures
Compilations

Each of the above are discussed in detail below

(a) Review engagement

The review engagement is a means of providing limited or moderate assurance on financial statements and potentially also other information. Many clients may simply require an overall review of the financial statements that also focusses on a specific area or areas in more detail. Under these circumstances, a review engagement may be the appropriate service to provide this assurance.

A review engagement does not normally involve a study and evaluation of internal accounting controls, detailed tests of accounting records, or corroborative evidence through inspection, observation and confirmation.

These are all the features of an audit. The procedures to be performed in a review engagement will vary depending on the specific requirements of the engagement.

They are generally based on:

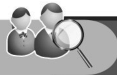
- gaining an understanding of the client's activities, including knowledge of the accounting practices of the industry or area in which the client operates and
- inquiry and analytical review.

The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which **do not provide all the evidence that would be required in an audit**, anything has come to the auditor's attention that cause the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework (negative assurance).

In a negative assurance the auditor has not come across any adversity regarding the subject matter reviewed.

The auditor does not state that the review is correct. The auditor states that there is nothing to indicate that the subject matter is incorrect.

Negative assurance is appropriate for a forecast because a forecast cannot be tested against the future. Hence, it is not possible for the auditor to state that the forecast is materially correct in terms of truth and fairness. The actual results may be different from the forecast because the actual conditions may be different from the conditions that were assumed during the preparation of the forecast.



Example

Negative assurance looks like this:

Based on our examination of the evidence supporting the assumptions, **nothing** has come to our attention that causes us to believe that these assumptions do not provide a reasonable basis for the projection.'

Difference between a review engagement and an audit engagement

This is very important!

In an audit, the independent practitioner's objective is to provide a reasonable (but not absolute) level of assurance on the reliability of financial statements. An audit is designed to result in the accountant providing a positive opinion which essentially states that, based on the work performed; the financial statements comply with generally accepted accounting principles (GAAP). The level of testing procedures to obtain the evidence necessary to support such an opinion is high.

In contrast, a review is designed to provide a negative assurance report giving only a moderate or limited level of assurance to readers on the reliability of the financial information. The report essentially states that nothing has come to the reviewer's attention to indicate that the financial information is not presented fairly in accordance with GAAP.

The criteria for audited financial statements are applicable law and accounting standards, but for a review engagement, the criteria will be whatever is agreed in the terms of agreement.

Example

Standard Review Report

Following our appointment as statutory auditors, we hereby report to you on the review of the accompanying financial statements of Glory Co as on 30 June 20Y0.

We have conducted our review in accordance to the financial reporting framework. Based on our review, nothing has come to our attention that causes us to believe that the financial statements prepared, in all material respects, are not in accordance with the financial reporting framework.

A review is less in scope than an audit and consequently, does not enable us to obtain assurance that we would become aware of all significant matters that may be identified in an audit. Therefore, we do not express an audit opinion.

M. Robertson, CPA

31 July 20Y0

(b) Agreed upon procedures

Agreed upon procedures is an engagement

(i) in which an auditor is engaged to carry out procedures of an audit nature;

(ii) to which the auditor and the entity and any appropriate third parties have agreed and

(iii) to report on factual findings.

In an 'agreed upon procedures' engagement, the auditor is engaged in performing certain procedures concerning individual items of financial data e.g. accounts receivable.

Example

If Richard, an auditor of Fast Co is engaged for agreed upon procedures on accounts receivables, he will perform the following procedure:

Obtain customers' statements or confirmation certificates from the customers.

Compare the balances in statements with the balances in the entity's books.

Obtain reconciliation and list outstanding invoices, credit notes and outstanding cheques etc. for large amounts.

Enquire into old and unusual items.

Compare the balances of major customers with the related names and amounts in the trial balance.

Compare the total amount of account receivables in the trial balance with the total amount in the general ledger.

He will not perform any other features, as done in the normal audit.

In an 'agreed upon procedures' engagement, the auditors **will not express their opinion,** instead they will only **give the factual findings. There will also be no assurance given by the auditors.** It is up to the person who has appointed the auditor to draw conclusions from the facts given by the auditors. The access to this report will be restricted to those parties that have agreed to the procedures to be performed.

(c) Compilations

A compilation of financial statements is an accounting service:

(i) in which an accountant prepares or assists in preparing financial statements;

(ii) without expressing any assurance

(iii) that the statements are accurate and complete.

In other words, it is an engagement which requires more accounting expertise than auditing expertise and is used to collect, classify and summarise financial information. It means to present data in a manageable and understandable form.

Compilation covers the preparation of the financial statements as a whole, or just a part of them. Compilation also includes collection, classification and summarisation of other financial information. **Compilation** does **not provide assurance** but it only **gives compiled information.**

The financial information compiled by the accountant should contain a reference such as **"Unaudited"**, "**Compiled without audit or review**" or "**Refer to Compilation Report**" on **each page** of the financial information or **in the front of the complete set** of financial statements.

The accountant's report in a compilation engagement should state the following:

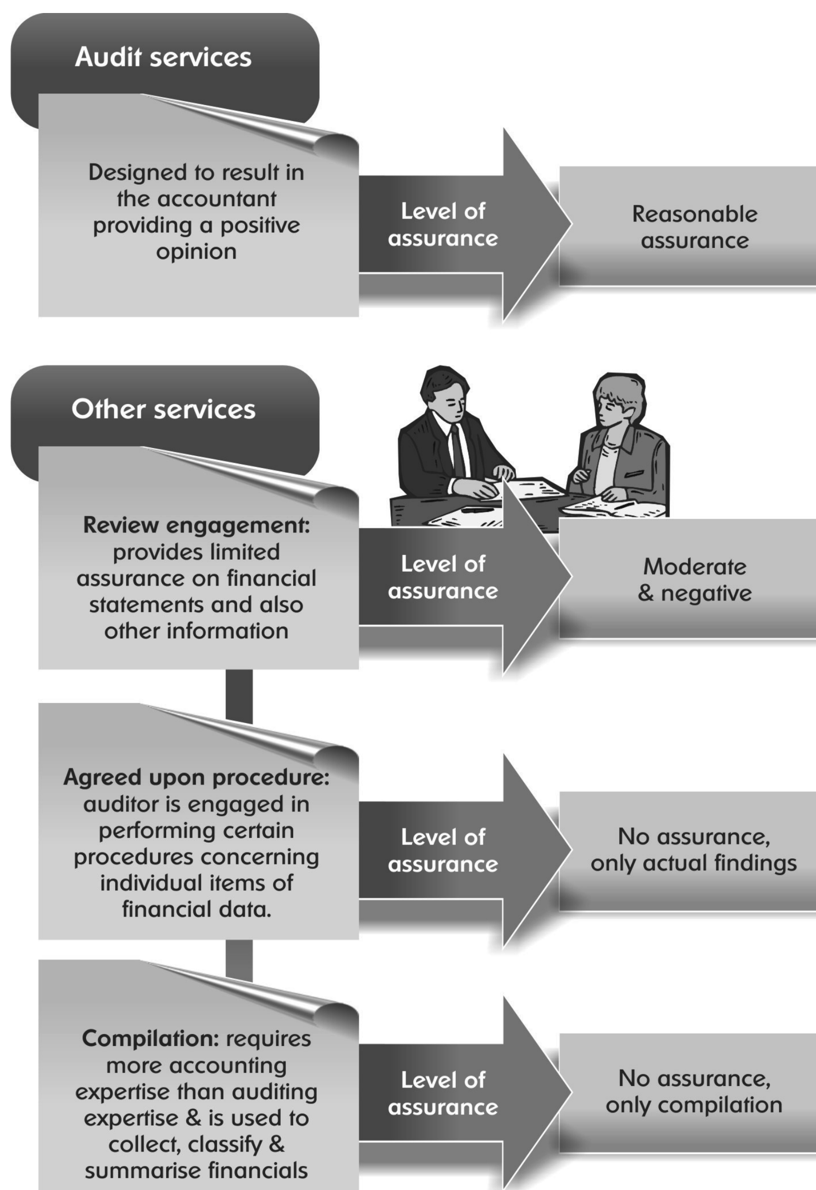
(a) A compilation is limited to a presentation of financial statements that are the representation of management.
(b) The accountant has not been audited.
(c) The accountant has not been reviewed.
(d) The accountant disclaims an opinion and gives no assurance on the financial statements.

Example

Jeremy Retails has asked its accountant, Ben, to compile financial statements that may not consider the disclosure of all generally accepted accounting principles.

Ben would compile the financial statements but would not express his opinion or give assurance. He would just present them in a manageable and understandable form and his report should clearly state that the financial statements have not been audited and reviewed.

Diagram 5: Statutory versus non-statutory audit



3.6 Operational audit vs. Audit of Financial Statements

1. Operational audit

An operational audit is an audit of the major operational processes of an organisation. The operations include procurement, marketing, treasury and human resources management. In operational internal audit assignments, the auditor measures the performance of the various procedures in terms of efficiency, effectiveness and economy.

(a) Procurement

Procurement is a process of obtaining goods and services. In the case of both trading and manufacturing entities, purchasing is a significant function. The purchase function includes interface with the outer world and accordingly runs a higher risk that fraud might take place and one should take due care while purchasing goods and services. The economy of the transaction is also a major consideration while purchasing goods from outside. One should keep in mind the 4R's of purchasing i.e. purchasing the **right quality** and **right quantity** of goods at the **right price** and at the **right time.**

While conducting an internal audit for the purchase department, an auditor needs to keep in mind the following:

(i) Understanding the procedure for procuring goods and services

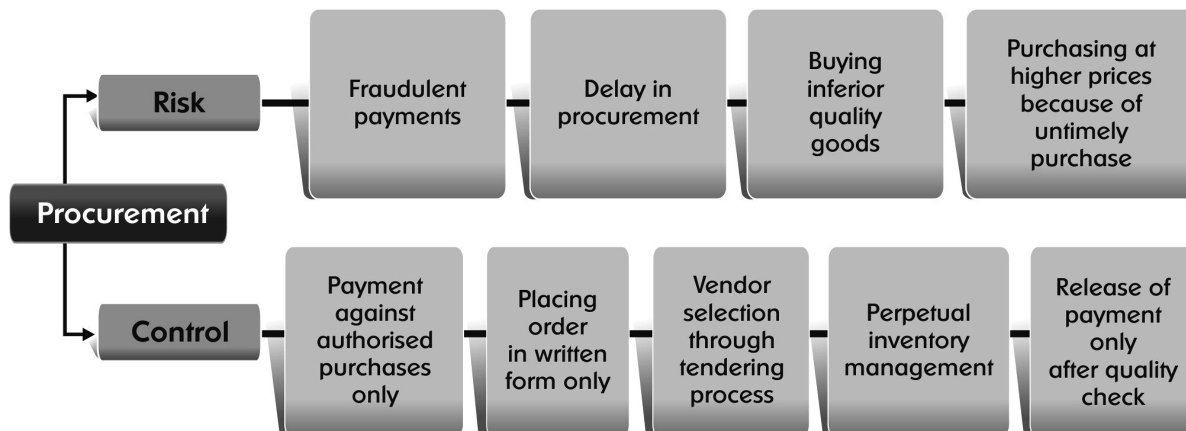
The internal auditors should understand the procedures for procuring goods and services in order to conduct their audit effectively. This **can be done by obtaining the purchase manual** (a written copy of the purchase procedure)**, reading it, and by observing the system of processing the transactions commencing from order placing to receiving materials and ultimately payment for the purchases**.

(ii) Evaluating the system

After understanding the system, **the auditor should assess the adequacy of the procedures and whether or not the internal control system is effective.**

If it is found that the procedure is not adequate, the auditor should suggest improvements to the board or audit committee. If the auditor is satisfied with the adequacy of the procurement procedures, they should assess their implementation and effectiveness.

Diagram 6: Risks involved in procurement and the controls suggested to be applied



(b) Treasury

The treasury function of an entity includes functions such as managing the cash flow, arranging working capital, arranging funds for the lowest possible cost, identifying the optimum cash balance, investing surplus cash in the most sensible manner and dealing with foreign exchange risk. It is a very important function in an organisation because it deals with how to **make best use of the available funds to maximise the organisation's wealth**. If the treasury function is not carried out effectively it will cause losses to the entity and may negate all the efforts made by the organisation to make profit. If the organisation runs out of funds, then receivership and liquidation are likely to follow soon.

The internal auditor needs to assess the strategies of the entity regarding managing the funds including raising working capital and investment of any surplus.

The auditor should determine the risk associated with the strategies made for managing the funds of the entity. These risks include:

- the risk of not raising funds from the cheapest possible source
- the risk arising from inadequate returns on investment
- the safety of the investment
- foreign currency risk etc.

After identifying the risks associated with the entity, the auditor should identify whether the risks are managed effectively or not.

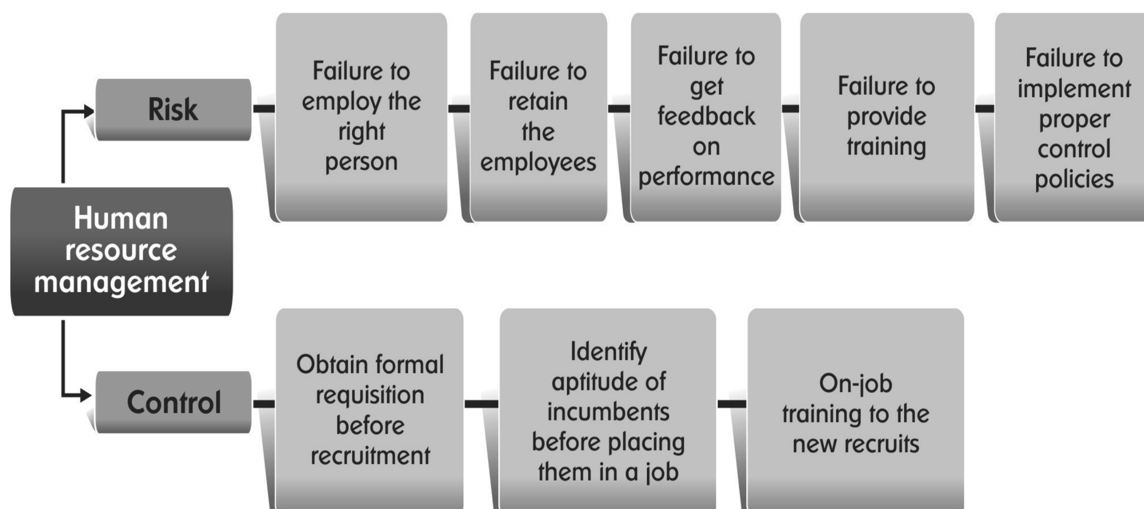
(c) Human resources management

Human resources management is the process of **managing the various activities associated with the labour force of the entity** i.e. from the recruitment of the employee until their retirement.

The human resources function includes:

- determining the need for staff and their qualification
- deciding recruitment policy
- deciding whether to employ them for permanent positions or to hire them from time to time as and when required
- determining the training needs of the employees and devising training programmes
- complying with equal opportunity legislation
- deciding policies for pay, holidays and other benefits etc.
- retaining good personnel

Diagram 7: Risks associated with human resources management and the controls to overcome them

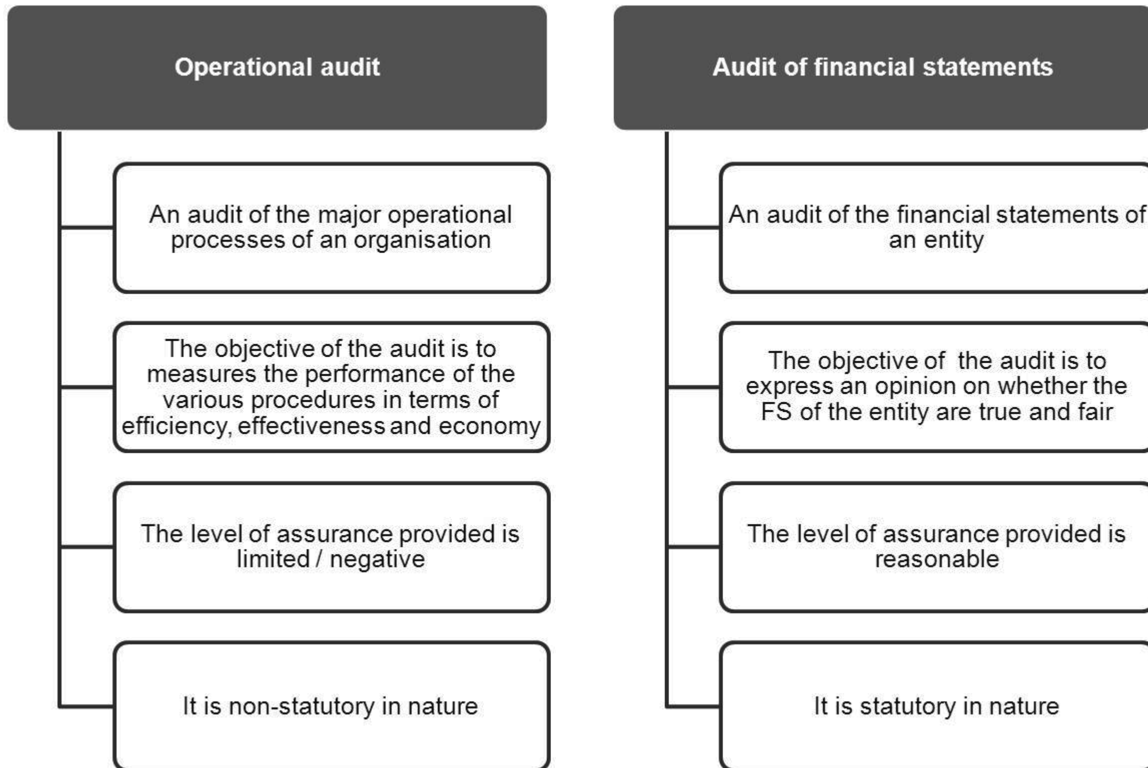


2. Audit of financial statements

This is already explained under external audit in para 3.4 above.

3. Operational vs. Audit of Financial Statements

Diagram 8: Operational versus audit of financial statements



4. Explain professional ethics of an auditor.

[Learning Outcome e]

4.1 Fundamental principles of IESBA Code of ethics

Like the members of many other professional bodies, accountants have a set of multiple ethical responsibilities.

They are required to act ethically towards and in the best interests of the following three groups:

their clients or employers;

the accounting profession and

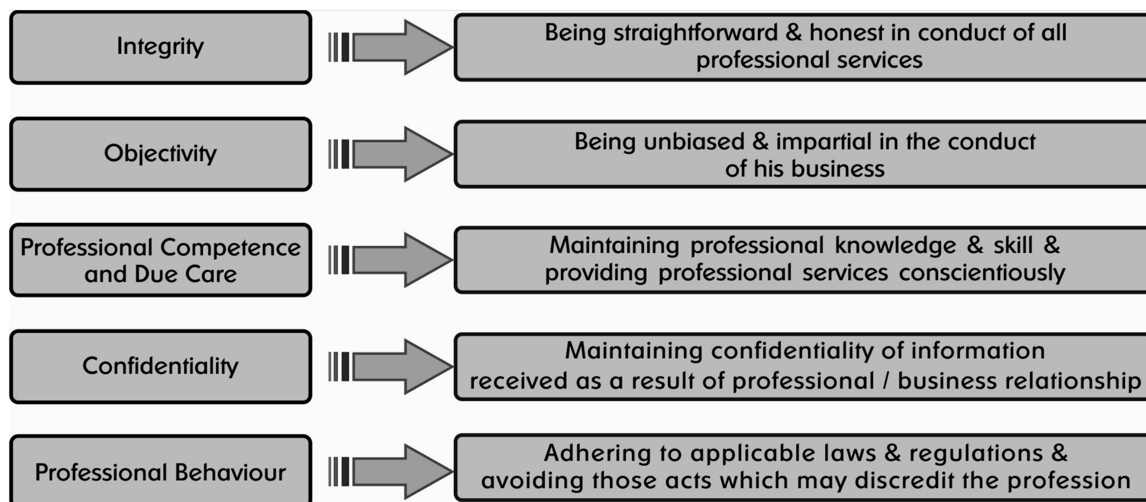
the public at a large.

Therefore accounting body such as the International Federation of Accountants ("IFAC") publish and issue sets of ethical standards that they expect their members to live by. The IFAC has an Ethics Standards Board for Accountants to "develop and issue, under its own authority, high quality ethical standards and other pronouncements for professional accountants for use around the world".

Furthermore, according to ISAE 3000, the practitioner should comply with the requirements of Parts A and B of the IFAC Code of Ethics for Professional Accountants (the Code).

These standards identify and outline 5 main principles that all members must comply with at all times.

Diagram 9: Fundamental principles of professional code of ethics



1. Integrity

This principle requires members to be "straightforward and honest in all professional and business relationships". In addition members must also not be associated with or "sign off" on any fraudulent or inaccurate financial reports and / or statements.

For this, the accountant must ensure that the financial statements and assurances provided:

(a) are carefully prepared
(b) do not contain information which is false or deceptive
(c) contain information which is relevant
(d) exclude information which is vague i.e. they must not misguide the users

In short, **integrity means acting with honesty and being fair and truthful** at all times. Integrity also means not accepting positions or situations where your integrity may be in doubt due to the behaviour of others.

It also means sticking up for what you believe in.

Example

The auditors of a pharmaceutical company noticed that out of 50% of the vouchers for development expenses, at least 40% were recorded incorrectly as revenue expenditure instead of capital expenditure (in contravention to IAS 38). The auditor therefore decided to verify all the vouchers for development expenses to ensure that all the development expenses were properly reflected in the financial statements as capital expenses.

In moral terms, **professional accountants should always be scrupulously honest**, particularly when it comes to compliance with laws.

2. Objectivity

A **professional accountant should be objective or unbiased**. For all professional decisions which are to be taken, accountants must ensure that there is no conflict of interest. Therefore, all of their findings and judgments should be based solely upon sound rationale and research.

In order to ensure objectivity, a professional accountant:

(a) should be unbiased and impartial. This applies to accounting and audit assignments;
(b) must avoid any relationship which will affect their professional judgement;
(c) must not accept or offer gifts or hospitality which will affect their professional judgement.

Example

The finance manager of a company is informed by the board that he will be paid an additional 5% of his salary as a bonus, provided the financial statements reveal excess revenue so that the net profits of the company are in line with the budgeted amounts.

This is expected to ensure that the shareholders continue to remain satisfied with the company. Here, the finance manager may face a conflict of interest since he may be tempted to employ creative accounting practices in the area of revenue recognition. However, accountants are expected to act with objectivity and hence, the finance manager should refuse to do as instructed.

---

3. Professional Competence and Due Care

Professional accountants must ensure they have the necessary professional skill and knowledge to handle the tasks that are assigned to them by their client. They must continuously update themselves with the latest developments with respect to knowledge and practices in the profession.

Accountant must **work meticulously and ensure that the services they provide are in accordance with the professional standards set by the relevant professional body.**

In order to ensure that they act in accordance with professional competence and due care, accountants must:

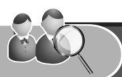
(a) **keep their professional knowledge and skills** up-to-date

(b) **ensure that clients or employers** are **provided** with professional services based on the **latest developments in the profession**, both legislative and technical

(c) **provide professional services by acting conscientiously** and in accordance with applicable technical and professional standards

(d) be **professionally competent** and make sound judgements while applying their professional knowledge and skills

(e) **ensure all their subordinates and staff have the necessary training and supervision to competently perform the tasks assigned to them**


Example

For instance a tax accountant who specialises in preparing and filing individual tax returns must ensure that:

they are up-to-date on all the latest relevant tax legislations;
they devote sufficient time and attention to each tax return they work on; and
their subordinates are up-to date and trained in applying the latest tax legislation, and are appropriately applying them when working on client returns

---

4. Confidentiality

This principle requires that accountants never disclose any confidential information of their clients or organisations to any other third party unless there is a legal duty to do so or a legal right to do so. It is important to note here that an accountant is still bound by this same confidentiality principle even after they have left the employ of an organisation or are longer engaged by a client.

Confidentiality comprises the following

(a) **Non-disclosure of information**. However **information can be disclosed to a third party if the accountant has the specific authority to do so (for example a client's permission)**, or the accountant **has a legal duty or professional right** to do so.

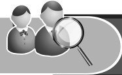
(b) **Non-utilisation of information** to the advantage of the accountant, e.g. the auditor sells shares in the client's company after receiving confidential information about the company which will reduce the price of the company's shares.

(c) Confidentiality **of information received from a prospective client or employer**

(d) Confidentiality of **information received within the firm / organisation** where the accountant is employed from a prospective client or employer.

(e) **Maintaining confidentiality of information within the firm or client organisation**

Professional accountants **should ensure that staff and associates** respect this duty of confidentiality also.



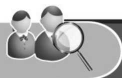
Example

Tom Jones is the auditor of a public listed company. Whilst auditing the organisation's financial statements he realises that the business will post better than expected results. This will probably cause the price of the stock to rise. However Tom cannot pass this information on to any other third party at any time until the financial statements are published.

---

5. Professional behaviour

The IFAC requires that its members "should comply with relevant laws and regulations and should avoid any action that discredits the profession." This organisation also requires that their members act ethically when marketing and promoting their services. Members should not engage in any false advertising and should not slander the work of any other accountant.



Example

John Lee is a partner with a mid-sized accounting firm. He has been approached by AMBY organisation, a large manufacturer of tyres to discuss whether he would consider taking on some audit assignments for the business.

John has heard through unsubstantiated rumours that AMBY are unhappy with their current auditor. John is eager to take on AMBY as a client but has had no experience auditing manufacturing firms.

During his discussions with AMBY, John cannot:

claim to have any specialised expertise in auditing manufacturing organisations and
cannot slander or unduly criticise AMBY's current auditors.

Test Yourself 4

Name all groups of persons towards whom accountants have an ethical responsibility.

---

1. Describe the qualities of an auditor.

[Learning Outcome f]

1. Competent

Auditors must be competent to carry out audits. **This requires the auditor to be:**

thoroughly conversant with accountancy principles as well as auditing standards and their practical application.

aware of business laws and taxation laws (for example the auditor must ensure that the entity which is being audited has complied with all the applicable laws).

aware of their duties (for example the auditor must examine, compare and verify the accounting records and returns with the financial statements. If the accounting records do not agree with the financial statements or are incomplete, then it is the duty of the auditor to report this fact to the shareholders).

aware of their rights (for example an auditor can ask any of the officers or other persons associated with the company to provide information or explanations essential to discharge their duties effectively as an auditor).

professionally competent to carry out the audit: possessing knowledge of audit and accountancy is not sufficient to carry out the audit. For conducting complex audits, the auditor must have the **knowledge, skill and experience** to carry out the audit. For example, a qualified systems auditor alone can carry out an information systems audit.

Tip

Therefore only a **member of a recognised supervisory body is** eligible to be appointed as an auditor. The person to be appointed as the auditor is required to hold a professional accountancy qualification. In Tanzania, auditors should be members of The NBAA and should have a qualification of CPA (T) (Certified Practicing Accountant) from the NBAA.

2. Independent

An external auditor is an independent person i.e. not related to the entity in any capacity other than as an auditor. Therefore, a person cannot be appointed as an auditor if he is:

(i) an officer or employee of the company

Example

Robert, a CPA is employed with PNG Ltd as the chief accounts officer. As an employee of the company he cannot be appointed as the auditor of the company.

(ii) an officer or employee of an associated company, parent company or subsidiary company

Example

Continuing the above example of PNG Ltd

PNG Ltd is a subsidiary company of Powerful Ltd. Robert cannot be appointed as the auditor of Powerful Ltd. This is because he is an employee of the associated company i.e. PNG Ltd.

(iii) a partner or an employee of an officer or employee of the company, or

(iv) a partnership of which such a person is a partner.

A person is qualified to be an auditor **only if he possesses a current audit-practising certificate issued** by a recognised supervisory body.

In addition to the above, a qualified auditor **should possess integrity, objectivity, professionalism, good communication skills, good information technology skills** and thorough knowledge of accounting and auditing issues.

The auditor must always act in accordance with the fundamental principles of the IESBA code of ethics. Thus the auditor must maintain integrity, objectivity, confidentiality, professional competence and due care and professional behaviour (explained in para 4.1 above)

Test Yourself 6

Identify the qualities that Jackson should possess in order to be appointed as the systems auditor of Express Plc, an IT company.

A He must be a qualified systems auditor
B He must have experience in carrying out systems audit
C He must be an employee of Express Plc
D He must possess a current **audit-practising certificate issued** by a recognised supervisory body

Answers to Test Yourself

Answer to TY 1

The fact that more and more entities are coming into the fold of compulsory audit and the fact that audit itself now has many branches speaks of the need for audit.

The need for audit can be summarised as follows:

(a) The accounts are more reliable for shareholders to use.
(b) Audit facilitates tax calculations and makes them more reliable and acceptable to tax authorities.
(c) Audited accounts make borrowing easier, prompt and adequate.
(d) Audited accounts help or even may be a necessity for securing a government contracts and various licences.
(e) Audited accounts are a source of evidence in a court of law.
(f) Auditing helps in settling disputes, obtaining credit, securing loans, admitting a partner and selling a business.

Answer to TY 2

The correct option is **B.**

All other options apply to accounting rather than auditing.

Answer to TY 3

The first statement that all the government guidelines with respect to environmental issues have been complied with is an example of a reasonable assurance engagement. The practitioner has given a positive assurance report, after having performed intensive procedures and gathering sufficient evidences to reduce risk to an acceptably low level.

The second statement that nothing has come to the notice of the practitioner that causes him to believe that PPF guidelines have not been complied with is an example of a limited assurance engagement. This is a negative assurance report that conveys a level of limited assurance that is proportional to the given level of circumstances and involves a moderate level of risk.

Answer to TY 4

Accountants have a responsibility to act ethically and in the best interests of their clients or employers; the accounting profession and the general public.

Answer to TY 5

(a) Alpha is taking the auditors to a nearby picnic spot for the past few years. This is known to the auditors, and as a result, the objectivity of the auditor may be affected. Therefore as a rule, auditors' should not accept any gift or hospitality from clients, as it will affect their objectivity.

(b) As Rob was one of the members of the audit team for Heral, he may have a friendly relationship with all the team members. As a result, it will be difficult for the team members to maintain their objectivity.

Answer to TY 6

The correct options are A, B and D.

Self Examination Questions

Question 1

Audit is an assurance assignment. State whether this is true or false and give reason.

Question 2

Match the following:

A	B
(a) Audit engagement	i. Agents of the shareholders
(b) Review engagement	ii. Owners of the organisation
(c) Shareholders	iii. High assurance and positive report
(d) Agreed upon procedures	iv. Moderate assurance but negative report
	v. No assurance, only factual finding

Question 3

Differentiate between an audit engagement and a review engagement.

Question 4

The IFAC code of professional ethics consists of:

A Fundamental principles of professional ethics for professional accountant
B Guidance on maintaining of ethical working relations with clients
C Handling of ethical issues of the organisation in which accountants are employed
D All of the above

Question 5

Under which of the following circumstances, would the auditor's independence be affected?

A Auditor has financial interest, business interest or personal relations with the client
B Auditors provides non-audit services to the organisation
C The auditor utilises information of client to obtain personal benefits
D All of the above

Question 6

For the maintenance of professional competence and due care, an accountant must ensure the following:

(i) Keep their professional knowledge and skills updated.
(ii) Provide clients or employees services based on latest developments in the profession.
(iii) Ensure necessary training and supervision to the subordinates or staff for performing tasks assigned to them competently.
(iv) Comply with relevant laws and regulations and avoid any action that discredits the profession.

A (i), (ii) and (iii)
B (i), (iii) and (iv)
C (ii), (iii) and (iv)
D (i), (ii) and (iv)

Answers to Self Examination Questions

Answer to SEQ 1

True. Audit is an assurance engagement because the financial statements are checked by an independent auditor and this therefore provides assurance to the user that they can be relied upon.

Answer to SEQ 2

a) (iii), b) (iv), c) (ii), d) (v)

Answer to SEQ 3

In the audit, the independent practitioner's objective is to provide a high (but not absolute) level of assurance on the reliability of financial statements. An audit is designed to result in the auditor providing a positive opinion which essentially states that, based on the work performed; the financial statements do comply with generally accepted accounting principles. The level of testing procedures to obtain the evidence necessary to support such an opinion is high.

In contrast, a review is designed to provide a negative assurance report giving only a moderate level of assurance to readers on the reliability of the financial information. The report essentially states that nothing has come to the reviewer's attention to indicate that the financial information is not presented fairly in accordance with GAAP.

The criteria for audited financial statements are applicable law and accounting standards, but for a review engagement, the criteria will be whatever is agreed in the terms of agreement. The level of assurance is comparatively low or moderate in the case of a limited assurance engagement. Review engagements are designed as a limited review of financial statements. Therefore the risk of mistakes, omissions or incorrect disclosures is considerably greater than with an audit. However, because the level of assurance provided by a review is lower, less work is required and consequently the cost is often significantly less.

Answer to SEQ 4

The correct option is **D.**

The IFAC code consists of three parts:

Part A: contains the fundamental principles of professional ethics for professional accountants.

Part B: provides guidance to accountants in professional practice for maintaining ethical working relationship with clients.

Part C: provides guidance for handling ethical issues related to the organisation in which accountants are employed.

Answer to SEQ 5

The correct option is **D.**

If the auditor has any kind of financial interest, business interest or personal relations with the client, his judgement is thought to be influenced as he becomes closer to the management of the organisation due to his relations. If the auditors provide some non-audit service to the client like designing control for a computerised environment or services in the absence of staff, their independence is affected. And, even if the auditor utilises the information of the client for his own benefits, his independence is affected.

Answer to SEQ 6

The correct option is **A.**

Point (iv) is incorrect because it is related to fundamental principle of professional behaviour.

Additional reading material

1. Engagement letter

An engagement letter represents an official document of all the terms and conditions of the audit and is signed by the auditor / accountant and the entity which is being audited. The accountant and the organisation workout the terms and scope of the audit and document these in an engagement letter which is then signed by both parties.

The content of an audit engagement letter is basically all the topics that have been discussed and agreed upon by the accountant and the organisation.

It contains:

a) **confirmation that the auditor has accepted the appointment**. The engagement letter creates a contract between the auditor and the client.

b) **a summary of the responsibilities of client's management** (e.g. directors in the case of a company) and auditors;

c) **details on:**

the **objective of the audit**

the **responsibilities of the directors** e.g. maintenance of accounting records, the preparation of the financial statements and the selection of accounting policies that are used to prepare them.

the **responsibilities of auditors** and the **scope of the audit** e.g. duty to conduct audit in accordance with various applicable auditing standards, to review accounting policies and practices of the client and to form an opinion on the client's financial statements

the **form of report that will be issued after the audit**

any **other services** that would be provided by the auditor

the **method through which the audit fees would be calculated and billing arrangements made** the various **applicable legislations**

Effectively, the engagement letter acts as a contract between auditor and client. Audit engagement letters are important because they outline the responsibilities and expectations of both parties and help to avoid any misunderstandings taking place during the course of the audit.

2. Auditing standards

The accounting profession believes in and practices both self regulation and self promotion. The profession established and maintains the **International Federation of Accountants ("IFAC")**. One of IFAC's main activities is publishing a uniform set of auditing standards to serve as a benchmark for professional accountants around the world when they are conducting their audits. IFAC heavily promotes these standards as it believes that their adoption will lead to a uniform quality of auditing across the globe.

In the late 1970s when IFAC created an **International Auditing Practices Committee ("IAPC")** to develop this uniform set of auditing standards. Throughout the 1980s and 1991 IAPC issued a series of **International Auditing Guidelines ("IAG")** which were the predecessors to **International Standards on Auditing ("ISA").**

Auditing standards provide guidance on various issues relating to the audit. These are the generally accepted procedures of audit, which an auditor should follow. Auditing standards provide guidelines for an auditor to follow in performing an audit. This brings uniformity to the work of the auditor.

Example

ISA 570 deals with going concern. This provides guidance on the auditor's responsibility in the audit of financial statements for the going concern status of an entity. This includes the auditor's responsibility when the entity's going concern status is in danger.

Auditors have a responsibility to **comply with the auditing standards**. The auditor should be familiar with all the applicable accounting standards because they are expected to report on any non-compliance with these and the reason for this non-compliance. If the auditor does not follow these guidelines, they may be held liable for professional negligence.

3. Audit opinion

The objective of an external audit engagement is to enable the auditor to express an opinion on whether all the financial statements have been prepared in all material respects, in accordance with the applicable financial reporting framework. The basic aim is to express an opinion on the **truth and fairness** of the financial statements.

The auditor's report contains a clear written expression of opinion on the financial statements. An unqualified opinion is expressed when the auditor concludes that the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

An example of how an opinion on the financial statements is expressed by an auditor is given below. This example highlights the objective of financial statements.

Example

Independent Auditor's Report

We have audited the financial statements of Red Co for the year ended October 31, 20X9. We conducted our audit in accordance with the International Standard on Auditing.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the supplementary information. We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the information is free from material misstatements

The financial statements of Red Co have been prepared, in all material respects, in accordance with the financial reporting framework. In our opinion and based on the information available to us, the financial statements provide a true and fair view of the financial position of the company.

M. Alex
8 December 20X9

The **auditor's conclusion** on the audit opinion would be based on the following factors:

- sufficiency and appropriateness of audit evidence
- materiality of uncorrected misstatements
- adequacy of disclosures relating to selection and application of accounting policies
- appropriateness of accounting policies selected
- consistency of the entity's accounting policies with the applicable financial framework
- reasonableness of accounting estimates used by the entity
- qualitative characteristics of financial information i.e. whether relevant, reliable, comparable and understandable
- fair presentation of financial information

An **external audit expresses an opinion on the truth and fairness of the financial statements**. The opinion expressed by the external auditor could be a modified opinion, an unmodified opinion etc. The **internal auditor,** on the other hand**, does not express an opinion on the financial statements**. The internal auditor's report varies from assignment to assignment.

STUDY GUIDE G2: AUDIT PLANNING AND AUDIT PROGRAMME

Get Through Intro

Auditing is a labour–intensive activity and it is therefore essential that proper control is exercised over the time spent by staff on each assignment so that costs are kept to the minimum commensurate with fulfilling the statutory obligations as auditors. The main objective of audit planning is to ensure that the audits are carried out effectively and efficiently. In a broader sense, audit planning also ensures that the best use is made of the firm's resources.

Client relations are not improved if the auditor does not have staff available to meet the client's accounting timetable. During the audit itself, proper planning can help auditors to make better assessments of the time required for completion and consequently to make any necessary reallocations of staff in good time, avoiding last minute overruns which can disrupt the audit currently in progress.

The auditor should plan the audit so that the engagement will be performed in an effective manner. Audit planning is a continuous process and should therefore be continued throughout the engagement. Planning involves developing an overall plan for the expected scope and conduct of the audit and also developing an audit programme showing the nature, timing and extent of audit procedures.

This Study Guide will help you to understand the need for audit planning and also to learn how to develop and document an audit programme.

Learning Outcomes

a) Define audit planning and audit programme.
b) Explain the differences between audit planning and audit programme.
c) Identify the benefits of planning the audit work.
d) State uses of audit programme.
e) Design an audit work program.

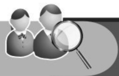
1. Identify the benefits of planning the audit work.

[Learning Outcome c]

The need and importance of planning an audit and the subsequent control of the work cannot be over-emphasised. **Planning assists an auditor in conducting the work in an effective manner.** It has the following benefits:

1. Identification of important areas that require more attention

In planning an audit, auditors obtain knowledge of the entity and its environment including the internal control system. They also identify the significant transactions and areas that need more attention. In planning an audit, auditors decide what work to delegate, to whom and to what extent. They also decide the number of days that should be allocated to a particular area.



Example

Monica was appointed as the auditor of the manufacturing company, Low Ltd. As Low Ltd was a new client, she held an initial interview with Low Ltd in which she tried to obtain as much background information as possible. She wanted to know the nature of the entity's business, the nature of the entity's products or services, the nature of the entity's records and the significant trends within and outside the entity. Monica also examined the previous year's financial statements and found that trade payables had increased by 40% and therefore, special attention was required in this area. This helped Monica to find the areas that required attention and she planned her audit accordingly.

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2. Identification of potential risks having effect on audit as well as financial statements

The audit programme covers the audit of potential risks associated with the financial statements. The plan ensures that the risk to financial statements is reduced to an acceptable level. For this the audit programme includes an identification and analysis of the risks associated with the financial statements.

Example

Tear Ltd had an unsettled dispute in which the customer of the company was claiming compensation of Tshs100,000 for the late delivery of cement pipes. Robert, the auditor of Tear Ltd, identified the risk, analysed it and included the conduct of test of details (a type of audit procedure) on the unsettled dispute in the audit programme accordingly. He also made a note to make a provision for the unclaimed compensation.

---

3. Planning work enables the conduct of an effective, efficient and timely audit

The time required for each section of the audit is estimated and the appropriate grade of staff required to conduct the audit is identified. The company's year-end accounting timetable and the deadlines for the completion of the audit are reviewed by the auditor with the company's chief financial officer to ensure that all deadlines have been met. A detailed audit timetable is then prepared, giving the dates on which schedules are due from the client and the dates when various sections of the audit will be completed.

Example

After accepting the appointment letter as an auditor of White Co, Roger prepared a detailed audit timetable, giving the dates when various sections of the audit would be completed. As White Co deals in complex transactions, a senior team was chosen rather than a new inexperienced audit staff.

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4. Allocation of work to assistants in such a manner that they would be best utilised

The audit programme ensures that the allocation of individuals to particular audits takes into account of the experience of each staff member and the degree of skill required for the particular assignment concerned. It is generally ensured that the audit team contains members of staff who have visited the client previously, not only to maintain good relationships but also because they will have gained detailed knowledge of the client and the industry in which the client operates.

Jerry, the auditor of Fair Ltd, appointed Peter, an experienced staff member, to supervise the work performed by the junior audit staff and also to review and report on the work done by them.

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5. Identification of the need for experts and co-ordination of work of others

The audit programme ensures that an audit is carried out effectively and efficiently and the work is controlled and recorded at each stage of its progress. The most important elements of control are the direction and supervision of the audit staff and the review of the work they have done. In certain specialist industries, it is desirable that some members of the audit team have previous audit experience in that industry. Furthermore, the audit programme also enables to ascertain whether the use of experts such as valuers, solicitors and architects would be needed for the audit.

The audit team prepared by Tom for the audit of Rare Co included John, who had been involved in the audit of the company for the last two years. John was chosen as he had knowledge of the industry and was able to plan his audit programme properly. It was also identified that an actuary's report would need to be provided in respect of the company's pension liabilities.

---

6. Determination of nature, timing and extent of the audit procedures

The audit programme also identifies the nature, timing and extent of the audit procedures that should be performed to carry out the audit work in an effective and timely manner. Once the procedure, the timing and extent are decided, it also becomes easy for the auditor to perform the audit according to the plan.

Anne is the auditor of Unfair Ltd, a manufacturing concern with a number of factories. Anne planned a programme of site visits on a rotational basis. She also determined the time when the audit would be completed and extent of the substantive audit procedures. This helped Anne to identify the problematic areas so they could be addressed in time and accordingly design the audit procedures.

List the advantages of audit programming.

What are the factors to be considered by the auditor in planning their audit?

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2. Define audit planning and audit programme.
Explain the differences between audit planning and audit programme.
Design an audit work programme.

[Learning Outcomes a, b and e]

2.1 Audit plan

An audit plan sets the scope, timing and direction of the audit and guides the development of the more detailed audit programme. Once the overall plan has been completed, detailed consideration can be given to each individual audit objective and how it can be best met.

Example

Henry was the auditor of Light Co. Henry decided the planning materiality at 5% of profits i.e. the estimate of the size of misstatement that would be regarded as 'material' in relation to the accounts under review. The plan adopted by Henry was that if any error exceeded 5% of profits, it would be considered material.

Audit plan includes the following information:

1. Understanding the entity's environment

It contains details of the industry such as its location, activities and strategies.

(a) Characteristics of the engagement that define its scope

Determination of the scope includes the consideration of **the financial reporting framework**, **statutory obligations on the auditor** and also the **scope** defined in the engagement letter. It also includes the consideration of the **need to use an expert** and **determination of the extent to which the auditor can rely on the work of the experts and the internal auditor**.

Example

Kelly has been appointed the auditor of Hire Ltd. She intends to liaise with the internal audit department to help her understand the whole internal control system before preparing the audit programme.

(b) Ascertaining the reporting objectives, timing of the audit and communications required

The engagement team considers the **type and timing of the audit report**. The auditor needs to set the **deadlines for interim as well as final reporting**. The plan also includes expected communication with third parties such as reports of experts whose work is considered in the financial statements. Furthermore, the schedule of meetings with management during the various stages of audit will be considered in the audit plan. The timing of carrying out the audit work must be considered as the audit plan is developed, since these are often closely inter-related. The normal timetable for an audit includes:

An interim visit, usually at least three-quarters of the way through the accounting year
Attendance at stocktaking
Year-end circulations
The final audit shortly after the accounting year-end

This pattern will often be modified to suit the needs of the particular business.

Example

Jeremy has many small clients. Interim visits may be uneconomical for small clients, while two interim visits may be appropriate if the client's accounting system is radically amended during the year, as would be the case when a system is computerised for the first time.

(c) Understanding the accounting and internal control systems

This includes details of accounting policies of the client and assessments of internal control systems during the previous year and whether the auditor can rely on them.

(d) Deciding the direction of the audit

The engagement team considers the important factors that will affect the nature, timing and extent of the audit procedures.

Such factors include:

(i) **preliminary risk assessment** i.e. areas with high risk of material misstatement on account of errors and fraud.
(ii) **identification of the entity, specific, industry, financial reporting or other developments** etc.
(iii) consideration of the **accounting policies adopted by the client and changes in those policies**.
(iv) setting of **materiality levels.**
(v) identification of areas of weaknesses during **previous audits.**

Richard has been appointed as an auditor of Jet Ltd. It is important for him to determine in advance the precise time when each audit procedure must be started and completed. This will enable him to divide the work among the various audit staff, thereby avoiding the possibility of wastage due to audit staff not being available. It is possible that the underlying records are not available as a result of their use by the employees of the client organisation or by other members of the audit team.

(vi) **consideration of the team-members required** i.e. while deciding the audit plan, of the composition of the engagement team should be considered using evidence obtained during the preliminary engagement activities. Preliminary engagement activities include evaluation of the compliance with ethical requirements, understanding of the terms of the engagements and the procedures regarding the continuance of the client relationship and the specific audit engagement.

Mark has been appointed as the auditor of Heavy Co. As it is the first audit, more elaborate preliminary arrangements will have to be made than in the case of a repeat audit. He will have to obtain a no objection certificate from the previous auditor and understand the terms of engagement before starting the work. He will also have to obtain knowledge of the economy and the industry within which Heavy operates before accepting the audit.

He may also find later that special visits by audit teams will be necessary to all or some of the locations where the client organisation carries out its business activities. In addition, particular locations may have material quantities of inventory, in which case arrangements will have to be made to attend stocktaking at such locations.

In audits of small entities, the entire audit may be conducted by a very small audit team. Many audits of small entities involve the audit engagement partner working with one engagement team member. With a smaller team, co-ordination and communication between team members are easier. Establishing the overall audit plan for the audit of a small entity need not be a complex or time-consuming exercise. It varies according to the size of the entity and the complexity of the audit.

The audit for a small concern, Clear Ltd, was carried out by a team with only two members, Danny and Fred. A brief summary was prepared based on the review of the working papers and highlighting issues identified in the audit just completed. Co-ordination and communication between team members was easier with a smaller team and establishing the overall audit plan for the audit was not a time-consuming exercise.

It is also important that the **audit plan suggested should be appropriate**.

Example

Ben is the auditor of a software company. Suggesting an inventory count for a software company whose work in progress consists of the unamortised costs of developing its products is not an appropriate audit plan.

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2. The nature, timing and extent of resources necessary to perform the engagement

This involves finalising the engagement budget, selecting the engagement team and assigning work to the various team members.

For example, the plan will take into account the amount of resources necessary for specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas.

2.2 Audit programme

1. Meaning

An audit programme **converts the audit plan into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed** by engagement team members in order to obtain sufficient appropriate audit evidence to **reduce audit risk to a low level**.

Audit programme is a detailed recording of each procedure and process required to perform an audit. Once the overall plan has been determined, the auditor should prepare a detailed plan of the areas determined in the audit plan. Once the audit plan has been decided, the next stage is to decide how it is going to be carried out; an audit programme is necessary. The audit programme contains the nature, timing and extent of the procedures to be performed.

An audit programme sets forth the **procedures that are to be performed in order to implement the audit plan**. An audit programme is a list of items for the audit staff to do in a sequential order to enable them to cover all the areas and aspects of audit and to guide them to obtain adequate and appropriate audit evidence. A written audit programme is an essential tool for the communication of audit directions to audit staff. The audit programme should be so designed that it complies with generally accepted auditing standards and that the procedures contained therein are in accordance with the requirements and situation of the particular engagement.

2. Characteristics of an audit programme

An audit programme must have the following features:

(a) It should be in **writing**.
(b) **Knowledge of the client's business** should be the basis of the audit programme.
(c) The procedures, examination and verification **steps needed to implement the overall audit plan** should be set forth in it.
(d) Audit programme should contain **audit objectives of each area**.
(e) It should be in a **detailed form** to serve as instructions to audit staff.

The timing of the audit programme is as important as the programme itself.

Example

Fat is the auditor of Light Co. He will have to time the interim work on the client's accounting system and related internal controls sufficiently early in the current financial year. At this stage, the procedures included in the programme should facilitate him to comprehend the manner in which the accounting system and related internal controls operate, to ensure whether they are actually operating and to figure out any weaknesses in them.

It is important to note that the audit programmes should be reconsidered and revised, wherever necessary. The revision should be based on the auditor's review of internal control, his preliminary evaluation and the results of compliance and substantive procedures.

3. Contents of audit programme

Following are some matters which are included in the audit programme:

(a) A description of the nature, timing and extent of planned risk assessment procedures which will enable the assessment of the risks of material misstatement due to fraud

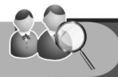
For example auditor will enquire about the management's knowledge of material errors and fraud which have occurred within the entity and suspected fraud which exists within the entity which is being investigated by the management,

(b) Understanding and assessing of the strength of the control environment of the entity

This will require an assessment of the control risk and the inherent risks which the entity. This assessment is very important as neither of the risks can be controlled by the auditor. Therefore, in order to reduce the level of the overall audit risk the auditor needs to plan and perform a much more rigorous and thorough audit when an entity faces a high inherent and / or control risk.

(c) A description of the nature, timing and extent of planned further procedures at the assertion level

This applies to each material class of transactions, account balance, and disclosure.


Example

Following is an extract of the audit programme (for 2011) prepared by Ponting & Co, the auditors of Stan plant Enterprises which manufactures mining equipment:

Inventory

Nature: Physical verification
Timing: 30 June 2011 and 31 December 2011
Extent: 100% verification

Receivables

Nature: Direct confirmation
Timing: 30th June 2011 and 31 December 2011
Extent: For all account receivables which exceed Tshs2,000 as on 31 December 2011 and all receivables having credit balances

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(d) Formation of audit team and allocation of work and duties to the assistants

Example

The audit senior carries out the audit in the areas which are exposed to significant risks (like review of the internal control questionnaire) whereas the junior auditor carries out audit of routine matters (like test of details in purchases).

The audit programme will set out the names of the team members and the nature of audit work which will be carried out by each of the members.

(e) Types of audit evidence desired in order to comply with ISAs

Example

Physical count of non-current assets
Physical count of inventory
Observation of disbursement of wages to employees
A bank's certificate confirming balances at a given date
Circularisation of receivables, where requests are sent to customers to confirm balances

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(f) Explanation on decision relating to testing the operating effectiveness of controls and nature, timing and extent of planned substantive procedures

The explanation is important as it will decide whether the auditor will be able to rely on the internal controls. The auditor can reduce the level of substantive procedures when the controls are operating properly. Therefore this decision is very important and hence needs to be documented.

Example

Example of an Audit programme

Name of the client	Planet 1 Ltd.
Address of the client	15 Lay Street, New York
Nature of the work (audit work)	Statutory Audit
Date of engagement letter	05/01/20X9
Period covered by audit	01/01/20X9 to 31/12/20X9
Details of the client	Buys tools and equipment to make machines for manufacturing sugar from various suppliers and then resells them. No. of warehouses 4 No. of branches 4
Expected date of the report	31/03/20Y0
Man hours required to complete the audit work	256 hours
Engagement team of the previous year	Mr. Borewell - manager Mr. Brook Miss. Grant Mr. Harvey Mr. David Ms. Martin
Engagement team of the current year	Mr. Borewell – manager Mr. Bernard Miss. Samuel Mr. Augustin Mr. Ivan Mr. David Ms. Martin
Evaluation of internal control system	Need to evaluate the whole internal control system.
Any change in the accounting or internal control system since last year	Yes, accounting system has been changed from manual to fully computerised, as a result of which the internal control system has also changed.
Any change in the accounting policy since last year	No change in the accounting policies of the entity.
Nature of audit	Tests of controls will be performed as far as possible.
Areas of special attention	Trade receivables have increased by about 50%. Therefore special attention is required.
Inventory verification	The inventory is required to be verified physically by the engagement team. Mr. David and Miss. Samuel will be responsible for physical verification of the inventory on 31/12/20X9.
Physical verification of cash and investments	The cash and the investments at the head office should also be verified physically by Mr. Ivan.
Audit of fixed assets	Physical verification by Mr. Augustin.
Associated party transactions	Ledger scrutiny by Mr. Martin.
Materiality level	Materiality level appears to be accurate.

Test Yourself 3

"Audit programming should be a continuous process throughout the audit". Do you agree?

2.3 Relationship between audit plan and audit programme

Generally, the audit plan is prepared before the audit programme. The audit programme is more detailed than the overall audit plan and includes the nature, timing and extent of audit procedures to be performed by engagement team members. However, the two planning activities i.e. **audit plan and audit programme are not necessarily discrete or sequential processes but are closely inter-related as change in one results in change in the other**. The audit plan **gives the overall guidelines for developing the audit programme**. It gives the expected scope and conduct of the audit procedures and therefore works as a base for developing a detailed audit programme. Detailed audit programme includes the nature, timing and extent of the audit procedures to obtain sufficient appropriate audit evidence.

Example

Sophie has already developed an audit plan for Seesaw Co. If, while developing a detailed audit programme, she decided that the materiality levels set earlier had to be increased on account of weaknesses in the internal controls which were highlighted in the latest internal audit reports, then a deviation from the audit plan is necessary. Therefore Sophie should first modify the overall plan and then prepare the audit programme accordingly. This shows that the audit plan and audit programme are not sequential processes but are closely inter-related as change in one result in change in the other.

Planning an audit is a continual and iterative process throughout the audit engagement. As a result of unexpected events, changes in conditions, or the audit evidence obtained from the results of audit procedures, the auditor may need to modify the overall audit plan and audit programme, and thereby the resulting planned nature, timing and extent of further audit procedures.

Example

Jane is the auditor of Fly Co. She will plan the risk assessment procedures at the beginning of the audit process. However, the planning of the nature, timing and extent of specific further audit procedures will depend on the result of earlier risk assessment procedures.

Diagram 1: Relationship between the audit plan and the audit programme

2.4 Differences between audit plan and audit programme

Audit plan	Audit programme
Meaning	
An audit plan sets the scope, timing and direction of the audit and guides the development of the more detailed audit programme.	An audit programme converts the audit plan into a more detailed plan and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to a low level.
Scope	
Audit plan includes the following information: Understanding the entity's environment and risk assessment process The nature, timing and extent of resources necessary to perform the engagement	Following are some matters which are included in the audit programme: A description of the nature, timing and extent of planned risk assessment procedures which will enable the assessment of the risks of material misstatement due to fraud Understanding and assessing of the strength of the control environment of the entity A description of the nature, timing and extent of planned further procedures at the assertion level Formation of audit team and allocation of work and duties to the assistants Types of audit evidence desired in order to comply with ISAs Explanation on decision relating to testing the operating effectiveness of controls and nature, timing and extent of planned substantive procedures
Extent of details	
An audit plan is brief and contains the overall audit strategy which will be adopted by the auditor.	Audit programme is a detailed recording of each procedure and process required to perform an audit.
Order of work	
Generally, the audit plan is prepared before the audit programme.	Generally, once the overall plan has been determined, the auditor should prepare a detailed plan of the areas outlined in the audit plan. Once the audit plan has been decided, the next stage is to decide how it is going to be carried out
Guidance in audit	
The audit plan gives the overall guidelines for developing the audit programme.	The contents of the audit programme depend wholly on the contents of the audit plan.

Test Yourself 4

Is it appropriate for an auditor to discuss the elements of their overall audit programme with the client?

Test Yourself 5

What are the major components of an audit programme?

3. State uses of audit programme.
[Learning Outcome d]

The audit programme also acts as a guideline for supervising and co-ordinating the audit progress. It should not be rigid but be flexible to suit the circumstances. It should be ensured that there should no duplication of work.

1. Uses of audit programs

There are numerous uses of audit programmes, which can be summarised as follows:

(a) It provides a **clear set of instructions to the audit staff,** particularly the less experienced staff, regarding the work to be done.

(b) It provides a **total perspective of work,** particularly for major audits.

(c) It encourages **division of work in an organised way**.

(d) It serves as a **guide for audits in the succeeding years**.

(e) It helps in **avoiding duplication of work**.

(f) It helps to **avoid omission of essential work**.

(g) A properly laid up audit programme helps the auditor in **defending action of negligence** brought against the auditor.

(h) It helps in **rational planning**, definition and segregation of work. This helps selection of assistants for jobs on the basis of their capability.

(i) It ensures **adherence to accounting standards**.

(j) The principal auditor can control the progress of various audits by going through the programmes installed by the juniors.

(k) It also **minimises the possibility of omitting any of the procedures**.

2. Disadvantages of audit programmes

(a) The audit **work may become too mechanical.** The audit work may be carried out without understanding the object of audit work. The variation in audit work may be overlooked.

(b) The **programme may become rigid**. The old programme may be carried on disregarding changes in business operations.

(c) **Individual thinking may be discouraged** and initiative may be stifled.

(d) Client's staff may become aware of standard audit routines and this **may encourage frauds.**

Despite the disadvantages, an audit programme is still recognised as a medium for having an organised audit. It is essential that an audit programme should be flexible enough to suit changing circumstances during the course of audit.

3. Standardised and tailored audit programmes

Standardised audit programmes are commonly used by large audit firms as they have a large number of clients. One set of standardised form is designed for large entities and the other set is designed for small entities.

(a) Advantages of standardised audit programmes

The advantages of standardised audit programmes are:

(i) There is a consistency in approach for all the audits.

(ii) It also minimises the possibility of omitting any of the procedures.

(iii) The reviewers of the programme can quickly get the information they want by having a quick glance, as they are familiar with the contents and design of the audit programme.

(b) Disadvantages of standardised audit programmes

(i) Standardised audit programmes are generally made to be suitable for audits of large entities. Therefore, they need to be tailored to suit the needs of small entities. This in turn would add to the cost of the audit.

(ii) The preliminary assessment of audit risk varies from entity to entity. This in turn means that the extent of tests of control as well as substantive procedures would also vary. Therefore, even in large audits, the standardised audit programmes cannot be used without customising.

(iii) When entities stick to standardised audit programmes, there is no element of surprise in the audit. Audit procedures must have an element of surprise in order to be effective. For example, surprise inventory verification is needed to confirm the effectiveness of internal cash controls. Furthermore, it also provides evidence of fraudulent practices (if they prevail in the entity).

(c) Advantages of tailored audit programmes

Each audit will have to be tailored to the unique characteristics of the client.

The advantages of following tailored audit programs are:

(i) Ready information is available.

(ii) The balance between tests of control and substantive procedures can be varied to match the preliminary assessment of inherent and control risk separately for each major financial statement assertion.

(iii) This helps the engagement staff to perform their work efficiently as they have been involved in the designing of the audit programme and have a better understanding of the internal controls and different operations of the entity.

Test Yourself 6

Nile & Co are the auditors of Uptown Ltd. The senior auditors have chalked out a standardised audit programme. The audit staff is reluctant to follow the standardised audit programme due to its disadvantages.

Required:

Explain how the senior auditors would help their audit staff to overcome these disadvantages.

Answers to Test Yourself

Answer to TY 1

Adequate appropriate planning helps in following ways:

1. It ensures appropriate attention to the important areas of the audit.
2. It prompts identification of potential problems.
3. It helps in speedy completion of work.
4. It helps in proper utilisation of members of the audit team.
5. It helps to co-ordinate the work done by other auditors and experts.

Answer to TY 2

In planning their audit, the auditor will consider factors such as:

The complexity of the audit
The environment in which the client operates
Their previous experience with the client
Knowledge of the client’s business

Answer to TY 3

It is true that audit programming is a continuous process throughout audit. The overall plan and the audit programme may have to be revised due to:

- changes in conditions (clients start a new line of business in addition to existing business).
- unexpected results of audit procedures such as fraud detected during the audit.

Answer to TY 4

It is appropriate, indeed essential, to discuss the overall audit programme and certain audit procedures with the client as it may improve the efficiency of the audit and help in co-ordination of the work of the client's staff. However, the overall audit programme and audit programme will continue to remain the auditor's responsibility.

Answer to TY 5

The major components of an audit programme are:

- The terms of the auditor's engagement
- The statutory responsibilities of the auditor
- The nature and timing of reports or other communications with the client that are expected under the engagement
- The client's accounting policies
- Deviations from accounting policies followed by the client in the past
- The effect of new accounting or auditing pronouncements (both national and international) on the audit
- The identification of significant audit areas
- The setting of materiality levels for audit purposes
- Conditions requiring special attention, such as the possibility of material error or fraud
- The nature and extent of audit evidence to be obtained
- The involvement of other auditors and experts in the audit

Answer to TY 6

As the standardised audit programme has been chalked out, the senior auditors would explain up-front to their assistants

- why a particular step is to be carried out and
- what the object and importance in the whole scheme is.

They can tell their audit staff that the instructions in the audit programme are only bare minimum and encourage assistants to use their initiative and intelligence, as and when required. Moreover, the audit programme should be periodically reviewed and updated for changes.

Self Examination Questions

Question 1

List and explain the purpose of the following sections of an audit plan document:

- Understanding the entity's environment:
- Understanding the accounting and internal control systems
- Risk and materiality
- Consequent nature, timing and extent of audit procedures
- Co-ordination, supervision and review of audit work

Question 2

What are the factors to be considered by the auditor in planning their audit?

Question 3

Which of the following should be considered while framing the audit programmes?

A Scope of the assignment
B Limitation of the assignment
C All possible errors and frauds
D All of the above

Question 4

Which of the following options contain incorrect statements?

A The auditor needs to consider whether the overall audit plan and audit strategy needs to be revised
B If the auditor perceives threats, he can perform less substantive audit procedures
C The auditor should not assume that an instance of fraud or error is an isolated occurrence

Question 5

What are the main elements of an audit plan?

Question 6

While planning an audit which four factors should be considered by an auditor?

Answers to Self Examination Questions

Answer to SEQ 1

Understanding the entity's environment section includes:

This section of the plan provides details of the industry area that the company is in, along with specific information about the activities and strategies of the individual client.

Understanding the accounting and internal control systems

The details of accounting policies of the client and previous assessments of internal control systems indicating the expected extent of reliance on those systems are mentioned in this section of the plan.

Risk and materiality

This includes:

- an assessment of risk for the client, risk of fraud and error and the identification of significant audit areas
- the materiality level which is used for planning the audit

Consequent nature, timing and extent of audit procedures

This section contains:

- details of the focus on audit work on specific areas
- details of the extent of use of audit software
- possible reliance on internal audit

Co-ordination, supervision and review of audit work

This section provides details of the extent of involvement of experts, client locations and staffing requirements for the audit.

Answer to SEQ 2

In planning their audit, the auditor will consider factors such as:

The complexity of the audit
The environment in which the client operates
Their previous experience with the client
Knowledge of the client's business

Answer to SEQ 3

The correct option is **D**.

The following points should be considered while framing the audit programme:

(i) The audit programme should be framed by keeping in mind the scope and limitation of the assignment.
(ii) Determine the evidence reasonably available and identify the best evidence available.
(iii) The audit programme should be framed considering all possibilities of errors and frauds.
(iv) The procedures should be selected which will give evidence for more than one assertion when applied.

Answer to SEQ 4

The correct option is **B.**

If the auditor perceives threats, he should perform extensive audit procedures.
The other options are incorrect as they contain true statements.

Answer to SEQ 5

Scope, timing and direction of audit

Answer to SEQ 6

Identify the objectives of the organisation
Determine the type of audit
Identify important audit areas
Assess staff resources

Additional reading material

1. Audit risks

Definition

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Alternatively put, it can be described as being the risk that an auditor will incorrectly certify that an organisation's financial statements are true and fair. When this occurs, the best interests of the client, the accounting profession and society at large have been compromised as inaccurate and / or fraudulent financial statements have been published.

The main reason for an incorrect audit opinion is that the auditors receive and rely upon fraudulent or inaccurate information to base their findings and conclusions on. Consequently the main reason why an auditor ends up using such information is because of the three different types of risks all organisations (and subsequently their audits face). These **risks are inherent risks, control risks and detection risks**.

Definition

Inherent risk: the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

ISA 200

Inherent risks are the risks that organisations face because of the business they are in and the nature of their industry. The term inherent is used here because these types of risks will always be present for the organisation and are an inevitable part of its business environment.

Organisations cannot eliminate these types of risks. However they can take steps and precautions to mitigate them. One of the most common methods is to implement a system of internal controls. However, this rarely mitigates all inherent risks. This leads to the second type of risk facing organisations.

Definition

Control risk: the risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

ISA 200

Control risk is the risk that an organisation's internal control systems do not adequately protect the organisation either because they have not been adequately designed and / or implemented.

Definition

Detection risk: the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

ISA 200

The third type of risk, detection risk covers the risk that an auditor's checking and sampling procedures will not uncover any existing irregularities or misrepresentations. The existence and combination of these risks all potentially lead to the possibility that any auditor may unwittingly end up using inaccurate or fraudulent information whilst conducting their audit. If detection risk is too high, auditors then carry out more audit procedures to mitigate the risk.

For a material error to finally appear in the audited and published financial statements, three things have to happen:

The error occurs in the first place (inherent risk)
The error is not detected and corrected by the internal control system (control risk)
The auditor does not identify the error as part of the audit procedures (detection risk)

Dawson's is a very large and high end retail shop selling suits, tuxedos, ties, shoes and other accessories for formal wear. The types of inherent, control and detection risks facing the organisation and its auditor are:

1. Inherent

Like almost all other organisations that operate in the retail industry, Dawson's is faced with the problem of pilferage. Items can and have either been shoplifted by customers or misappropriated by employees. The risk to the auditor here is that inventory records (one of Dawson's main assets) will not be accurate.

2. Control

To mitigate this main risk, Dawson's implements the following internal controls. All items on display have a security tag attached to them which can only be removed at the sales counter. If a customer tries to leave with the security tag still attached, an alarm will ring at the exit door (which is manned by a security guard). In addition, to help prevent misappropriation by employees, inventory levels are physically verified on a weekly basis. However the control risk still exists here that despite these measures items will still be stolen (and hence again leading to inaccurate inventory records). For instance an employee may work in conjunction with a "shoplifter" by removing the security tag even though the customer has not paid.

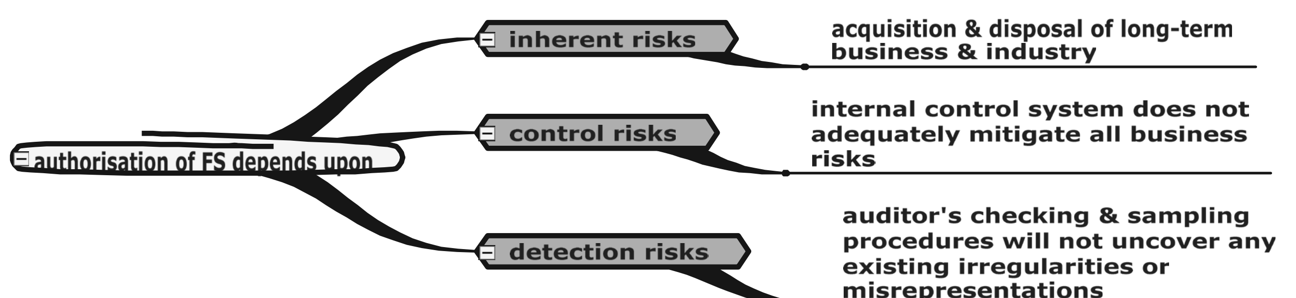
3. Detection

Being aware of the existence of these risks, Dawson's auditor first checks the effectiveness of the security system in place. He does this by observing the employees at work for some time satisfying himself that they are diligently removing the security tags only after payment has been made and that security is stopping any customers trying to leave when the alarm sounds.

The auditor also attends a few of the weekly inventory counts to satisfy himself that the goods on hand are accurately counted and recorded. In addition the auditor also does a routine sample check of a few sales transactions where he checks to see if the sale is accurately recorded in the inventory, sales and cash records. However in spite of these procedures the auditor may still not uncover incidents where items have been either stolen or misappropriated.

Diagram 1: Audit Risk

SUMMARY



STUDY GUIDE G3: INTERNAL CONTROL SYSTEM

Get Through Intro

The Oxford English Dictionary defines ‘control’ as being the power of directing or restraining. In an organisational context, the term can be used to describe how an organisation is in charge of its activities. Organisations need to have control over not only the quality of the goods and services they produce, but also over how their policies and procedures are carried out. A part of control also means ensuring the correct usage and safeguarding of the organisation’s assets e.g. its cash and technology.

Part of your function as an accountant is to be a “watchdog” for the organisation. You will be required to design, implement and / or monitor a system of internal controls that will protect all of the organisation’s assets; including its finances and technology.

This Study Guide will provide you with an understanding of the system of internal financial controls and checks that exist within organisations. It will also define and describe the importance of security for an organisation’s IT systems and software.

Learning Outcomes

a) Define internal control system and internal check.
b) State the objectives of internal control system.
c) Explain management responsibility to internal control system.
d) Identify features of effective internal control system.
e) State inherent limitation of internal control system.

1. Define internal control system and internal check.
[Learning Outcome a]

1.1 Internal Control

An internal control system is the name given to the process that organisations use to help ensure that:

their financial reporting is **timely, reliable and accurate**
their operations are conducted **effectively and efficiently** and
They are in **compliance with all applicable laws and regulations**.

Internal control systems are designed and implemented in response to any risks that may prevent an organisation from achieving the above three stated objectives.

Example

The internal auditor may check payments made by the company to ensure they were authorised. He will do this by comparing the signature on a sample of payments to the authorised signatories in the official company records (e.g. on the official confirmation letters sent from the bank).

The need for internal control systems came about because of the following two factors:

The separation of ownership and management present in most large organisations and
The fact that managers in turn delegate much of their responsibilities to subordinates.

Therefore both owners and managers need to have a **system or a set of controls** in place that will allow them to know whether the policies and procedures of the organisation are being properly carried out.

Internal controls can be divided into three main types:

1. **Detective controls**: are designed to find errors or irregularities after they have occurred. E.g. to review monthly departmental account reports for inappropriate charges.

2. **Corrective controls**: are designed to fix errors or irregularities after they are detected. E.g. budget variance reports.

3. **Preventive controls**: are designed to discourage errors or irregularities from occurring. E.g. processing travel vouchers only after signatures have been obtained from appropriate personnel.

The controls associated with an **internal control system** can be classified as being either accounting controls or administrative controls.

(a) Accounting controls relate to areas such as:

(i) **safeguarding of assets** (e.g. implementing a control system where inventory is regularly physically verified and compared with the book balance to ensure none is stolen / obsolete)

(ii) **prevention and detection of fraud and error** (e.g. payments to workers are physically made by their supervisor, thereby eliminating the possibility of payments going to fictitious or non existent workers)

(iii) **completeness and accuracy of books of accounts** (e.g. having an internal auditor regularly verify the books to ensure all transactions exist and are recorded properly)

(iv) **timely preparation of reliable financial information** (e.g. having an internal auditor regularly monitor the work of the accounting department, to ensure that the financial statements are ready by the agreed date)

(b) Administrative controls relate to the areas such as:

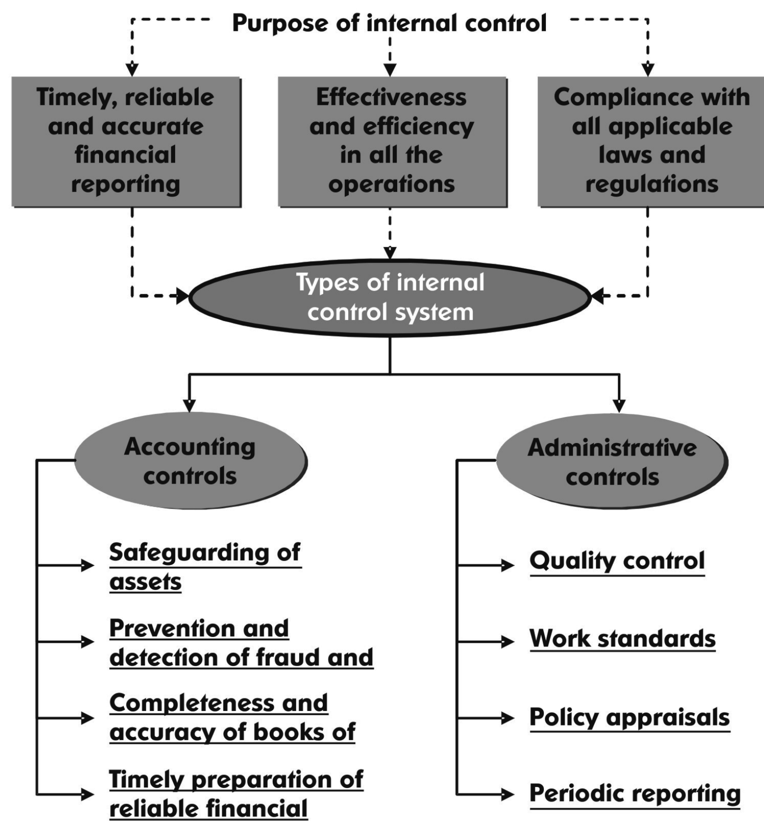
(i) **Quality control** (e.g. having the production department prepare a monthly report on all defects so the organisation can look at minimising them)

(ii) **Work standards** (e.g. having daily production reports that can be compared with industry standards to ensure that production is efficient. In case, work standards are not efficient,, corrective steps can be taken)

(iii) Policy appraisals (e.g. having an annual review on all policies to ensure that they remain relevant to the organisation meeting its objectives)

(iv) Periodic reporting on non-accounting matters (e.g. Glaspo Inc has a procedure of monitoring the number of successes out of the total sales calls made by each sales person. In case, sales manager finds that any of the sales persons is not selling effectively, corrective action such as more training can be arranged

Diagram 1: Internal control



1.2 Internal Check

Internal checks are a **component of an internal control system**. They represent a system of checks that are conducted **continuously throughout the day to day operations** of an organisation to ensure that policies and procedures are being properly carried out. The basic purpose of the internal check is to detect / prevent any errors, whether they are done intentionally or unintentionally. They are also designed to ensure that malpractices such as fraud or theft do not occur.

Example

To reduce the possibility of embezzlement, Kelly Co divides the functions involved with purchasing goods amongst different employees. For instance, one employee, Peter is responsible for placing purchase orders with suppliers; whilst another employee, Raj is required to check the delivered purchases and another, Chang makes the appropriate payment. By having these roles split, it would be harder for Peter to order extra goods for himself, as Raj checks the goods coming in. Raj would notice the extra goods and return them.

This system of **divided responsibilities and cross checking** amongst different employees is the core of the system of internal checks. The ideal system is one where the following aspects of a transaction are entrusted to different persons:

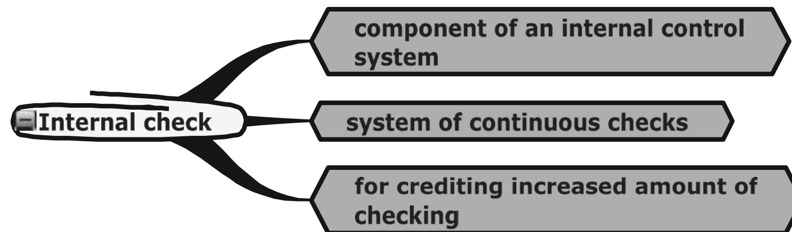
authorisation of a transaction
execution of a transaction
physical custody of the related asset, if required, and
maintenance of records and documents

Example

Continuing with the above example,

Kelly Co has a policy that only the purchase manager, Ken, can authorise a transaction (purchase). However, the actual purchase (execution) must be undertaken by Peter, who is from his department. The next step of checking is to have yet another employee, Raj verify and take custody of the physical goods when they arrive. Finally, one last employee, Chang, records the transaction with all the supporting documentation.

SUMMARY



Test Yourself 1

An internal control system is the process that organisations follow to ensure that:

A Their financial reporting is timely, reliable and accurate.
B They are in compliance with all applicable laws and regulations.
C Both **A** and **B**
D None of the above

---

2. State the objectives of internal control systems.
[Learning Outcome b]

Internal control is a process which is implemented by those charged with governance, management and other personnel.

Specifically, the general objectives of internal control are as follows:

efficiency and effectiveness of operation
reliability of financial reporting
compliance with applicable laws and regulations

Each of the above has been explained in turn below:

1. Efficiency and effectiveness of operation

Efficiency and effectiveness of operation will assure the auditors that the financial statements reflect a reasonably correct picture of the financial status of the entity.

This can be ensured by:

(i) adhering to all management policies

(ii) safeguarding assets and records

Example

Venus Ltd has the following policies

(a) With respect to staff attendance

<table>
<tr><th>Control</th><th>Impact on financial statements</th></tr>
<tr><td>All employees are required to swipe their identity cards while entering and leaving the office premises.</td><td rowspan="2">The financial statements relating to employee salary will be correct if the salary sheet is made based on the attendance policies mentioned alongside.</td></tr>
<tr><td>All employees going on outdoor duty are required to enter an outdoor slip duly authorised by their seniors.</td></tr>
</table>

(b) With respect to safeguarding of inventory

<table>
<tr><th>Control</th><th>Impact on financial statements</th></tr>
<tr><td>Inventory is stored only in the inventory stores.</td><td rowspan="6">The control activities will ensure that the inventory is properly safeguarded. So the value of the inventory which appears in the financial statements will be reliable and accurate.</td></tr>
<tr><td>The stores are kept under lock and key.</td></tr>
<tr><td>No outsiders are permitted to enter the stores.</td></tr>
<tr><td>Only the persons who are working in the stores are allowed access to the stores.</td></tr>
<tr><td>Every quarter, the management carries out a physical verification of the inventory.</td></tr>
<tr><td>The inventory is also insured against natural disasters, theft and riots.</td></tr>
</table>

2. Reliability of financial reporting

This is essential if the financial statements are true and fair. Reliability of financial reporting is possible if controls are in place to ensure the **accuracy** and **completeness** of accounting records.

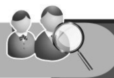
Example

Venus Ltd follows the following method of accounting for inventory:

<table>
<tr><th>Control</th><th>Impact on financial statements</th></tr>
<tr><td>Materials received in stores are supported by purchase orders.</td><td rowspan="5">The controls mentioned alongside will ensure that the financial statements with respect to purchases and inventory are reliable, since the information of receipt of purchases is accurate and complete.</td></tr>
<tr><td>Materials received are supported by goods received notes.</td></tr>
<tr><td>Materials received are tested by the quality control department.</td></tr>
<tr><td>Only tested material is issued for production.</td></tr>
<tr><td>Purchase vouchers are prepared after comparing the goods received notes and purchase orders.</td></tr>
</table>

3. Compliance with applicable laws and regulations

The internal controls should ensure compliance with applicable laws and regulations. Sometimes, controls designed to detect non-compliance with laws and regulations may have a direct and positive impact on the financial statements.



Example

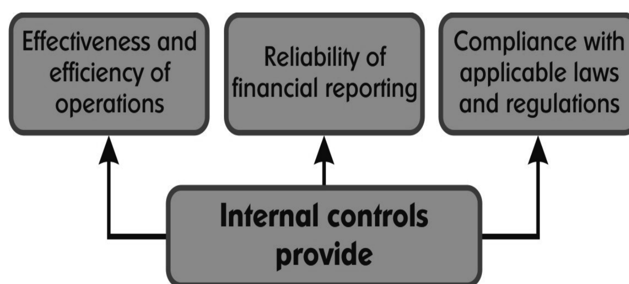
Indobank has employed Sam & Co as consultants. They are entrusted with the task of checking that the entity has complied with all applicable laws and regulations.

Control	Impact on financial statements
All the laws and regulations (banking laws, labour laws etc.) which are applicable to Indo bank.	The controls will ensure that the company adheres to all laws and regulations. This will ensure that the financial statements prepared by the entity have taken into account all the liabilities which are applicable to the entity in this account. Hence the financial statements will be more reliable and there is no risk of any statutory non-compliance.
Ensure that the bank is kept informed of all new laws or regulations which are applicable to Venus Ltd.	

The scope of internal controls includes not just accounting controls but also operational controls such as quality controls, budgetary controls (i.e. testing whether expenses, assets etc. are according to budget) quantitative controls (e.g. actual output / production from machine matches the expected production), internal checks (i.e. ensuring that the work of one person is verified by another official) and so on.

Therefore internal controls assure management of the accuracy of the financial statements, that the operations of the entity are conducted efficiently and that the entity has complied with all the laws and regulations which are applicable to the entity.

Diagram 2: Internal controls



Test Yourself 2

Your firm has recently been appointed as auditor to Bouche Ltd, a private company that runs a chain of small supermarkets selling fresh, frozen food, canned and dry food. Bouche has very few controls over inventory because the company trusts local managers to make good decisions regarding the purchase, sale and control of inventory, all of which is done locally.

Required:

What reasons would you give to management as to why inventory should be safeguarded and what recommendations will you make to management to safeguard Bouche Ltd's inventory?

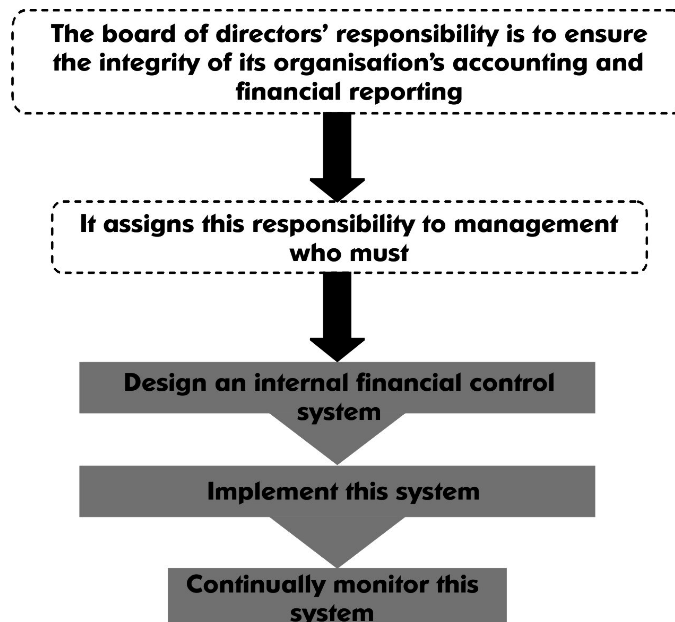
3. Explain management responsibility to internal control system.

[Learning Outcome c]

The corporate governance regulations of many countries have recently expanded the roles that an organisation's board of directors is required to play. One increased responsibility is that directors are to **ensure the integrity of their organisation's accounting and financial reporting by having appropriate internal financial control and systems in place**.

The **design, implementation and monitoring** of such systems is then assigned to the **management** of an organisation by their board. Management is required to regularly report to the board on the working conditions and effectiveness of these systems. It is the responsibility of the management team to establish an appropriate and sound internal financial control system, which continuously monitors the effectiveness of the system. A sound internal financial control system provides reasonable assurance.

Diagram 3: Responsibilities of management for internal financial control



1. Design of the system

The main steps involved in designing an internal control system are:

(a) Studying the flow of transactions and authorisations that occur during the operations of the organisation along with existing procedures (e.g. for a sales transaction the flow would be obtaining a sales order, dispatching the goods, recording the dispatch and collecting payment).

(b) Critical evaluation of the procedure (e.g. a critical review reveals that before an order is accepted, the inventory level and the credit limit of the customer should be verified).

(c) Designing an internal control system (e.g. the above steps are added to the design of the internal control system).

2. Implementation of the internal control system

For instance, with the sales order system example above, the internal control system would consist of the following:

(a) A post of a **sales dispatch supervisor** is created.

(b) The individual filling the position of sales dispatch supervisor is made responsible for ensuring that all sales orders are dispatched on time without omitting to comply with the organisation's policies.

(c) This requires that the supervisor coordinates with both the inventory and credit control managers.

(d) The inventory manager should ensure that sufficient quantities of the goods ordered are in stock (and if not to ensure that they are ordered).

(e) The credit control manager should ensure that the customer is within the assigned credit limits (and if not to ensure that the sales order is not processed).

3. Monitoring of the system

An internal auditor will verify whether the above system is actually operating in practice. Periodically he will review if any changes need to be made to the system. For instance, if orders are now to be accepted over the internet, additional controls will be needed. An example of such a control would be ensuring that a follow-up phone call is made to the customer the next day to confirm the details of the order.

Test Yourself 3

The board of directors is responsible to ensure the integrity of its organisation's accounting and financial reporting, by having appropriate internal financial controls in place.

A true
B false

4. Identify features of effective internal control system.
[Learning Outcome d]

Effective financial control procedures will have the following features:

(a) A system of internal checks

These help the management to design and implement an effective internal financial control system.

Example

Authorisation of material to be issued is done by the manager in charge of production; however the actual issuing of the material will be done by the storekeeper. After necessary authorisation procedures, the materials will then be received by the production supervisor.

(b) Well laid out documentation on internal controls and procedures

This makes it **easier** for the concerned persons to **understand and follow the system** being prescribed.

Example

A manual procedure will lay down all the above steps, and any permissible exceptions as well as the authority limits of each employee involved with the process.

(c) Clear directives on the roles, responsibilities and authority levels of all employees

Example

Again this makes it **easier** for employees to **understand and follow the system**. (e. g. the above said procedures can be communicated to the employees in person or through written communication such as an email).

(d) The ability to record transactions promptly

This helps to ensure that the information recorded is **timely and accurate**.

Example

The accountants of an organisation should have the necessary infrastructure such as adequate hardware and software packages, to be able to record and process invoices for customers immediately.

(e) The ability to safeguard and verify assets

The system should ensure that assets are safeguarded from **unauthorised access, use or disposition**. It should also provide for a verification of assets at **reasonable intervals**.

Example

No employee should be allowed to take out any official assets outside the organisation's premises.

(f) Cost effective

The costs of running such a system should not be so high that they outweigh the benefits of detecting and correcting errors.

Example

For a small organisation it may not be economically feasible to have two different people to receive and record the cash transactions. Here the owner will have to play a role in monitoring the activities. This will act as a deterrent.

(g) Current

The system should be **regularly reviewed** in light of the changing circumstances; otherwise, it may lose its significance and effectiveness. (E.g. if an organisation suddenly decides to start offering its products over the internet, it will mean that additions to the organisation's internal control system will have to be made).

Example

Having a secure encryption on the server for when customers upload their credit card details.

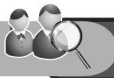
(h) Authorisation

Authorisation is a preventive control. It is an approval (in accordance with pre-determined criteria, whether judgmental or not) for a transaction or a process by an authorised person:

a **transaction** (e.g. signature on the cash payment voucher for the purchase of a computer) or

a **process** (e.g. signature on the purchase order for the purchase of a computer, after calling for alternative quotations and preparation of a price comparison sheet to decide which vendor the computer will be purchased from).

The **person responsible for authorisation will inspect the document and also the supporting documents, and satisfy himself that the transaction is appropriate and valid.** He then approves it by initialling and dating the document.


Example

A person authorising the payroll will review the timesheet, overtime records etc. of the employees, check the calculations and then authorise the payroll by initialling and dating it.

Every organisation must identify:

all the important transactions and processes which require authorisation

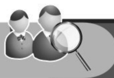
the level of authority that is responsible for the authorisation

This will ensure that:

Important transactions and processes have the approval of officials decided by the management.

The entity has complied with the policies of the entity.

Authorisation may be general or specific. The approval authority is often linked to specific dollar levels.


Example

Granting permission to an entire department to utilise the resources allocated to it can be an example of general authorisation.

Granting permission for a specific act like increasing the credit limit of an individual customer can be an example of a specific authorisation.

(i) Segregation of duties

Segregation of duties is a control element designed to prevent errors and frauds. The same individual should not have responsibility for all three components of a transaction cycle i.e.:

initiation
processing
reconciliation / review.

Where staffing levels permit, it is preferable to segregate all three components.

Evaluation of an organisation chart will enable an external auditor to know who is responsible for what and who is reportable to whom. If a single person is given the responsibility to execute various stages of a transaction, this will contradict the rationale behind the segregation of duties. **The rule of the segregation of duties is that no single person should have exclusive right over any transaction.**

These activities include **assigning** the responsibilities of **authorising transactions**, **recording transactions** and **maintaining custody of assets** to **different people.**

For example, in a purchase transaction:

the purchase manager will raise the purchase order.
the storekeeper will receive the goods.
the accountant will record the purchase transaction.
the cashier will make the payment for the purchase.

Segregation of duties is carried out to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.

Test Yourself 4

There needs to be well laid out documentation on internal controls and procedures in order to make an organisation's internal financial control procedures effective.

A true
B false

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5. State inherent limitation of internal control system.
[Learning Outcome e]

An auditor relies on the internal controls if they are effective, but the internal control system itself has certain inherent limitations:

1. Design of the system

The internal control system may be weak because it is not desig[n]ed properly. **Even if an internal control system is operating according to its design, it may not be effective due to improper design.**

Example

If segregation of duties is not in place, e.g. all responsibilities regarding receipts are given to one person and all responsibilities for payments are given to another person, it means that the person receiving the money is not only making the entries in the books but is also in possession of the cash. This segregation is improper as the concerned person is in a position to misappropriate money. Segregation should be such that the work of one person will automatically be checked by another.

---

2. Human error

Internal controls are not free of human error. Human error **might be caused due to** subjectivity in the decisions made and thus resulting in **wrong decisions or due to simple mistakes**.

Example

Jamie is the auditor of Premium Plc. During the course of the audit, he found that the internal control system was effective e.g. the computer system is designed to generate an exception report for transactions of exceptional nature (e.g. for high value purchases).

However, this system will not work effectively if there is an error in typing the amount (e.g. typing Tshs5,000 instead of Tshs50,000). In this case, the transaction will not be recorded in the exception report and the internal control on high value transactions will fail, due to human error.

Even if the internal control system is well-designed, if it is not implemented by the staff and management it will turn out to be ineffective, giving rise to human error.

Example

Sam is the auditor of Tall Co. During the course of the audit, he found that the internal control system was adequate. The policy of the company was that every voucher exceeding Tshs6,000 had to be approved by two officials – the department head and the finance manager. Apparently, this policy seemed very adequate but the manager started splitting the amounts above Tshs6,000 and thereby, avoided taking the approval of the two officials. This meant that Sam could not rely on the proper operation of the system. Even if he used tests to ensure that the system was working properly, he would use only a few tests, therefore a complete examination was not possible.

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3. Controls are not cost-effective

Cost is a very important aspect which is considered by an entity while setting out the internal controls of the entity. Good internal control systems require segregation of duties, but this will involve employing more people and consequently will increase the expenses of the entity. The controls may not be cost effective for small entities. Ineffective controls, on the other hand, can lead to errors.

4. Transactions of unusual nature

Internal controls are framed in such a way that they handle daily transactions of a routine nature, under normal circumstances. However, they are not set out to handle unusual circumstances and unusual transactions. Therefore, the internal controls might not be able to deal with these errors effectively.

5. Controls by-passed or over-ridden

Authorised persons may take advantage of their positions to manipulate records and by-pass controls. The manipulation of records may be done for personal gains or to ensure that third parties are benefited. This can lead to fraud and errors.

Example

In Sisco Ltd, the supervisor is responsible for approving the working hours recorded by employees and also for making their payments. In this case, the supervisor may manipulate the working hours of an employee to show an increased number of hours, and on payment, can share the additional wages with the employee. Hence, this is a weakness in the design of internal control systems on payment.

Management is in a position to override controls and manipulate transactions, estimates or opinions which are required for preparing the financial statements. Therefore **controls can be overridden by management.**

An internal control system can be effective only if it is implemented by management and staff in the true spirit.

Test Yourself 5

Which of the following options does not relate to inherent limitations of the internal control system?

A Goods received notes are prepared for all goods procured.
B Internal audit is not performed on a timely basis.
C The purchase manager of a company orders for materials from vendors over the telephone, without raising a purchase order.
D Bank reconciliation has not been carried out.

Test Yourself 6

Describe the reasons why it is important that the management of a company designs a good system of internal control.

Answers to Test Yourself

Answer to TY 1

The correct option is **C.**

Internal control systems are:

designed and implemented to mitigate any risks that may prevent an organisation from having timely, reliable and accurate financial reporting,
complying with all applicable laws and regulations and
Also conducting its operations effectively and efficiently.

Answer to TY 2

Reasons for safeguarding inventory

(a) In the given case, the inventory is of perishable nature. Hence, if it is not well-managed it may result in:

breach of health and safety regulations which may result in fines or even closure of the supermarkets.
wastage of inventory leading to excess cost for the entity.

(b) Again sales, purchase and custody of inventory is in the hands of local managers, and as there are few controls they or their staff might misappropriate inventory.

(c) Supermarket inventory is very easily stolen either by staff or customers even where it is well controlled, so there are high risks when it is not controlled.

Safeguards for inventory

(a) An integrated system should be introduced across all supermarkets that link sales, purchases and inventory records. This would enable the company to have:

an overall view of the inventory which is held at any particular time.
a central order system which would reduce the scope for theft. It would also take control away from local managers.

(b) Regular and continuous inventory counting should be carried out at each supermarket together with prompt update of inventory records for discrepancies found and investigation of the reasons for the discrepancies.

(c) Spot checks of inventory should be carried out by head office personnel.

(d) Gross profit percentages for the different types of food will be well known and stable. This will allow a reconciliation of sales and cost of sales.

(e) Closed circuit TV should be installed in the shops and their store rooms.

Answer to TY 3

The correct option is **A.**

The corporate governance regulations of many countries have recently expanded the roles that an organisation's board of directors is required to play. One increased responsibility is that directors are to ensure the integrity of their organisation's accounting and financial reporting by having appropriate internal financial control and systems in place.

Answer to TY 4

The correct option is **A.**

Well laid out documentation on internal controls and procedures, makes it easier for employees to understand and follow the internal financial control system being prescribed, which in turn makes its implementation easier.

Answer to TY 5

The correct option is **A.**

Goods received notes being prepared for all goods procured indicates that the policies of the company are followed.

Options B, C and D are inherent limitations of internal control systems as they indicate instances of management override of controls.

Answer to TY 6

The management of the company should ensure that the company has a good system of internal control. This is essential because good internal controls assure the accomplishment of goals and objectives. If the company does not have an effective internal control system, it will be difficult for the company to achieve its objectives. Internal controls ensure that the company's operations are effective and efficient. They provide reliable financial reporting for management decisions. They also ensure compliance with applicable laws and regulations to avoid the risk of public scandals.

Self Examination Questions

Question 1

Internal control is a component of internal check.

A true
B false

Question 2

The system of internal financial control is established by an organisation to help ensure that all its _____________ are properly safeguarded:

A systems and procedures
B assets and records
C employees and customers
D none of the above

Question 3

The management of an organisation is required to regularly report to the board on the working condition and effectiveness of internal financial control systems.

A true
B false

Question 4

An effective internal financial control procedure needs to be:

A cost effective
B current
C clear
D all of the above

Question 5

Review of internal control system helps the auditor to:

(i) Handle unusual transactions and circumstances
(ii) Determine the level of reliance on the various control systems.
(iii) Determine areas of weak internal control
(iv) Determine nature, extent and timing of audit tests to be applied.

A (i), (ii) and (iii)
B (ii),(iii) and (iv)
C (i), (iii) and (iv)
D (i), (ii) and (iv)

Question 6

Identify features of effective internal control system.

Answers to Self Examination Questions

Answer to SEQ 1

The correct option is **B**.

Internal checks are a component of an internal control system. They represent a system of checks that are conducted continuously throughout the day to day operations of an organisation to ensure that policies and procedures are being properly carried out.

Answer to SEQ 2

The correct option is **B.**

Organisations implement internal financial controls to help ensure that all assets and records are properly safeguarded, thus reducing the possibility of misappropriation, theft etc.

Answer to SEQ 3

The correct option is **A.**

To ensure the integrity of an organisation's accounting and financial reporting, management is assigned with the responsibility of design, implementation and monitoring of its internal financial control systems. It is required to regularly report to the board on the working order and effectiveness of these systems.

Answer to SEQ 4

The correct option is **D.**

An effective internal financial control procedure needs to be: (a) cost effective because the costs of running such a system should not be so high that they will outweigh the benefits of detecting and correcting errors, (b) current, because it should be regularly reviewed in light of the changing circumstances and (c) clear in respect to the roles, responsibilities and authority levels of all employees in order to make it easier for employees to understand and follow the system.

Answer to SEQ 5

The correct option is **B**.

Internal controls are usually framed in such a way that they handle daily transactions of a routine nature, under normal circumstances.

Answer to SEQ 6

Effective financial control procedures should have the following features:

(a) **Well laid out documentation on internal controls and procedures:** this makes it easier for the concerned persons to understand and follow the system being prescribed.

(b) **Clear directives on the roles, responsibilities and authority levels of all employees:** this makes it easier for employees to understand and follow the system.

(c) **The ability to record transactions promptly:** helps to ensure that the information recorded is timely and accurate.

(d) **The ability to safeguard and verify assets:** from unauthorised access, use or disposition. It should also provide for a verification of assets at reasonable intervals.

(e) **Cost effective:** the costs of running such a system should not be so high that they outweigh the benefits of detecting and correcting errors.

Additional reading material

Audit trail

An audit trail is defined as the chain of evidence provided through coding, cross-references, and documentation connecting account balances and other summary results with the original transaction source documents. Therefore an audit trail means maintaining a record of all actions relating to each transaction of an entity. It helps the auditor to identify who initiated the transaction, when the transaction was recorded (time, day, date), what files were updated as a result of that transaction etc.

Example

When the purchase voucher is recorded into the computer system, the system will be able to generate a report which will indicate the person who logged into the system to record the purchase voucher, the date and time when the transaction was recorded and the names of files which were updated.

The non-availability of audit trail affects the conduct of manual audit.

Example

Instead of a human, a computer may match suppliers' invoices and delivery notes, before any invoices are passed for payment. In the earlier days, this process was carried out manually, with hard copies of all the documents attached, physically checked and signed by the concerned officials. Now that the computer does the work, there is no audit trail of hard evidence that this was done.

Therefore this is a very important detective control.

STUDY GUIDE G4: RECORDING OF AUDIT WORK

Get Through Intro

Auditing, like accounting, has to make significant use of working papers, used for noting, calculating or reconciling. The audit team, consisting of senior and junior staff, document their findings and work at various levels of audit. These working papers serve as record of the audit work completed.

These documents supply the raw materials necessary – the audit evidence - for finalising the audit report. The material (working papers) prepared, obtained and retained by the auditor in connection with the performance of the audit is audit documentation.

Audit working papers are not a bundle of papers. They have to communicate to be purposeful. It is for this reason that these have to be well-organised, cross-referenced, properly arranged and kept safely.

This Study Guide deals with the need for and importance of audit documentation and also with the forms and contents of audit working papers.

Learning Outcomes

a) Define and explain audit working papers.
b) Identify forms of working papers.
c) State the objectives of audit working papers.
d) Explain the content of working papers.
e) Explain the differences between permanent and current audit file.

1. Define and explain audit working papers.
State the objectives of audit working papers.
[Learning outcomes a and c]

1.1 Meaning of audit working papers

Audit working papers is also referred to as audit documentation.

Definition

Audit documentation' means the record of audit procedures performed, relevant audit evidence obtained and the conclusions the auditor reached.

ISA 315

The definition of documentation includes several terms that are explained below:

1. **Audit procedures** are the procedures followed or methods used by the auditor during the course of audit.

Example

If the auditors are engaged in checking the accounts payables, they will perform the following procedures:

(i) Obtain suppliers' statements or confirmation certificates from the suppliers.
(ii) Compare the balances in the statements with the balances in the entity's books.
(iii) Obtain reconciliation and list outstanding invoices, debit notes and outstanding cheques etc. for large amounts.
(iv) Enquire into old and unusual items.
(v) Compare the balances of major suppliers with the related names and amounts in the trial balance.
(vi) Compare the total amount of account payables in the trial balance with the total amount in the general ledger.

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2. **Audit evidence** means all the information used by the auditor in order to arrive at the conclusions on which they form their opinion.

Example

Continuing the above example:

The audit evidence that the auditors would obtain in order to form their opinion (about the truth and fairness of the accounts payable) will include a review of the following information:

(i) The suppliers' statements or confirmation certificates.
(ii) Reconciliations and the list of outstanding invoices.
(iii) Debit notes and outstanding checks.

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3. **A conclusion** means a clear written expression of opinion on the financial statements. The objective of an audit is to enable the auditor to express an opinion on whether all the financial statements have been prepared in accordance with the applicable financial reporting framework that is designed to achieve true and fair presentation of the financial position of the concern.

4. **Documentation** means the records maintained by the audit team during the course of audit. It includes all important documents, data-analysis, calculation papers, schedules, notes, certificates extracts and completed audit programmes. **Terms such as working paper or working papers are often used for documentation**. In other words, working papers are also records of the auditor's collection of evidence and examination.

1.2 Objectives of audit working papers / audit documentation

Audit documentation should contain sufficient information to enable an experienced auditor, who has had no previous connection with the audit, to ascertain from the audit documentation the evidence that supports the auditors' conclusions.

A summary of why audit documentation is necessary is below.

1. Facilitates adequate planning

Documentation helps to ensure that:

- planning is completed in an organised manner,
- planning decisions are followed during the conduct of audit;
- an appropriate reference point is available for review both during and upon completion of the audit.

In short, working papers make the auditor aware of the work performed. This helps the auditor in designing and deciding the nature, timing and extent of the audit procedures. It also saves time and repetition of work, as well as training the audit staff. Audit projects are often repeated, extended to cover additional areas or used as a basis for planning other assignments.

Example

Earn & Co is an audit firm. The company does not emphasise the preparation of working papers by the members of the audit team. As a result, during the course of the audit of Rayon Steels, the team members do not document the work done on an individual basis. As a result, the general ledger is checked twice and hence, the work is duplicated. Earn & Co realises the importance of audit documentation and henceforth, makes it mandatory for the audit team to document their work so that efficient planning of audit programmes and procedures can be carried out.

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2. Facilitates supervision and review of the audit work

Working papers provide an efficient means for the audit team to communicate the results of their work to their senior auditors. Working papers **enable the team members to be accountable for their work**. Working papers are the means by which the auditor supervises and maintains control of the audit work already done and yet to be done. An audit is performed by the audit team, as it is not possible for the senior auditor to perform all the procedures.

The members of the team perform the audit and the senior auditor reviews their work. The auditor can also review how and to what extent the audit team has taken its assignment and followed accounting principles and auditing standards. Well-organised papers facilitate review by helping the senior auditor find omissions, deviations from normal procedures and unusual problems. The auditor can assess the performance of their staff so as to have an idea of the reliability of their own report. They can also adopt timely reliable measures if anything goes wrong with their team or in the case of non-cooperation by the client. Hence, good working papers provide for meaningful communication of key results and conclusions through the summarisation of individual details. The supervision and review of working papers further **facilitates the conduct of quality control review and inspections within the firm.**

Example

Rambo has engaged an audit team for the audit of Rocky Ltd. The team consists of five people. He has delegated the work to five people.

- The first member has to verify the bank accounts and transactions.
- The second member is required to verify cash transactions, balances.
- The third needs to verify the fixed assets register (including its physical presence).
- The fourth is asked to verify the inventory.
- The fifth has to verify the minutes, adjustment entries, budgets, etc.

All five members of the audit team document their findings and show them to Rambo. He goes through them and, with the help of these documents; he knows the extent and nature of the audit performed by his team members. This helps Rambo to supervise and review the audit work and also allows him to concentrate on matters requiring major decisions.

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3. Provide the basis of audit report

Working papers represent evidence of the work done. The auditor may not be able to remember everything that has been noticed or observed during the audit up to the time of completion or issuance of report. Working papers facilitate the preparation of the report since everything noticed during the audit, queries raised and responses received are recorded here. An auditor refers to the audit findings recorded in the working papers while preparing the audit report and expressing an opinion on the financial statements of the entity.

Example

Ken is the auditor of Buzz Ltd. He has appointed an audit team, who have documented their findings and submitted them to him. Ken has to prepare an audit report in which he has to express his opinion on the financial statements of Buzz Ltd. Ken will refer to all these working papers and examine each of the areas of audit. If there were no working papers, it would not be possible for him to easily obtain this information form the team. Hence, the working papers permit accumulation of information for the final report.

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4. Allows discussion of audit findings with management

The auditor is able to discuss the audit plan before commencing the audit, and also the findings of the audit before issuing the audit report. Working papers are an effective means by which the auditor is able to discuss major audit findings with management or audit committee of the client.

Example

The audit team engaged by Ben & Co for the audit of Reliable Ltd finds some cash misappropriations while checking the petty cash book. They document these misappropriations and bring them to the attention of the senior auditor. The senior auditor immediately discusses these with management, as it is a matter of major concern. Hence, they are able to detect the fraud and prove their findings on the basis of evidence recorded in their working papers.

---

5. Provide defence against negligence charges

An auditor may be charged with negligence in a Court of Law for not detecting a material fraud or error. The suit may come up a long time after the audit is completed. The working papers will enable them to defend themselves by proving that they had taken reasonable care while carrying out their audit and drafting their report.

Example

Jim has been the auditor of Blue Co for the last five years. After Blue Co's bankruptcy, the concerned authorities questioned the company's financial statements and alleged that they were not true and fair. Management, in turn, accused the auditor of incompetency in his audit work. They accused him of not providing for the obsolete inventory and not including in the closing inventory. Jim defended himself by saying that he had asked the marketing department for information on the obsolete inventory and they had shown him the sales invoices for these items. As Jim had documented all his findings during the course of his audit, he was able to show the copy of the sales invoice to prove his innocence.

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6. Serves as guide for succeeding auditors

While preparing the working papers, the auditor should keep in mind that these working papers should be prepared in such a way that they are useful not only to them but also to a new auditor. Therefore, the working papers have to be well-organised properly arranged and should be kept safely.

Given the typical limitations on staff continuity, good working papers contribute to the quality of subsequent or complementary audits by providing a good starting point for succeeding auditors to:

reduce time spent in understanding the nature of the business operations,
identify areas of audit risks,
determine the scope of audit required and;
determine, with a greater degree of accuracy, the time and staff required.

Example

Kirsty has been appointed the new auditor of Hall Ltd. Andrew, the ex-auditor of the company has handed over all the necessary documents and working papers that will be of help to Kirsty in the course of the audit. These working papers provide a good starting point for Kirsty, allowing her to reduce the time spent in understanding the nature of the business operations of Hall Ltd, identify the areas of audit risks and determine the scope of audit.

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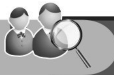
7. Serves as a data bank

Working papers help in accumulation of information for the final report. The various lists, statements and schedules supply a lot of information on different aspects of the concern. This information is useful both for current and future audits.


Example

Shah & Co has engaged its audit team for the audit of White Ltd. During the course of the audit, the audit staff find and document some bad debts. In the next year, while conducting the audit, they can refer to these working papers and try to see whether these bad debts have been recovered or not. This shows that the working papers serve as a data bank for current as well as future years.

Test Yourself 1

Who owns the working papers: the auditor or the client? Discuss.

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2. Identify forms of working papers.
Explain the content of working papers.
Explain the differences between permanent and current audit file.

[Learning outcomes b, d and e]

A uniform file structure and method of preparing working papers guides the audit staff on the job and thereby reduces the chance of omission or incorrect application of procedures. In addition, audit records serve as an important basis for understanding the audit programmes, objectives and activities.

2.1 Features and nature of audit documentation

There is no precise form of working papers and perhaps, there cannot be one because the form of the working papers depends upon the particular circumstances of each audit. However, general characteristics such as the following may exist:

1. Informative

Working papers are prepared to provide finalised opinions. They must be informative and avoid irrelevant and unnecessary details which could create confusion.

2. Accuracy

The information conveyed in the working papers must be accurate. Inaccurate information will lead to further complexities.

3. Clarity

The working papers should be very clear in thought and expression. Unclear information is no information. Every audit working paper has relatively more of a deferred long-term value than an immediate value.

4. Legibility

All the working papers should be legible. Complete, accurate and clear information will be useless if it cannot be read.

5. Design

The working paper should have a design and layout which leads to better understanding. This may be achieved by using pre-printed audit stationery or automatically-generated standard working paper formats. A standard format will ensure uniformity and help in better understanding of the working papers.

6. Proper index

The working papers should be indexed with a proper narration for all volumes in an audit summary file and an index for each of the working paper files.

7. Confidentiality

Above all, the information contained in the working papers is confidential information and should not be disclosed to the client's staff during the course of the audit. As far as outsiders are concerned, it should not be disclosed either during the currency of the audit or afterwards or even when a new auditor has been appointed. Disclosure could be made either with the express consent of the client or by the operation of law in force.

2.2 Form and content of working papers

Audit documentation may be recorded on paper or on electronic or other media.

Documentation should include, at a minimum, a record of:

- the planning and preparation of audit objectives
- the audit programme
- the audit steps performed and audit evidence gathered
- conclusions about the evidence gathered
- any report issued as a result of the audit work

It includes audit programmes, analyses, issues memoranda, summaries of significant matters, letters of confirmation and representation, checklists, and correspondence concerning significant matters.

Tip

It is important to note that audit documentation is not a substitute for the entity's accounting records.

Example

Jackson is the auditor of Arihant Ltd. He prepared a bank reconciliation statement for the firm. The accountant of the firm, Randy, did not consider it necessary to prepare a separate bank reconciliation statement for accounting records, as he thought that it had been prepared by the auditor and there was no need to maintain a separate statement. This was wrong because audit documentation is not a substitute for the entity's accounting records.

Tip

Oral explanations by the auditor, on their own, do not represent adequate support for the work the auditor performed or conclusions the auditor reached and are not audit documentation.

Example

Jeremy is the auditor of Young Ltd. During the course of the audit, he finds discrepancies in the accounting of debit / credit notes. However, he does not document the details of these discrepancies such as date, debit note etc. His oral explanations to the accountant that there are discrepancies in the debit / credit note is not adequate support for the work performed as an oral explanation cannot be recalled easily and can be disputed. It makes more sense to ensure that this is documented.

2.3 Factors affecting the form, content and extent of audit documentation

1. Nature of the engagement

The working papers which are required to be maintained vary from engagement to engagement, as the scope and the objective varies from engagement to engagement.

Example

Ben has an audit engagement with a small grocery shop and a large software company. The working papers that Ben will prepare for both of the businesses will be different as they are both different types of business and their scale of operations is also different. The working papers required for the grocery shop will be very few, just focussing on the main areas of audit, whereas the working papers for the software company will be many, as its operations are large.

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2. Nature, size and complexity of the entity's internal control

The working papers will be prepared on the basis of nature and size of the internal control system in an entity.

Example

Thomas is the auditor of a manufacturing firm, Access Ltd, and also a trading firm, Brown Ltd. The working papers to be prepared for Access Ltd will be numerous in comparison to those for the trading firm, Brown Ltd. The reason behind this is that the internal control of a manufacturing firm will be complex due to the involvement of a number of activities whereas internal control in the case of Brown Ltd will be reasonably simple.

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3. Nature of audit procedures

Working papers vary depending upon the nature of audit procedures which in turn are affected by the type of transactions involved.

Example

Adam is the auditor of a corrugated box company, Light Co. The working papers prepared for the sale of the boxes will be extensive, as it will involve many activities in comparison to the working papers prepared for the purchase of non-current assets, as these transactions will be much rarer.

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4. Nature and extent of exception (discrepancy) identified

The working papers will be different depending upon the number of discrepancies found.

Example

Anna is the auditor of Heavy Ltd. During the course of the audit, she finds a number of discrepancies in the recording of inventory and only a few in accounts receivables. Hence, the working papers will be many in the case of working papers related to the inventory compared to the working papers related to accounts receivables.

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5. Specific audit methodology and technology

The type of audit methodology and technology will also determine the type of working papers required and kept.

Example

Annie is the auditor of two firms: Back Ltd and Front Ltd. Back Ltd still follows manual accounting whereas Front Ltd has computerised accounting. Hence, Front Ltd will have a greater number of working papers relating to computer security than Back Ltd.

2.4 Types of audit files

The files in which all the working papers are put are termed audit files. Every audit generally requires two types of files:

1. Permanent file papers

The permanent file contains matters of continuing importance affecting the company or the audit. This generally has future or long term use. A permanent audit file generally contains the following papers:

Type of papers	Details
(a) Documents and other legal papers	Certified copies of the Memorandum of Association, Articles of Association or other deeds Extracts of various material agreements Extracts of minutes from the minutes books Engagement letter New client questionnaire
(b) About the company and its personnel	Organisational set-up-holding / subsidiary; Managerial set-up with list of directors; executives and other officers Accounts section and the books maintained
(c) Functioning of the organisation	Organisational set-up-holding / subsidiary; Managerial set-up with list of directors; executives and other officers Accounts section and the books maintained Internal control documentation Its evaluation by the auditor Lists of books and registers
(d) Final Processing	Copy of approved income statement and SOFP Tax returns and tax proceedings Copy of auditor's report to shareholders / appointing authorities

2. Current file papers

The current file which is broadly concerned with the accounts being audited generally serves an immediate purpose. It generally contains the following papers:

(a) Relating to current year's audit

Details of the assistants who performed the audit and the date the work was completed
Details of who reviewed the audit work performed
Internal control questionnaire and management's reply thereto
Audit programmes in force
Working papers of assistants and the reviewed remarks
Last year's accounts and auditor's report
Working trial balance
Adjusting entries affecting income statement and SOFP
Audit notes
Lists / statements / schedules, certificates and confirmations
Queries and the replies thereto, other correspondence to and from the client
Draft final accounts for the year
Draft auditor's report for the year
Management letter
Communication with experts

(b) Relating to each audit area

Risk assessment
Sampling plans
Audit programmes
Analytical review
Details of substantive tests and tests of control
Major observations and conclusions drawn

Audit documentation is generated at the time of gathering audit evidence. However, modifications are sometimes needed to the working papers, may be on account of errors in the original working papers, discovered at a future date. At such times, care needs to be taken to ensure that the document includes the circumstances which led to the change, the reasons for the change, the time and the persons involved in the change.

Audit files may be recorded on paper or through electronic or other media.

Example

Crispy Snacks Ltd is a partnership company. Its accounting is computerised. It is a reputable company and its range of snacks is well-known and popular. The sales are increasing day by day and it has a worldwide market.

Ashley also won the audit engagement of Crispy Snacks Ltd. Since it is his the first audit of Crispy Snacks Ltd he needs to set up both a permanent and current audit file. The audit team will obtain various documents from the entity for these files

In the permanent file:

- Partnership Deed
- Memorandum of Association
- Articles of Association
- Organisation chart, rules and policies
- List of directors
- Engagement letter.
- Internal control documentation

In the current file:

- Copies of letters concerning audit matters communicated to client
- Correspondence related to acceptance of annual appointment
- Audit plan and the audit programme
- Analysis of transactions and balances,
- Draft of financial statements and auditor's report

2.5 Differences between permanent and current audit file

Permanent audit file	Current audit file
The permanent file contains matters of continuing importance affecting the company or the audit. This generally has future or long term use.	The current file is broadly concerned with the accounts being audited or the current year's audit. This generally serves an immediate purpose.
The purpose of a permanent file is to preserve information which is useful to succeeding audits. For example information relating to the company's organisation structure would be included in this file. This facilitates easy review.	The purpose of a current file is to preserve information relating to the current year of audit: for example, queries and the replies there to and other correspondence to and from the client. This generally serves an immediate purpose. Therefore it facilitates easy review.
A permanent audit file generally contains the following papers: documents and other legal papers like extracts of various material agreements, extracts of minutes from the minutes books about the company and its personnel like managerial set-up with list of directors; executives and other officers functioning of the organisation like Internal control documentation final Processing like copy of approved SOPL and SOFP	A current audit file generally contains the following papers: matters relating to current year's audit like Audit programmes in force matters relating to each audit area like Risk assessment
Permanent files are useful for recurring audit engagements where the segregation of working papers into temporary and permanent is required.	Current files are useful for the audit of a single period as well as recurring audits ,

Test Yourself 2

What do you understand by standardisation of working papers? What are the benefits of standardisation?

Test Yourself 3

Can the auditor obtain and utilise working papers prepared by the client?

Answers to Test Yourself

Answer to TY 1

The auditors claim ownership and control on the grounds that the working papers are prepared by them, during the course of the audit. They have to keep these as evidence of their work and for that reason must be in possession of the papers for a reasonable time. It is argued by the auditors that the working papers belong to them because they act as independent contractors and not as agents of the client. Hence, they have a right to retain the working papers as if it was their property, even after being paid their audit fee in full.

Answer to TY 2

The standardisation of working papers involve use of standardised papers such as checklists, standard audit programs, specimen letters, consistently laid out schedules etc. The benefits of standardisation of working papers are:

- It improves the efficiency in preparation and review of working papers.
- It facilitates delegation of work.
- It provides a means to control the quality of audit work delegated to assistants.

Answer to TY 3

The auditor may obtain and utilise schedules, analysis and other working papers prepared by the client to improve the audit efficiency. However, the auditor should satisfy themselves that these working papers have been properly prepared, so that the financial statements prepared by them show a true and fair picture of the financial position of the company. For example, an auditor can use a copy of a client's bank reconciliation, but should independently verify, by reperformance, that it has been correctly prepared.

Self Examination Questions

Question 1

What is the rationale for maintaining both a permanent file and a current file for recurring audits?

Question 2

Which of the following options relating to working papers is correct?

A Working papers include information that is useful for past as well as future audits
B Oral explanation by auditor also forms a part of audit documentation
C Working papers may not be an effective way to discuss audit findings with management

Question 3

Audit documentation refers to:

A Records of audits for past years
B Records maintained by auditor regarding audit plan
C Records of audit procedures performed, relevant audit evidence obtained & the conclusions the auditor reached
D Records of relevant audit evidence obtained

Question 4

Which is not a type of working paper?

A Audit planning memorandum
B Organisational structure of the entity
C Copy of tax returns and tax processing
D Audit file

Question 5

Which of the following is not true for audit documentation?

A It allows a discussion on the audit findings with management
B It defines the objective and scope of the audit
C It records the conclusions drawn by the audit team
D It serves as a guidance factor for future auditors

Question 6

Which of the following statements show the need for and importance of audit documentation?

(i) It assists in planning and performing the audit
(ii) It is used by management for the decision making process
(iii) It helps in the supervision and review of the audit work
(iv) It serves as the best guide for a new auditor

A (i), (ii) and (iv)
B (ii), (iv)
C (i), (iii) and (iv)
D All of the above

Answers to Self Examination Questions

Answer to SEQ 1

It is very important to maintain a permanent and current file separately for recurring audits. Certain documents such as the Memorandum of Association or Articles of Association or Partnership Deed / Trust deed have continuing relevance not only for the current year's audit but for future years also. It may happen that assistants may take a document out of a previous year's file and put it in the current year's file. If the audit firm has been auditing the client for, say, 15 years, then to locate a document of continuing importance, they have to search the files for the last 15 years. In order to avoid this, documents of continuing importance beyond a particular year's audit are filed in a permanent file. Documents which are of relevance only to a particular period's audit will be filed in that period's current file.

Answer to SEQ 2

The correct option is **D**.

Option A is incorrect as working papers are useful for current and future audits.

Option B is incorrect as oral explanation by the auditor does not represent adequate support for work performed or conclusions reached by the auditor and is not audit documentation.

Option C is incorrect as working papers are an effective means by which the auditor is able to discuss major audit findings with management.

Answer to SEQ 3

The correct option is **C**.

Answer to SEQ 4

The correct option is **D.**

An audit file cannot be qualified as a working paper. An audit file is a file in which the working papers are stored. All the others are types of working papers.

Answer to SEQ 5

The correct option is **B.**

The objective and scope of the audit is defined in the engagement letter and not in the audit documentation. The rest of the sentences are true for audit documentation.

Answer to SEQ 6

The correct option is **C.**

Audit documentation belongs to the auditor and is for his reference. It is not used by management for the decision- making process.