

*Accounting Guideline 1*

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# Preparation and Presentation of Accounts from Incomplete Records



Hong Kong Institute of  
**Certified Public Accountants**  
香港會計師公會

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*Accounting Guidelines have effect as guidance statements and indicators of best practice. They are persuasive in intent. Although Accounting Guidelines are not mandatory on members of the Hong Kong Institute of Certified Public Accountants (HKICPA), they help define accounting practice in the particular area or sector to which they refer. Therefore, they should normally be followed and members of the HKICPA should be prepared to explain departures if called upon to do so.*

## **ACCOUNTING GUIDELINE 1**

### ***Preparation and Presentation of Accounts from Incomplete Records***

#### **Part 1 - Introduction**

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- 1 Accountants are all too often faced with the problem of preparing accounts from incomplete records. The following statement relates to the preparation and presentation of accounts from incomplete records and the submission of such accounts to third parties. The statement refers primarily to business undertakings, but may also be applicable in appropriate circumstances to the accounts of various types of non-trading concerns.
- 2 It is hoped that for those engaged in this type of work this statement may be useful as a summary of considerations which should be kept in mind when preparing accounts from incomplete records and of procedures which have been found helpful in practice.

#### **Part 2 - Definitions**

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- 3 *Incomplete records* means the state of affairs which exists when there is lacking some or all of the prime accounting information from which in the normal way the books of a business are written up and final accounts prepared. It is not, for instance, applicable where an adequate system exists for supplying the accountant with information in a suitable form for writing up his client's books or otherwise collating the essential information and subsequently preparing final accounts.

#### **Part 3 - Recommended Practice**

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- 4 The scope of the work undertaken by the accountant is governed by his client's instructions, unless the work involves the audit of the accounts of a limited company. Although the accountant is rarely required to audit accounts prepared from incomplete records, auditing procedures such as vouching and verification are employed as far as possible to ascertain basic information and ensure that items are properly treated in the accounts. The greater the extent to which these procedures are employed, the greater will be the reliability of the accounts and the degree of responsibility which the accountant may assume in respect of them.
- 5 When accepting new work involving incomplete records it is desirable to observe the normal professional precaution of confirming instructions in writing and defining the scope of the work to be carried out. Sometimes instructions are, however, necessarily vague because the scope of the work which can be performed cannot be determined until a detailed examination of the business and its records has been carried out. In this case it is desirable to report on the work done when submitting the accounts to the client or at some other suitable time.
- 6 Accounts prepared from incomplete records are normally required for a specific purpose, such as taxation, probate, negotiations for sale, or in support of requests for loans or bank overdrafts. Sometimes, however, they are put to uses other than those originally intended. Whatever the purpose for which the accounts are prepared or the use to which they may be put, the accountant's primary duty is towards his client and his main object in preparing the accounts is to show, so far as practicable in the circumstances, a true and fair view of the trading results for the period under review and of the state of affairs of the business at the close of the period.
- 7 The accountant may not know the eventual uses to which accounts may be put, or the extent to which they may be relied upon in the formation of opinions by third parties. It

is therefore most important that accounts should carry a statement clearly defining the extent of the accountant's responsibility for the figures, expressing any opinion which he has been able to form on their adequacy and noting any significant limitation to their reliability. The appropriate form of report is illustrated in the Auditing Guideline No. 3.330 "Audit report examples". It is always desirable, and where accounts are being submitted for tax purposes essential, to obtain the client's signature to the final accounts, as evidence that they have his approval.

- 8 On first being instructed to prepare accounts from incomplete records the accountant will be restricted to such information as his client can make available, or he himself can obtain, but at the same time he should endeavour to suggest improvements that will make his task in future lighter, by introducing some system, no matter how rudimentary, that will provide as much as possible of the basic information required. The essence of any proposed system must be simplicity, and its form will depend on the circumstances of the business and the willingness and ability of the proprietor to assist. Every effort should be made to persuade the client to improve his records, particularly those relating to cash receipts and payments, and it should be made clear that accounts prepared from incomplete records cannot be regarded as wholly reliable and must consequently be limited in value to the client. It is essential to stress the importance of keeping purchase invoices, copy sales invoices, receipted accounts, paid cheques (where available), cheque book counterfoils and bank paying-in books and statements. A common form of omission which clients should be asked to rectify is the failure to include sufficient detail on bank paying-in slips to identify the items concerned.

#### **Preparation of accounts from incomplete records**

- 9 The steps in the preparation of the accounts of a trading concern from incomplete records may be summarised as follows:
- (a) drawing up an opening balance sheet where one is not available;
  - (b) preparing summary cash and bank accounts;
  - (c) scheduling debtors and creditors;
  - (d) ascertaining, in consultation with the client, that the amount at which stock is to be stated appears reasonable, having regard to the nature of the trade and the circumstances of the business;
  - (e) making year end adjustments for provisions, transfers, etc.;
  - (f) preparing the final accounts from the information thus assembled.

#### **Summary cash and bank accounts**

- 10 Before beginning to build up and analyse the summary cash and bank accounts, it is important to obtain the client's assurance that he has made available all the requisite information pertaining to his business, and that no business receipts or expenses have been passed through other bank, deposit or petty cash accounts. Failing this, it is desirable to examine such other bank statements.
- 11 The adequacy of the final accounts depends largely on the care with which summary cash and bank accounts are prepared. Normally at least some records are available (bank statements, some vouchers, possibly a cash book) but by definition they will be incomplete because either (a) items have been recorded but are unexplained and unsupported, or (b) items have been wholly omitted.
- 12 Any unexplained items remaining after analysis of the bank statement require examination to determine whether they relate to private or business transactions and in the latter case whether these are capital or revenue. Payments into the bank should also be scrutinised to ensure that any non-trading receipts such as dividends, rents from private properties or capital items are segregated from trading items. Unusually large receipts or payments will generally stand out clearly from the normal level of trading items, and will prompt inquiry. They may be attributable, inter alia, to the

introduction of new capital, loans or the realisation of business assets, or, if they are outgoing, to loans, purchases of new equipment, or personal drawings.

- 13 In preparing the summary cash account the usual procedure is to attempt to reduce the likelihood of omissions by inquiring into those payments which are known to be of a recurring nature. Some are fixed or semi-fixed in amount and may be readily accounted for: rent, rates and insurance, for example, or in some businesses, wages and salaries. Other payments, while variable, are known to recur, and omissions may be remedied by inquiry or reasonable estimate. Thus inquiry can be made as to whether telephone, gas and electricity charges have been paid when due and properly accounted for, or whether a monthly account with a major supplier has been regularly discharged; if necessary it may be possible to obtain duplicate statements. By concentrating attention on cash outgoings (which will normally include payments on private account and drawings), assistance is often obtained in arriving at the figure for business takings where no record of these is available. Similar inquiries should be made so as to ensure that recurring income (such as rents receivable) is fully accounted for.
- 14 If after full inquiry any cash difference revealed by the foregoing procedure remains unexplained it is normally treated, in the absence of evidence to the contrary, as unrecorded sales in the case of a cash excess (that is, where cash disbursements exceed cash receipts) and as unrecorded disbursements in the case of a shortage. If there is nothing to indicate that any business outgoings have been omitted then the shortage would normally be dealt with as drawings. Before taking these steps, however, the unexplained difference should be fully discussed with the client and the effect of the proposed treatment made dear to him. The possibility should not be overlooked that even an immaterial difference may be the net result of material errors on both sides of the account. Thus a cash shortage of \$500 might represent the difference between unrecorded sales of \$7,500 and unrecorded drawings of \$8,000.

#### **Debtors and creditors**

- 15 In preparing schedules of debtors and creditors the accountant will draw on such evidence as is available, supported by personal observation and his knowledge of the client's business. Usually the client keeps some form of record of debtors and care should be taken to separate business from private debtors and guard against omissions. Reference to bankings and any record of cash receipts after the end of the client's accounting year may serve to indicate whether any material items have been omitted. In the same way the schedule of creditors may be drawn up or tested by reference to payments made after the year end. Comparison with the previous year's schedule, if available, may indicate whether a regular supplier's account has been omitted and past experience may be of assistance in suggesting creditors who would normally be expected at the year end or who are lax in presenting accounts. Information regarding prepayments and accruals should be noted so that the normal adjustments may be made in preparing the accounts.

#### **Stock and work in progress**

- 16 The amount at which stock and work in progress is to be stated in the accounts should be ascertained in the light of such supporting evidence as is available, the objects being to ascertain that it appears consistent with the circumstances of the business and to ensure that it is appropriately described in the accounts. Examination of the schedule of year end creditors may help to indicate material omissions or over-statements, and regard should be had to any relevant trade customs, such as the post-dating of invoices. In respect of business trading in stocks with a high unit value it is desirable, where possible, to prove the closing stock figure by reconciling unit purchases and sales for the period under review with opening stock. Consideration should be given by the accountant to attendance at stocktaking whilst it is in progress whenever practicable, and to the performance of such other tests as he may deem necessary. This is especially important where stock and work in progress is a material

factor in relation to the total assets of the business.

- 17 Particular inquiry should be made as to the basis used to arrive at the amount at which stock is stated. This should be appropriate to the circumstances of the business, and should be consistently applied from year to year.
- 18 Sometimes stocktaking is carried out by professional valuers. It may be advisable for the accountant to consult with the valuer to ascertain the treatment of items which present special problems, such as goods received but not invoiced at the stocktaking date and goods on sale or return.
- 19 The extent to which the amount at which stock is stated can be reasonably verified will determine its description in the accounts. The description should concisely indicate the basis used in arriving at the stock figure; for example, where it proves necessary to accept stock at an amount as estimated by the proprietor the narrative should make this clear.

### **Provisions, transfers and year end adjustments**

- 20 *Depreciation.* An adequate amount should be charged for the depreciation of fixed assets employed in the business.
- 21 *Taxation.* Various methods of dealing with tax in accounts prepared from incomplete records may be adopted, and the amount so charged should be disclosed separately in the drawings or capital account. Whatever treatment is adopted, it is important that the basis on which tax has been charged is made clear in the accounts, and that the client understands the liabilities pending and likely to arise on his current profits.
- 22 *Personal benefits from the business, etc.* A number of adjustments may have to be made before completing the final accounts in respect of such items as private accommodation in business premises, private use of car and private consumption of trading goods. Other transfers may involve charging the business a notional rent for the use of business premises owned by the proprietor or making a charge for the use of various private facilities provided by the trader. Where the relevant proportions have been agreed with the Inland Revenue Department it may be found convenient to adopt the same proportions in the accounts in order to avoid adjustments in the tax computation.
- 23 *Contra accounts.* In certain circumstances transactions may be settled by the exchange of goods, cash passing only to the extent of the difference in value. For example, it is common practice for motor vehicles to be purchased and sold on a part exchange basis. There may be no adequate record of such transactions, and the problem may be made more acute by the set-off of trading against private items. Where such transactions are known to be customary or probable the accountant should inquire into them and ensure that they are properly accounted for.

### **Critical review**

- 24 Once the final accounts have been prepared they should be subjected to a critical review, with the object of ensuring, so far as possible, that they present a true and fair view, the accountant bringing to bear his professional skill and judgement in reviewing the figures in the light of the circumstances of the business and his knowledge of the way it works.
- 25 It is normal procedure to make comparisons with previous years' figures and gross profit percentages; the latter should also be compared with such information as is available concerning other similar businesses. Variations do not necessarily indicate accounting inconsistencies, but should be inquired into until an adequate explanation has been obtained. If the nature of the business permits, a quantity reconciliation of stocks, purchases and sales should be made.

- 26 The capital account should also be scrutinised to see whether the drawings shown in it appear consistent with the client's circumstances (after allowing for other sources of income) and to ascertain the sources of any new capital introduced. It is usual to show separately such items as taxation, life assurance premiums, investment purchases and details of cash introduced. The treatment and description of such items will depend on the particular circumstances of each case.
- 27 Having completed his critical review, the accountant will probably have a number of queries arising on the draft accounts which will necessitate an interview with the client. It is important to discuss the accounts with the client to ensure that they accord with his knowledge of the facts, and the opportunity may be taken to draw attention to a number of less obvious points revealed by the accounts, which may prove of help to the client in directing his business and encourage him to recognise the practical use to which reliable accounts may be put.

### **Presentation**

- 28 Appropriate grouping, clarity, and conciseness of narrative are the main requirements. Particular care should be taken that estimated or approximate items are clearly described as such and that the treatment of significant special items, such as any material difference on the cash account, is made clear. In unsatisfactory cases it may be necessary to head the accounts 'Approximate'.

### **Capital computation method of estimating profits**

- 29 Sometimes records and information are so inadequate that it proves impossible to prepare accounts in the normal way. It may then be necessary to use the capital computation method to arrive at the estimated business profits. The net assets at the beginning and the end of each relevant financial period are compared, the difference indicating the variation in the client's business capital over the period. This figure is then adjusted to arrive at the profits of the business for the period, allowance being made for the amount of known or estimated outgoings of a non-trading nature: for example, drawings and other payments on private account such as holiday or medical expenses, salaries tax payments, etc. A contrary adjustment is made to eliminate receipts of a non-trading character such as income from private investments, legacies, moneys arising from the realisation of private assets, etc. The resulting figure will be the estimated business profits for the period under review. It is not practicable to adopt this method effectively without full information of the client's private affairs as well as those relating to his business.