

FINANCIAL ACCOUNTING

PART I

SECTION 1

**CPA
CIFA**

STUDY TEXT

RCM ONLINE COLLEGE 0719525000

SYLLABUS

PAPER NO 1: FINANCIAL ACCOUNTING

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to prepare financial statements for different entities

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Prepare books of original entry and basic ledger accounts under double entry system
- Prepare basic financial statements of sole traders, partnerships, companies and manufacturing entities and not for profit organisations
- Comply with the regulatory framework in the accounting field
- Account for assets and liabilities
- Analyse financial statements by use of ratios and statement of cash flows

CONTENT

1. Introduction to Accounting

- The nature and purpose of accounting
- Objectives of accounting
- Users of accounting information and their respective needs
- The accounting equation
- Regulatory framework of accounting (regulatory bodies such as ICPAK, IFAC, IASB, IPSAB)
- Accounting standards (IAS/IFRS), (Importance and limitations)
- Professional ethics
- Accounting concepts/principles
- Qualities of useful accounting information

2 Recording transactions

- Source documents (quotations_ purchases order, statement of account, remittance advice, receipts, petty cash vouchers_ sales and purchase invoices, credit notes and debit notes, bank statements)
- Books of original entry: sales journal, purchases journal, returns inward, returns outward journal, cashbook, petty cashbook and general journal
- Double entry and the ledger; general ledger, sales ledger, purchases ledger
- The trial balance
- Computerised accounting systems- Role of computers, application and accounting softwares in the accounting process, benefits and challenges of operating computerised accounting systems

3. Accounting for assets and liabilities

3.1 Assets

- Property, plant and equipment — recognition, capital and revenue expenditure, measurement (depreciation and revaluation), disposal and disclosures — property, plant and equipment schedule
- Intangible assets — recognition, measurement (amortisation, impairment and revaluation), disposals and disclosures
- Inventory - recognition, measurement and valuation using specific. cost method (FIFO and weighted average cost)
- Trade receivables - bad debts and allowance for doubtful debts and receivables control accounts
- Accrued income and prepaid expenses
- Cash at bank -- cashbook and bank reconciliation statement
- Cash in hand - cash book and petty cash book

3.2 Liabilities

- Bank overdraft - cash book and bank reconciliation
- Trade payables - payables control accounts
- Loans - accounting treatment of repayment of principal and interest
- Prepaid income and accrued expenses

4. Correction of errors and suspense account

5. Financial statements of a sole trader

- Income statement
- Statement of financial position
- Preparing financial statements under incomplete information

6. Financial statements of a partnership

- Partnership agreement
- Distinction between current and fixed capital
- Income statement
- Statement of financial position
- Changes in partnership – Admission of a new partner, retirement and change in profit sharing ratio

7. Financial statements of a company

- Types of share capital - ordinary shares and preference shares
- Issue of shares (exclude issue by instalment and forfeiture)
- Types of reserves — share premium, revaluation reserve, general reserves and retained profits
- Income tax -Accounting treatment and presentation (exclude computation)
- Financial statements - Income statement and statement of financial position
- Published financial statements (describe a complete set of published financial statements but not preparation)

8. Financial statements of a manufacturing entity

- Features of a manufacturing entity
- Classification and apportioning costs between manufacturing and selling and administration
- Financial statements - manufacturing account, income statement and statement of financial position

9. Financial statements of a not-for-profit organisation

- Features
- Types of funds and their accounting treatment
- Income and expenditure account
- Statement of financial position

10. Analysing financial statements

- Statement of cash flows (categories of cash, methods of preparing statement of cash flows and the importance)
- Financial ratios — definition, categories, analysis and interpretation, application and limitations

11. Introduction to public sector Accounting

- Features of public sector entities (as compared to private sector)
- Structure of the public sector (National and county governments: state corporations and other agencies)
- Regulatory structures and oversight [IPSASB, PSASB (establishment, mandate and functions), Director of Accounting Services, National Treasury, Parliamentary Committees. Accounting Officers at national and county levels]
- Objectives of public sector financial statements
- Objectives of IFSAS
- Accounting techniques in public sector (budgeting, cash, accrual: commitment and fund) (Preparation of financial statements should be excluded)

12. Emerging issues and trends

CONTENT	PAGE
Topic 1: Introduction to Accounting	6
Topic 2: Recording transactions	38
Topic 3: Accounting for assets and liabilities	89
Topic 4: Correction of errors and suspense account	153
Topic 5: Financial statements of a sole trader	166
Topic 6: Financial statements of a partnership	213
Topic 7: Financial statements of a company	253
Topic 8: Financial statements of a manufacturing entity	284
Topic 9: Financial statements of a not-for-profit organisation	301
Topic 10: Analysing financial statements	319
Topic 11: Introduction to public sector Accounting	351

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TOPIC 1

INTRODUCTION TO ACCOUNTING

NATURE AND PURPOSE OF ACCOUNTING

Accounting is considered the language of business. It has evolved throughout the years as information needs changed and became more complex. After finishing this article, the reader should be able to have a general understanding about accounting, be acquainted with the different definitions, know the different types of information found in accounting reports, and know the different uses of accounting information.

Some say that accounting is a **science** because it is a body of knowledge which has been systematically gathered, classified, and organized. It could be influenced by a lot of factors, specifically by economic, social and political events. Some say that accounting is an **art** because it requires creative skill and judgment. Furthermore, accounting is also considered as an **information system** because it is used to identify and measure economic activities, process the information into financial reports, and communicate these reports to the different users of accounting information.

To further understand what accounting is, we must take a look at the different definitions.

Accounting as a Science	Accounting as an Art	Accounting as an Information System
Accounting is the process of identifying, measuring, and communicating economic information to permit informed judgment and decisions by users of information.	Accounting is the art of recording (journalizing), classifying (posting to the ledger), summarizing in a significant manner and in terms of money, transactions and events which are, in part, at least of a financial character, and interpreting the results thereof to interested users.	Accounting is a service activity, which functions to provide quantitative information, primarily financial in nature, about economic entities that is intended to to be useful in making economic decisions.

The first definition emphasizes the following:

- **Identifying** - in accounting, this is the process of recognition or non-recognition of business activities as accountable events. Stated differently, this is the process which determines if an event has accounting relevance.
- **Measuring** - in accounting, this is the process of assigning monetary amounts to the accountable events.
- **Communicating** - As we could notice with the above definitions, one main similarity between the three is the impact of communication. In order to be useful, accounting information should be communicated to the different decision makers. Communicating accounting information is achieved by the presentation of different financial statements.

The second definition emphasizes the following:

- **Recording** - The accounting term for recording is journalizing. All the accountable events are recorded in a journal.
- **Classifying** - The accounting term for recording is posting. All accountable events that are recorded in the journal are then classified or posted to a ledger.
- **Summarizing** - the items that are journalized and posted are summarized in the five basic financial statements.

The third definition emphasizes that accounting is a service activity and that Information provided by accounting could be classified into 3 types:

- **Quantitative information** - this is information that is expressed in numbers, quantities or units
- **Qualitative information** - this is information that is expressed in words
- **Financial information** - this information is expressed in terms of money

Therefore, given the definitions, accounting is a service activity that is all about recording, classifying and summarizing accountable events in order to communicate quantitative, qualitative, and financial economic information, to different users in order to make relevant decisions.

OBJECTIVES OF ACCOUNTING

The objectives of accounting can be given as follows:

- **Systematic recording of transactions** - Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.
- **Ascertainment of results of above recorded transactions** - Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue exceeds expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.
- **Ascertainment of the financial position of the business** - Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.

- **Providing information to the users for rational decision-making** - Accounting like a language of commerce communicates the monetary results of a venture to a variety of stakeholders by means of financial reports. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.
- **To know the solvency position:** By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

USERS OF ACCOUNTING INFORMATION AND THEIR NEEDS

Users of accounting information could be divided into 7 major groups which could be easily be remembered using the acronym **GESCLIP**. This stands for Government, Employees, Suppliers (trade creditors), Customers/Clients/Consumers, Lenders, Investors, and Public. Let us then discuss each user and find out why they need accounting information.

1. **Government** – the government needs accounting information during its day-to-day operations. The government needs accounting information to assess the amount of tax to be paid by a business or an individual (like the Bureau of Internal Revenue or the Internal Revenue Service when assessing income tax, estate tax, donor's tax or other taxes); accounting information is needed when determining the fees to be charged in acquiring a business permit or a mayor's permit; when the Securities and Exchange Commission determines the legality of the amount of share capital subscribed, accounting information is used; when the government deals with certain economic problems like inflation, still accounting information is used. Of course, this list could go on and on.
2. **Employees** – if you are an employee working in the accounting, finance or sales department, definitely, accounting information is essential. However, the use of accounting information is not delimited to employee working under accounting related departments. Employees need accounting information to know if the business could provide the necessary benefits that is due to them. Through accounting information, employees would not be in the dark with regards to the operations of the firm that they are working for.
3. **Suppliers and Other Trade Creditors** – suppliers and trade creditors are providers of merchandise on account to different business establishments. Some examples of suppliers are Coca-Cola and Pepsi. Coca-Cola and Pepsi products that are sold to different fast-food chains and supermarkets but are not paid in cash immediately. Before extending credit to customers, Coca-Cola and Pepsi should look into the accounting records of an entity to determine if they would sell their products on account or not. Telecommunication providers like Smart Telecom, Globe, and At&t, could also be considered as suppliers. Before getting a plan from these telecommunication providers, they ask for different proofs of income from the clients availing of a plan. This is because suppliers could determine from the accounting information if a business or an individual has the ability to pay accounts on time.
4. **Customers/Clients/Consumers** - Customers need accounting information in order to determine the continuity of a business, most especially when there is a long-term engagement between the parties or if the customer is dependent on the enterprise. For instance, students

have to go to a financially stable school that could continue to provide quality education until they graduate. Through accounting information, customers could also check if prices that are being charged are reasonable. Students could look into the financial statements of a school and determine if they are being charged the right tuition fees.

5. **Lenders** - Lenders have similar needs as suppliers wherein they interested in accounting information that enable them to determine the ability of a client to pay their obligations and the interest attached when the loan becomes due. However, in contrast to suppliers, lenders are providers of money (like banks or lending institutions) while suppliers are providers of tangible goods.
6. **Investors and Businessmen** - Investors need accounting information in order to make relevant decisions. Through accounting information, they could determine whether to purchase stocks, sell stocks or hold the stock. Businessmen could determine which operations to continue or discontinue, which product line is profitable, and many more. They need to know about the financial performance, position, and cash flows of a business.
7. **Public** - All of us need accounting information. We want to know the status of the economy, we want to know what is happening with our favorite fast food chains, we want to know the status of retirement plants, families need to budget their money, monitor receipts and disbursements, and many more.

ACCOUNTING EQUATION

The accounting equation, also called the basic accounting equation, forms the foundation for all accounting systems. In fact, the entire double entry accounting concept is based on the basic accounting equation. This simple equation illustrates two facts about a company: what it owns and what it owes.

The accounting equation equates a company's assets to its liabilities and equity. This shows all company assets are acquired by either debt or equity financing. For example, when a company is started, its assets are first purchased with either cash the company received from loans or cash the company received from investors. Thus, all of the company's assets stem from either creditors or investors i.e. liabilities and equity.

Here is the basic accounting equation.

Accounting Equation				
Assets	=	Liabilities	+	Equity

As you can see, assets equal the sum of liabilities and owner's equity(Capital). This makes sense when you think about it because liabilities and equity are essentially just sources of funding for companies to purchase assets.

The equation is generally written with liabilities appearing before owner's equity because creditors usually have to be repaid before investors in a bankruptcy. In this sense, the liabilities are considered

more current than the equity. This is consistent with financial reporting where current assets and liabilities are always reported before long-term assets and liabilities.

This equation holds true for all business activities and transactions. Assets will always equal liabilities and owner's equity. If assets increase, either liabilities or owner's equity must increase to balance out the equation. The opposite is true if liabilities or equity increase.

Now that we have a basic understanding of the equation, let's take a look at each accounting equation component starting with the assets.

Assets

An asset is a resource that is owned or controlled by the company to be used for future benefits. Some assets are tangible like cash while others are theoretical or intangible like goodwill or copyrights.

Another common asset is a receivable. This is a promise to be paid from another party. Receivables arise when a company provides a service or sells a product to someone on credit.

All of these assets are resources that a company can use for future benefits. Here are some common examples of assets:

- Cash
- Accounts Receivable
- Prepaid Expenses
- Vehicles
- Buildings
- Goodwill
- Copyrights
- Patents

Liabilities

A liability, in its simplest terms, is an amount of money owed to another person or organization. Said a different way, liabilities are creditors' claims on company assets because this is the amount of assets creditors would own if the company liquidated.

A common form of liability is a payable. Payables are the opposite of receivables. When a company purchases goods or services from other companies on credit, a payable is recorded to show that the company promises to pay the other companies for their assets.

Here are some examples of some of the most common liabilities:

- Accounts payable
- Bank loans
- Lines of Credit
- Personal Loans
- Officer Loans
- Unearned income

Equity (Capital)

Equity represents the portion of company assets that shareholders or partners own. In other words, the shareholders or partners own the remainder of assets once all of the liabilities are paid off.

Owners can increase their ownership share by contributing money to the company or decrease equity by withdrawing company funds. Likewise, revenues increase equity while expenses decrease equity.

Here are some common equity accounts:

- Owner's Capital
- Owner's Withdrawals
- Revenues
- Expenses
- Common stock
- Paid-In Capital

Example

Let's take a look at the formation of a company to illustrate how the accounting equation works in a business situation.

Ted is an entrepreneur who wants to start a company selling speakers for car stereo systems. After saving up money for a year, Ted decides it is time to officially start his business. He forms Speakers, Inc. and contributes \$100,000 to the company in exchange for all of its newly issued shares. This business transaction increases company cash and increases equity by the same amount.

Accounting Equation				
\$100,000 ↑				\$100,000 ↑
Assets	=	Liabilities	+	Equity

After the company formation, Speakers, Inc. needs to buy some equipment for installing speakers, so it purchases \$20,000 of installation equipment from a manufacturer for cash. In this case, Speakers, Inc. uses its cash to buy another asset, so the asset account is decreased from the disbursement of cash and increased by the addition of installation equipment.

Accounting Equation				
\$20,000 ↓		\$20,000 ↑		
Assets	=	Liabilities	+	Equity

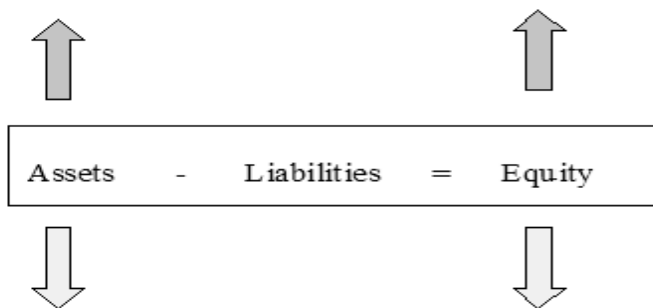
After six months, Speakers, Inc. is growing rapidly and needs to find a new place of business. Ted decides it makes the most financial sense for Speakers, Inc. to buy a building. Since Speakers, Inc. doesn't have \$500,000 in cash to pay for a building, it must take out a loan. Speakers, Inc. purchases a \$500,000 building by paying \$100,000 in cash and taking out a \$400,000 mortgage. This business transaction decreases assets by the \$100,000 of cash disbursed, increases assets by the new \$500,000 building, and increases liabilities by the new \$400,000 mortgage.

Accounting Equation				
\$100,000	\$500,000		\$400,000	
↓	↑		↑	
Assets	=	Liabilities	+	Equity

As you can see, all of these transactions always balance out the accounting equation. This is one of the fundamental rules of accounting. The accounting equation can never be out of balance. Assets will always equal liabilities and owner's equity.

Transactions that affect Assets and Equity of the entity

These transactions result in the increase in Assets and Equity of the entity simultaneously. Conversely, the transactions may cause a decrease in both Assets and Equity of the entity.



Any increase in the assets will be matched by an equal increase in equity and vice versa causing the Accounting Equation to balance after the transactions are incorporated.

Example 1

ABC LTD issues share capital for \$2,500 in cash

Before Transaction: Assets \$10,000 - Liabilities \$5,000 = Equity \$5,000

After Transaction: Assets \$12,500* - Liabilities \$5,000 = Equity \$7,500*

*Assets \$12,500 = \$10,000 Plus \$2,500 (Cash)

*Equity \$7,500 = \$5,000 Plus \$2,500 (Share Capital)

7 500=5 000+2 500

Example 2

ABC LTD pays dividend of \$500 in cash.

Before Transaction: Assets \$10,000 - Liabilities \$5,000 = Equity \$5,000

Vertical format

Name of business
Balance sheet as 31st December 20xx

	Sh	sh
Non-Current Assets:		
Land and buildings		xxx
Plant and machinery		xxx
Fixtures, furniture and fittings		xxx
Motor vehicle		xxx
Current assets:		
Stocks	xxx	
Debtors	xxx	
Cash at Bank	xxx	
Cash in hand	<u>xxx</u>	<u>xxx</u>
Total assets		<u>xxx</u>
Capital		xxx
Non-current liabilities		
Loan		xxx
Current liabilities		
Overdraft		xxx
Creditors		<u>xxx</u>
		xxx

Non-current assets are listed in order of performance as shown i.e. from land and buildings to motor vehicles. The current assets are listed in order of liquidity i.e. which assets is far from being converted into cash. Example, stock is not yet sold, (i.e. not yet realized yet) then when it is sold we either get cash or a debtor (if sold on credit). When the debtor pays then the debtor may pay by cheque (cash has to be banked) or cash.

The current liabilities are listed in order of payment i.e. which is due for payment first. Bank overdraft is payable on demand by the bank, then by creditors

Illustration 1

Kamau has a business that has been trading for some time. You are given the following information as 31.12.2014

	Sh “000”
Building	22 000
Furniture	11 000
Motor vehicle	11 600
Stocks	17 000
Debtors	11 200
Cash at bank	3 000
Cash in hand	800
Creditors	5 000
Capital	61 600
Loan	10 000

You are required to prepare a balance sheet as at 31 December 2014

Solution

Kamau
Balance sheet as 31st December 2014

	Sh “000”	Sh “000”
Non-Current Assets:		
Buildings		22 000
Furniture and fittings		11 000
Motor vehicles		<u>11 600</u>
		44 600
Current assets:		
Stocks		
Debtors	17 000	
Cash at Bank	11 200	
Cash in hand	3 000	
Total assets	<u>800</u>	<u>32 000</u>
		<u>76 600</u>
Capital		61 600
Non-Current liabilities		
Loan	10 000	
Current liabilities		
Creditors	<u>5 000</u>	<u>15 000</u>
		<u>76 600</u>

Illustration 2

D Mwangi has the following assets and liabilities as on 31 April 2012:

	Sh.
Creditors	15,800
Equipment	46,000
Motor Vehicle	25,160
Stock	24,600
Debtors	23,080
Cash at bank	29,120
Cash in hand	160

During the first week of May 2012 Mwangi:

- Bought extra equipment on credit for Sh5,520.
- Bought extra stock by cheque Sh 2,280.
- Paid creditors by cheque Sh 3,160.
- Debtors paid Sh 3,360 by cheque and Sh 240 by cash.
- Mwangi put in extra Sh 1,000 cash as capital.

Required:

- Determine the capital as at 1st May 2012.
- Draw up a balance sheet after the above transactions have been completed.

Solution

Using the accounting equation of Assets = Liabilities + Capital, then assets and liabilities can be listed as follows

	Sh
Assets	
Equipment	46,000
Motor Vehicle	25,160
Stock	24,600
Debtors	23,080
Cash at bank	29,120
Cash in hand	160
	<u>148 120</u>
Liabilities	
Creditors	15,800

Capital = Assets - Liabilities

= Sh 148,120 - Sh 15,800

= Sh 132,320

- To draw up the balance sheet, we consider the effect of the above transactions on the relevant balances:

- Buying extra equipment means that the equipment balance will increase by Sh 5,520 and the creditors will also increase by the same amount.
- Buying extra stock by cheque means that the level of stock goes up by Sh 2,280 and the balance at bank reduces by the same.
- Paying creditors by cheque reduces the balance on the creditors account and also reduce the amount at the bank.
- Debtor paying the firm reduces the debtors balance by Sh 3,600 and increases the cash at bank and cash in hand by Sh 3,360 and Sh 240 respectively.
- Additional cash of Sh 1,000 increases the cash in hand balance by Sh 1,000 and the capital balances.

This is also summarized as follows:

Assets/Liabilities	Opening Balance	Adjustment Increase / Decrease	Closing Balance
Equipment	46,000	5,520	51,520
Motor Vehicle	25,160		25,160
Stock	24,600	2,280	26,880
Debtors	23,080	-3,600	19,480
Cash at bank	29,120	(-2,280 - 3,160 + 3,360)	27,040
Cash in hand	160	(+240 + 1000)	1,400
Creditors	15,800	(+5,520 - 3,160)	18,160
Capital	132,320	1,000	133,320

The balance sheet will therefore be prepared as follows:

Mwangi
Balance sheet as at 1st May 2012

	Sh	Sh
Non-Current Assets		
Equipment		51,520
Motor vehicle		25,160
		<u>76,680</u>
Current Assets		
Stock	26,880	
Debtors	19,480	
Cash at bank	27,040	
Cash in hand	<u>1,400</u>	<u>74 800</u>
		<u>151,480</u>
Current Liabilities		
Creditors		18,160
Capital		<u>133,320</u>
		<u>151,480</u>

REGULATORY FRAMEWORK OF ACCOUNTING

INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANT (ICPAK)

The Institute of Certified Public Accountants of Kenya (**ICPAK**) was established in 1978. The Institute is a member of the Pan-African Federation of Accountants (PAFA) and the International Federation of Accountants (IFAC), the global umbrella body for the accountancy profession. The Vision of the Institute is *‘A world class professional accountancy institute’*, while the Mission is *‘To develop and promote internationally recognised accountancy profession that upholds public interest through effective regulation, research and innovation’*.

The Institute is guided by the following core values: **Credibility, Professionalism and Accountability**. The Institute draws its mandate from the **Accountants Act (no 15 of 2008)**.

Its mandate includes:

The Accountants Act No 15, 2008 prescribes the following as the functions of the Institute:

- To promote standards of professional competence and practice amongst members of the Institute
- To promote research into the subject of accountancy and finance and related matters, and the publication of books, periodicals, journals and articles in connection therewith;
- To promote the international recognition of the Institute.
- To advise the Examination Board on matters relating to examinations standards and policies;
- To advise the Minister on matters relating to financial accountability in all sectors of the economy;
- To carry out any other functions prescribed for it under any of the other provisions of this Act or any other written law and
- To do anything incidental or conducive to the performance of any of the preceding functions.

The International Federation of Accountants (IFAC)

The International Federation of Accountants (IFAC) was founded on 7 October 1977, in Munich, Germany, at the 11th World Congress of Accountants. IFAC comprises 179 member and associate member organisations in 130 countries, representing more than 2.5 million accountants in public practice, education, government service, industry, and commerce.

IFAC has established the following boards. We maintain separate pages for each board, with a history of developments for each board:

Body	Function
International Public Sector Accounting Standards Board (IPSASB)	Sets International Public Sector Accounting Standards (IPSAS) for use by the public sector
International Auditing and Assurance Standards Board (IAASB)	Sets International Standards on Auditing, Assurance Engagements and Related Services
International Accounting Education Standards Board (IAESB)	Develops International Education Standards
International Ethics Standards Board for Accountants (IESBA)	Develops the international <i>Code of Ethics for Professional Accountants</i>
Public Interest Oversight Board (PIOB)	Oversees IFAC's standard-setting activities, particularly with respect to auditing, assurance, ethics, and independence. The PIOB also oversees IFAC's compliance activities.

IFAC also supports the IASB with respect to setting accounting standards.

The International Accounting Standards Board (IASB)

The International Accounting Standards Board (IASB) is an independent, private-sector body that develops and approves International Financial Reporting Standards (IFRSs). The IASB operates under the oversight of the IFRS Foundation. The IASB was formed in 2001 to replace the International Accounting Standards Committee. Currently, the IASB has 14 members.

The IASB's role

Under the IFRS Foundation Constitution, the IASB has complete responsibility for all technical matters of the IFRS Foundation including:

- Full discretion in developing and pursuing its technical agenda, subject to certain consultation requirements with the Trustees and the public
- The preparation and issuing of IFRSs (other than Interpretations) and exposure drafts, following the due process stipulated in the Constitution
- The approval and issuing of Interpretations developed by the IFRS Interpretations Committee

ACCOUNTING STANDARDS (IMPORTANCE AND LIMITATION)

Accounting standards is a set of standards, guidelines and procedures that are used when accounting for the affairs of most governmental and non-governmental bodies. The interpretation of numbers and the wherewithal to place them in the proper context are at the heart of accounting. Standards exist to ensure that accounting decisions are made in a unified and reasonable way.

The objective of setting standards is to bring about uniformity in financial reporting and to ensure consistency in the data published by enterprises. For accounting standards, to be useful tool to enhance the corporate governance and responsibility, two criteria must be satisfied, i.e.

- i. A standard must provide a generally understood and accepted measure of the phenomena of concern.
- ii. A standard should significantly reduce the amount of manipulation of the reported numbers and is likely to occur in the absence of the standards.

Accounting standards facilities uniform preparation and reporting of general purpose financial statements published annually for the benefit of shareholders, creditors, employee and public at large. They are very useful to the investors and other external groups in assessing the progress and prospects of alternative investments in different companies in different countries.

Accounting standards can be seen as providing an important mechanism to help in the resolution of potential financial conflicts of interest between the various important groups in society. It is essential that accounting standards should command the greatest possible credibility among shareholders, creditors, employee and public at large.

Their important can be summarized as follows:

Comparability

Paramount to the role of accounting standards is the universality that it brings to financial record keeping. Governmental organizations must follow accounting procedures that are the same as their counterparts, and non-governmental organizations must do the same. The result is that it is easy to compare the financial standing of similar entities. All comparisons within groups are a matter of comparing "apples to apples." This helps both external and internal observers weigh the state of an entity in the context of other comparable entities. For instance, the financial standing of a town can be measured against a neighboring town with the assumption that the pertinent numbers have been reached in a similar fashion.

Transparency

Accounting standards are designed to enforce transparency in organizations. The principles, procedures and standards that make up the generally accepted accounting principles were chosen with the purpose of ensuring that organizations lean in the direction of openness when deciding how to provide information to observers. This kind of transparency is especially important in the case of public entities, such as governments or publicly traded companies. Standards limit the freedom and flexibility of entities to use clever accounting to move items around or even to hide them.

Relevance

Standards work to help entities provide the most relevant information in the most reasonable way possible. In this way, an organization guided by accounting standards will generate the kind of financial information that observers are most interested in examining. Entities ultimately should provide information in a way that most fairly and clearly represents the current financial standing of the operation. The standards make it more difficult for organizations to misdirect observers and to fool them with data that does not have sufficient relevancy.

Audiences

Ultimately, the importance of accounting standards lies in the value that it brings to financial documents for the various audiences that view and make critical decisions based on it. An absence of accounting standards would make the work of investors, regulators, taxpayers, reporters and others more difficult and more risky. For instance, without standards, an investor who has studied the financial statements of a large publicly traded company would not know whether to trust the findings on those statements. Standards mean that taxpayers can see how their tax dollars are being spent, and regulators can ensure that laws are followed.

Limitations of accounting standards

- i. Alternative solutions to certain accounting problems may each have arguments to recommend them. Therefore, the choice between different alternative accounting treatments may become difficult.
- ii. There may be a trend towards rigidity and away from flexibility in applying the accounting standards.
- iii. Accounting standards cannot override the statute. The standards are required to be framed within the ambit of prevailing statutes.

PROFESSIONAL ETHICS

A professional accountant is required to comply with the following fundamental principles:

a. Integrity

A professional accountant should be straight forward and honest in all professional and business relationships.

b. Objectivity

A professional accountant should not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

c. Professional Competence and Due Care

A professional accountant has a continuing duty to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. A professional accountant should act

diligently and in accordance with applicable technical and professional standards when providing professional services.

d. Confidentiality

A professional accountant should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose.

Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the professional accountant or third parties.

e. Professional Behaviour

A professional accountant should comply with relevant laws and regulations and should avoid any action that discredits the profession.

ACCOUNTING CONCEPT/PRINCIPLES

Accounting Concepts and Principles are a set of broad conventions that have been devised to provide a basic framework for financial reporting. As financial reporting involves significant professional judgments by accountants, these concepts and principles ensure that the users of financial information are not misled by the adoption of accounting policies and practices that go against the spirit of the accountancy profession. Accountants must therefore actively consider whether the accounting treatments adopted are consistent with the accounting concepts and principles.

In order to ensure application of the accounting concepts and principles, major accounting standard-setting bodies have incorporated them into their reporting frameworks such as the IASB Framework.

Following is a list of the major accounting concepts and principles:

- Relevance
- Reliability
- Matching Concept
- Timeliness
- Neutrality
- Faithful Representation
- Prudence
- Completeness
- Single Economic Entity Concept
- Money Measurement Concept
- Comparability/Consistency
- Understandability
- Materiality
- Going Concern
- Accruals
- Business Entity
- Substance over Form

- Realization Concept
- Duality Concept

In case where application of one accounting concept or principle leads to a conflict with another accounting concept or principle, accountants must consider what is best for the users of the financial information. An example of such a case would be the trade off between relevance and reliability. Information is more relevant if it is disclosed timely. However, it may take more time to gather reliable information. Whether reliability of information may be compromised to ensure relevance of information is a matter of judgment that ought to be considered in the interest of the users of the financial information.

Relevance:

Information should be relevant to the decision making needs of the user. Information is relevant if it helps users of the financial statements in predicting future trends of the business (Predictive Value) or confirming or correcting any past predictions they have made (Confirmatory Value). Same piece of information which assists users in confirming their past predictions may also be helpful in forming future forecasts.

Example:

A company discloses an increase in Earnings Per Share (EPS) from \$5 to \$6 since the last reporting period. The information is relevant to investors as it may assist them in confirming their past predictions regarding the profitability of the company and will also help them in forecasting future trend in the earnings of the company.

Relevance is affected by the materiality of information contained in the financial statements because only material information influences the economic decisions of its users.

Reliability

Information is reliable if a user can depend upon it to be materially accurate and if it faithfully represents the information that it purports to present. Significant misstatements or omissions in financial statements reduce the reliability of information contained in them.

Example:

A company is being sued for damages by a rival firm, settlement of which could threaten the financial stability of the company. Non-disclosure of this information would render the financial statements unreliable for its users.

Reliability of financial information is enhanced by the use of following accounting concepts and principles:

1. Neutrality
2. Faithful Representation
3. Prudence
4. Completeness
5. Single Economic Entity Concept

Neutrality

Information contained in the financial statements attempting to present them in a favored light. Information may be deliberately biased or systematically biased.

Deliberate bias

Deliberate bias: Occurs where circumstances and conditions cause management to intentionally misstate the financial statements.

Examples:

- Managers of a company are provided bonus on the basis of reported profit. This might tempt management to adopt accounting policies that result in higher profits rather than those that better reflect the company's performance inline with GAAP.
- A company is facing serious liquidity problems. Management may decide to window dress the financial statements in a manner that improves the company's current ratios in order to hide the gravity of the situation.
- A company is facing litigation. Although reasonable estimate of the amount of possible settlement could be made, management decides to disclose its inability to measure the potential liability with sufficient reliability.

Systematic bias

Systematic bias: Occurs where accounting systems have developed an inherent tendency of favoring one outcome over the other over time.

Examples:

Accounting policies within an organization may be overly prudent because of cultural influence of an over cautious leadership.

Faithful Representation

Information presented in the financial statements should faithfully represent the transaction and events that occur during a period.

Faithful representation requires that transactions and events should be accounted for in a manner that represents their true economic substance rather than the mere legal form. This concept is known as Substance Over Form.

Substance over form requires that if substance of transaction differs from its legal form then such transaction should be accounted for in accordance with its substance and economic reality.

The rationale behind this is that financial information contained in the financial statements should represent the business essence of transactions and events not merely their legal aspects in order to present a true and fair view.

Example:

A machine is leased to Company A for the entire duration of its useful life. Although Company A is not the legal owner of the machine, it may be recognized as an asset in its balance sheet since the Company has control over the economic benefits that would be derived from the use of the asset. This is an application of the accountancy concept of substance over legal form, where economic substance of a transaction takes precedence over its legal aspects.

Prudence

Preparation of financial statements requires the use of professional judgment in the adoption of accountancy policies and estimates. Prudence requires that accountants should exercise a degree of caution in the adoption of policies and significant estimates such that the assets and income of the entity are not overstated whereas liability and expenses are not understated.

The rationale behind prudence is that a company should not recognize an asset at a value that is higher than the amount which is expected to be recovered from its sale or use. Conversely, liabilities of an entity should not be presented below the amount that is likely to be paid in its respect in the future.

Example:

Inventory is recorded at the lower of cost or net realizable value (NRV) rather than the expected selling price. This ensures profit on the sale of inventory is only realized when the actual sale takes place.

However, prudence does not require management to deliberately overstate its liabilities and expenses or understate its assets and income. The application of prudence should eliminate bias from financial statements but its application should not reduce the reliability of the information.

Completeness

Reliability of information contained in the financial statements is achieved only if complete financial information is provided relevant to the business and financial decision making needs of the users. Therefore, information must be complete in all material respects.

Incomplete information reduces not only the relevance of the financial statements, it also decreases its reliability since users will be basing their decisions on information which only presents a partial view of the affairs of the entity.

Single Economic Entity Concept Consolidation Accounting

Consolidated financial statements of a group of companies are prepared on the basis of **single economic entity concept**.

Single Economic Entity Concept suggests that companies associated with each other through the virtue of common control operate as a single economic unit and therefore the consolidated financial statements of a group of companies should reflect the essence of such arrangement.

Consolidated financial statements of a group of companies must be prepared as if the entire group constitutes a single entity in order to avoid the misrepresentation of the scale of group's activities.

It is therefore necessary to eliminate the effects of any inter-company transactions and balances during the consolidation of group accounts such as the following:

- Inter-company sales and purchases

- Inter-company payables and receivables
- Inter-company payments such as dividends, royalties & head office charges

Inter-company transactions must be eliminated as if the transactions had not occurred in the first place. Examples of adjustments that may be required to eliminate the effects of inter-company transactions include:

- Elimination of unrealized profit or loss on the sale of assets member companies of a group
- Elimination of excess or deficit depreciation expense in respect of a fixed asset purchased from a member company at a price that was higher or lower than the net book value of the asset in the books of the seller.

Money Measurement Concept in Accounting

Definition

Money Measurement Concept in accounting, also known as Measurability Concept, means that only transactions and events that are capable of being measured in monetary terms are recognized in the financial statements.

Explanation

All transactions and events recorded in the financial statements must be reduced to a unit of monetary currency. Where it is not possible to assign a reliable monetary value to a transaction or event, it shall not be recorded in the financial statements.

However, any material transactions and events that are not recorded for failing to meet the measurability criteria might need be disclosed in the supplementary notes of financial statements to assist the users in gaining a better understanding of the financial performance and position of the entity.

Recognition Criteria

The recognition criteria defined by IASB and FASB require that the elements of financial statements (i.e. assets, liabilities, income and expense) must only be recognized in the financial statements if its cost or value can be measured with sufficient reliability. Therefore, an entity shall not recognize an element of financial statement unless a reliable value can be assigned to it.

Examples of Application

- Skills and competence of employees cannot be attributed an objective monetary value and should therefore not be recognized as assets in the balance sheet. However, those transactions related to employees that can be measured reliably such as salaries expense and pension obligations are recognized in the financial statements.
- Where it is not possible to measure reliably the amount of settlement of a legal claim against the company, no liability is recognized in the financial statements. Instead, the nature and circumstances surrounding the lawsuit are disclosed in the supplementary notes to the financial statements if considered material.
- IAS 38 *Intangible Assets* -require that **internally** generated goodwill shall not be recognized as an asset in the balance sheet. This is due to the difficulty in identifying and measuring the

cost of internally generated goodwill as distinct from the cost of running the day to day operations of the business.

However, IFRS 3 *Business Combinations* permit **purchased** goodwill to be recognized as an asset in the financial statements since the cost of purchased goodwill is usually determinable objectively as the amount of consideration paid in excess of the value of other identifiable assets of the acquired business.

Matching Principle & Concept

Matching Principle requires that expenses incurred by an organization must be charged to the income statement in the accounting period in which the revenue, to which those expenses relate, is earned.

Examples of the use of matching principle in IFRS and GAAP include the following:

- **Deferred Taxation**

IAS 12 Income Taxes and FAS 109 Accounting for Income Taxes require the accounting for taxable and deductible temporary differences arising in the calculation of income tax in a manner that results in the matching of tax expense with the accounting profit earned during a period.

- **Cost of Goods Sold**

The cost incurred in the manufacture or procurement of inventory is charged to the income statement of the accounting period in which the inventory is sold. Therefore, any inventory remaining unsold at the end of an accounting period is excluded from the computation of cost of goods sold.

- **Government Grants**

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance requires the recognition of grants as income over the accounting periods in which the related costs (that were intended to be compensated by the grant) are incurred by the entity.

Matching Vs Accruals Vs Cash Basis

In the accounting community, the expressions 'matching principle' and 'accruals basis of accounting' are often used interchangeably. Accruals basis of accounting requires recognition of income and expenses in the accounting periods to which they relate rather than on cash basis. Accruals basis of accounting is therefore similar to the matching principle in that both tend to dissolve the use of cash basis of accounting.

However, the matching principle is a further refinement of the accruals concept. For example, accruals basis of accounting requires the recognition of the estimated tax expense in the current accounting period even though the actual settlement of the provision may occur in the subsequent period. However, matching principle would also necessitate the recognition of deferred tax in the accounting periods in which the temporary differences arise so as to 'match' the accounting profits with the tax charge recognized in the accounting period to the extent of the temporary differences

Timeliness of Accounting Information

Timeliness principle in accounting refers to the need for accounting information to be presented to the users in time to fulfill their decision making needs.

Timeliness of accounting information is highly desirable since information that is presented timely is generally more relevant to users while conversely, delay in provision of information tends to render it less relevant to the decision making needs of the users. Timeliness principle is therefore closely related to the relevance principle.

Timeliness is important to protect the users of accounting information from basing their decisions on outdated information. Imagine the problem that could arise if a company was to issue its financial statements to the public after 12 months of the accounting period. The users of the financial statements, such as potential investors, would probably find it hard to assess whether the present financial circumstances of the company have changed drastically from those reflected in the financial statements.

Examples

Users of accounting information must be provided financial statements on a timely basis to ensure that their financial decisions are based on up to date information. This can be achieved by reporting the financial performance of companies with sufficient regularity (e.g. quarterly, half yearly or annual) depending on the size and complexity of the business operations. Unreasonable delay in reporting accounting information to users must also be avoided.

In several jurisdictions, regulatory authorities (e.g. stock exchange commission) tend to impose restrictions on the maximum number of days that companies may take to issue financial statements to the public.

Timeliness of accounting information is also emphasized in IAS 10 Events After the Reporting Period which requires entities to report all significant post balance sheet events that occur up to the date when the financial statements are authorized for issue. This ensures that users are made aware of any material transactions and events that occur after the reporting period when the financial statements are being issued rather than having to wait for the next set of financial statements for such information.

Timeliness Vs Reliability - A Conflict

Whereas timely presentation of accounting information is highly desirable, it may conflict with the objective to present reliable information. This is because producing reliable and accurate information may take more time but the delay in provision of accounting information may make it less relevant to users. Therefore, it is necessary that an appropriate balance is achieved between the timeliness and reliability of accounting information.

Substance Over Legal Form

Substance over form is an accounting concept which means that the *economic substance* of transactions and events must be recorded in the financial statements rather than just their *legal form* in order to present a true and fair view of the affairs of the entity.

Substance over form concept entails the use of judgment on the part of the preparers of the financial statements in order for them to derive the business sense from the transactions and events and to present them in a manner that best reflects their true essence. Whereas legal aspects of transactions and events are of great importance, they may have to be disregarded at times in order to provide more useful and relevant information to the users of financial statements.

Example:

There is widespread use of substance over form concept in accounting. Following are examples of the application of the concept in the International Financial Reporting Standards (IFRS).

- IAS 17 *Leases* requires the preparers of financial statements to consider the substance of lease arrangements when determining the type of lease for accounting purposes.
For example, an asset may be leased to a lessee without the transfer of legal title at the end of the lease term. Such a lease may, in substance, be considered as a finance lease if for instance the lease term is substantially for entire useful life of the asset or the lease agreement entitles the lessee to purchase the asset at the end of the lease term at a very nominal price and it is very likely that such option will be exercised by the lessee in the given circumstances.
- IAS 18 *Revenue* requires accountants to consider the economic substance of the sale agreements while determining whether a sale has occurred or not.
For example, an entity may agree to sell inventory to someone and buy back the same inventory after a specified time at an inflated price that is planned to compensate the seller for the time value of money. On paper, the sale and buy back may be deemed as two different transactions which should be dealt with as such for accounting purposes i.e. recording the sale and (subsequently) purchase. However, the economic reality of the transactions is that no sale has in fact occurred. The sale and buy back, when considered in the context of both transactions, is actually a financing arrangement in which the seller has obtained a loan which is to be repaid with interest (via inflated price). Inventory acts as the security for the loan which will be returned to the 'seller' upon repayment. So instead of recognizing sale, the entity should recognize a liability for loan obtained which shall be reversed when the loan is repaid. The excess of loan received and the amount that is to be paid (i.e. inflated price) is recognized as finance cost in the income statement.

Importance

The principle of Substance over legal form is central to the faithful representation and reliability of information contained in the financial statements. By placing the responsibility on the preparers of the financial statements to actively consider the economic reality of transactions and events to be reflected in the financial statements, it will be more difficult for the preparers to justify the accounting of transactions in a manner that does fairly reflect the substance of the situation. However, the principle of substance over form has so far not been recognized by IASB or FASB as a

distinct principle in their respective frameworks due to the difficulty of defining it separately from other accounting principles particularly reliability and faithful representation.

Comparability/Consistency

Financial statements of one accounting period must be comparable to another in order for the users to derive meaningful conclusions about the trends in an entity's financial performance and position over time. Comparability of financial statements over different accounting periods can be ensured by the application of similar accountancy policies over a period of time.

A change in the accounting policies of an entity may be required in order to improve the reliability and relevance of financial statements. A change in the accounting policy may also be imposed by changes in accountancy standards. In these circumstances, the nature and circumstances leading to the change must be disclosed in the financial statements.

Financial statements of one entity must also be consistent with other entities within the same line of business. This should aid users in analyzing the performance and position of one company relative to the industry standards. It is therefore necessary for entities to adopt accounting policies that best reflect the existing industry practice.

Example:

If a company that retails leather jackets valued its inventory on the basis of FIFO method in the past, it must continue to do so in the future to preserve consistency in the reported inventory balance. A switch from FIFO to LIFO basis of inventory valuation may cause a shift in the value of inventory between the accounting periods largely due to seasonal fluctuations in price

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Understandability

Transactions and events must be accounted for and presented in the financial statements in a manner that is easily understandable by a user who possesses a reasonable level of knowledge of the business, economic activities and accounting in general provided that such a user is willing to study the information with reasonable diligence.

Understandability of the information contained in financial statements is essential for its relevance to the users. If the accounting treatments involved and the associated disclosures and presentational aspects are too complex for a user to understand despite having adequate knowledge of the entity and accountancy in general, then this would undermine the reliability of the whole financial statements because users will be forced to base their economic decisions on undependable information.

Materiality

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements (IASB Framework).

Materiality therefore relates to the significance of transactions, balances and errors contained in the financial statements. Materiality defines the threshold or cutoff point after which financial information becomes relevant to the decision making needs of the users. Information contained in the financial statements must therefore be complete in all material respects in order for them to present a true and fair view of the affairs of the entity.

Materiality is relative to the size and particular circumstances of individual companies.

Example - Size

A default by a customer who owes only \$1000 to a company having net assets of worth \$10 million is immaterial to the financial statements of the company.

However, if the amount of default was, say, \$2 million, the information would have been material to the financial statements omission of which could cause users to make incorrect business decisions.

Example - Nature

If a company is planning to curtail its operations in a geographic segment which has traditionally been a major source of revenue for the company in the past, then this information should be disclosed in the financial statements as it is by its nature material to understanding the entity's scope of operations in the future.

Materiality is also linked closely to other accounting concepts and principles:

- **Relevance:** Material information influences the economic decisions of the users and is therefore relevant to their needs.
- **Reliability:** Omission or misstatement of an important piece of information impairs users' ability to make correct decisions taken on the basis of financial statements thereby affecting the reliability of information.
- **Completeness:** Information contained in the financial statements must be complete in all material respects in order to present a true and fair view of the affairs of the company.

What is a Going Concern?

Going concern is one the fundamental assumptions in accounting on the basis of which financial statements are prepared. Financial statements are prepared assuming that a business entity will continue to operate in the foreseeable future without the need or intention on the part of management to liquidate the entity or to significantly curtail its operational activities. Therefore, it is assumed that the entity will realize its assets and settle its obligations in the normal course of the business.

It is the responsibility of the management of a company to determine whether the going concern assumption is appropriate in the preparation of financial statements. If the going concern assumption is considered by the management to be invalid, the financial statements of the entity would need to be prepared on break up basis. This means that assets will be recognized at amount which is expected to be realized from its sale (net of selling costs) rather than from its continuing use in the ordinary course of the business. Assets are valued for their individual worth rather than their value as a combined unit. Liabilities shall be recognized at amounts that are likely to be settled.

What are possible indications of going concern problems?

- Deteriorating liquidity position of a company not backed by sufficient financing arrangements.
- High financial risk arising from increased gearing level rendering the company vulnerable to delays in payment of interest and loan principle.
- Significant trading losses being incurred for several years. Profitability of a company is essential for its survival in the long term.
- Aggressive growth strategy not backed by sufficient finance which ultimately leads to over trading.
- Increasing level of short term borrowing and overdraft not supported by increase in business.
- Inability of the company to maintain liquidity ratios as defined in the loan covenants.
- Serious litigations faced by a company which does not have the financial strength to pay the possible settlement.
- Inability of a company to develop a new range of commercially successful products. Innovation is often said to be the key to the long-term stability of any company.
- Bankruptcy of a major customer of the company.

Accruals Concept

Financial statements are prepared under the Accruals Concept of accounting which requires that income and expense must be recognized in the accounting periods to which they relate rather than on cash basis. An exception to this general rule is the cash flow statement whose main purpose is to present the cash flow effects of transaction during an accounting period.

Under Accruals basis of accounting, income must be recorded in the accounting period in which it is earned. Therefore, accrued income must be recognized in the accounting period in which it arises rather than in the subsequent period in which it will be received. Conversely, prepaid income must be not be shown as income in the accounting period in which it is received but instead it must be presented as such in the subsequent accounting periods in which the services or obligations in respect of the prepaid income have been performed.

Expenses, on the other hand, must be recorded in the accounting period in which they are incurred. Therefore, accrued expense must be recognized in the accounting period in which it occurs rather than in the following period in which it will be paid. Conversely, prepaid expense must be not be shown as expense in the accounting period in which it is paid but instead it must be presented as such in the subsequent accounting periods in which the services in respect of the prepaid expense have been performed.

Accruals basis of accounting ensures that expenses are "matched" with the revenue earned in an accounting period. Accruals concept is therefore very similar to the matching principle.

Business Entity Concept

Financial accounting is based on the premise that the transactions and balances of a business entity are to be accounted for separately from its owners. The business entity is therefore considered to be distinct from its owners for the purpose of accounting.

Therefore, any personal expenses incurred by owners of a business will not appear in the income statement of the entity. Similarly, if any personal expenses of owners are paid out of assets of the entity, it would be considered to be drawings for the purpose of accounting much in the same way as cash drawings.

The business entity concept also explains why owners' equity appears on the liability side of a balance sheet (i.e. credit side). Share capital contributed by a sole trader to his business, for instance, represents a form of liability (known as equity) of the 'business' that is owed to its owner which is why it is presented on the credit side of the balance sheet.

Realization Concept (*Revenue Recognition Principle*)

In accounting, also known as revenue recognition principle, refers to the application of accruals concept towards the recognition of revenue (income). Under this principle, revenue is recognized by the seller when it is earned irrespective of whether cash from the transaction has been received or not.

In case of sale of goods, revenue must be recognized when the seller transfers the risks and rewards associated with the ownership of the goods to the buyer. This is generally deemed to occur when the goods are actually transferred to the buyer. Where goods are sold on credit terms, revenue is recognized along with a corresponding receivable which is subsequently settled upon the receipt of the due amount from the customer.

In case of the rendering of services, revenue is recognized on the basis of stage of completion of the services specified in the contract. Any receipts from the customer in excess or short of the revenue recognized in accordance with the stage of completion are accounted for as prepaid income or accrued income as appropriate.

Example

Motors PLC is a car dealer. It receives orders from customers in advance against 20% down payment. Motors PLC delivers the cars to the respective customers within 30 days upon which it receives the remaining 80% of the list price.

In accordance with the revenue realization principle, Motors PLC must not recognize any revenue until the cars are delivered to the respective customers as that is the point when the risks and rewards incidental to the ownership of the cars are transferred to the buyers.

Importance

Application of the realization principle ensures that the reported performance of an entity, as evidenced from the income statement, reflects the true extent of revenue earned during a period rather than the cash inflows generated during a period which can otherwise be gauged from the cash flow statement. Recognition of revenue on cash basis may not present a consistent basis for evaluating the performance of a company over several accounting periods due to the potential volatility in cash flows

Dual Aspect Concept | Duality Principle in Accounting

Dual Aspect Concept, also known as Duality Principle, is a fundamental convention of accounting that necessitates the recognition of all aspects of an accounting transaction. Dual aspect concept is the underlying basis for double entry accounting system.

Explanation

In a single entry system, only one aspect of a transaction is recognized. For instance, if a sale is made to a customer, only sales revenue will be recorded. However, the other side of the transaction relating to the receipt of cash or the grant of credit to the customer is not recognized.

Single entry accounting system has been superseded by double entry accounting. You may still find limited use of single entry accounting system by individuals and small organizations that keep an informal record of receipts and payments.

Double entry accounting system is based on the duality principle and was devised to account for all aspects of a transaction. Under the system, aspects of transactions are classified under two main types:

1. **Debit**
2. **Credit**

Debit is the portion of transaction that accounts for the increase in assets and expenses, and the decrease in liabilities, equity and income.

Credit is the portion of transaction that accounts for the increase in income, liabilities and equity, and the decrease in assets and expenses.

The classification of debit and credit effects is structured in such a way that for each debit there is a corresponding credit and vice versa. Hence, every transaction will have 'dual' effects (i.e. debit effects and credit effects).

The application of duality principle therefore ensures that all aspects of a transaction are accounted for in the financial statements.

Example

Mr. A, who owns and operates a bookstore, has identified the following transactions for the month of January that need to be accounted for in the monthly financial statements:

	\$
1. Payment of salary to staff	2,000
2. Sale of books for cash	5,000
3. Sales of books on credit	15,000
4. Receipts from credit customers	10,000
5. Purchase of books for cash	20,000
6. Utility expenses - unpaid	3,000

Under double entry system, the above transactions will be accounted for as follows:

Account Title	Effect	Debit	Credit
		\$	\$
1. Salary Expense	<i>Increase in expense</i>	2,000	
Cash at bank	<i>Decrease in assets</i>		2,000
2. Cash in hand	<i>Increase in assets</i>	5,000	
Sales revenue	<i>Increase in income</i>		5,000
3. Receivables	<i>Increase in assets</i>	15,000	
Sales revenue	<i>Decrease in income</i>		15,000
4. Cash at bank	<i>Increase in asset</i>	10,000	
Receivables	<i>Decrease in asset</i>		10,000
5. Purchases	<i>Increase in expense</i>	20,000	
Cash at bank	<i>Decrease in asset</i>		20,000
6. Utility Expense	<i>Increase in expense</i>	3,000	
Accrued expenses	<i>Decrease in asset</i>		3,000

QUALITIES OF USEFUL ACCOUNTING INFORMATION

In order for accounting information to be useful, it must contain certain qualities and meet certain standards. These qualities include:

1. Relevance

Relevance in accounting information is necessary for predictive and feedback value. If investors cannot review accounting information for a company and assess its financial worthiness, then the information is not relevant and fails the relevance test. If management cannot review accounting information and use it to make decisions concerning business operations, then the information fails the feedback test.

2. Timeliness

Timeliness is a quality subset of relevance. If you do not present accounting information in a timely manner, its usefulness to investors and managers is diminished or completely eliminated. The quality of timeliness requires both recording the financial transaction in the appropriate accounting period and generating accounting reports as soon as all data are posted so that issues with business operations are discovered before the problem grows.

3. Reliability

If accounting information is not reliable, it cannot be used to make quality business decisions. In order to meet GAAP standards for reliability, accounting information must be verifiable, meaning you should be able to prove the authenticity and show a paper trail for every income and expense entry recorded to the accounting general ledger. In order for accounting information to be reliable, it must also be neutral, meaning only GAAP standards were used when the accounting information was recorded; that is, the information was not recorded to reflect better on the company's financial performance.

4. Consistency

In order for accounting information to be useful in decision making, it must be recorded consistently, meaning the same accounting treatment must be applied at all times to a given type of accounting data. Recording the same monthly expense in different expense accounts skews the expense categories and makes it harder to determine the actual expense in any one category. Large-scale accounting changes, such as changing inventory method, also affect consistency in accounting data. You should make every attempt to limit large-scale changes altogether, and if they are necessary, implement them at the beginning of a new accounting year.

5. Comparability

Comparability is a subset of consistency. If you cannot compare accounting information for one period of time to another, then you cannot derive useful information in order to make operational decisions. Without consistency, any comparison of accounting data is useless, as the data compared will not have been created using the same methods or standards.

TOPIC 2

RECORDING TRANSACTIONS

SOURCE DOCUMENTS

The details of financial transactions are usually described on various documents received by or produced within an accounting system. These documents provide input into the system. The purchase of supplies or materials will produce a purchase order (if used), an invoice and/or statement and a voucher. Each of these documents provides input into various stages of the system either as a control device or authorization of the transaction.

Some of source documents include;

1. Quotations
2. Purchase orders
3. Statement of account
4. Remittance advice
5. Receipts
6. Petty cash vouchers
7. Sales invoice
8. Purchase invoice
9. Credit notes
10. Debit notes
11. Bank statements

1. QUOTATIONS

A quotation is used to let a potential customer know the cost of goods or services before they decide to purchase them. When a seller sends a quotation, it commits them to a certain price. This is why quotations are mostly used when costs are relatively stable and the services/goods to be provided can be accurately estimated (labor, cost of raw materials, etc.).

What to include in a quotation

There are a number of items that should be included and considered when preparing a quotation for a customer.

First of all, a quotation should include the price that you have decided to charge for the service or goods you will provide. In a quotation; you can include a breakdown of the components leading to the settled price (such as labor costs, raw material costs, VAT etc.) You may also want to specify a time schedule: i.e. how long the project will take you or how long it will be until goods are

delivered, A quotation may also indicate a specific time period for which it is valid, e.g. 30 days. Also, a project or service quotation may include an explanation of how any requests for modifications or changes will affect the price once the project is-underway

2. PURCHASE ORDERS

A purchase order (PO) is a commercial document issued by a buyer to a seller, indicating types, quantities and agreed prices for products or services the seller will provide to the buyer. Sending a Purchase order to a supplier constitutes a legal offer to buy products or services. Acceptance of a purchase order by a seller usually forms a contract between the buyer and seller, so no contract exists until the purchase order is accepted.-It is used to control the purchasing of products and services from external suppliers.

Companies use purchase orders for several reasons:

- Purchase orders allow-buyers to clearly and explicitly communicate their intentions to sellers
- Sellers are protected in case of a buyer's refusal to pay for goods or services
- Purchase orders help a purchasing, agent to manage incoming orders and pending orders
- Purchase orders provide economies in that they streamline the purchasing process to a standard procedure
- Commercial lenders or financial institutions may provide financial assistance on the basis of purchase orders.

Electronic Purchase Orders

Many purchase orders are no longer paper-based, but rather transmitted electronically over the Internet. It is common for electronic purchase orders to be used to buy goods or services online for services or physical goods of any type.

3. STATEMENT OF ACCOUNT

Also known as an account-statement, a statement of account is a record of the transactions that have occurred on a customer's account during a specified period of time. The line items on the account will record information about purchases made by the customer, -any payments rendered by the customer, and any other miscellaneous adjustments that have been made to the current balance due on the account. Statements of this type are normally issued for each billing period specified in the contract that established the customer account, and note balances on account at the beginning and ending dates of the period. Customers can also sometimes request account statements that cover a longer period of time than just the most current billing period.

The statement of account is associated with many different types of accounts. A statement for a checking account at a bank is normally issued on a monthly basis, allowing the bank customer to see which deposits have been posted to the account, as well as which cheques have cleared during the period under consideration. The bank account statement will also include details about any other

types of debits or credits that have had an impact on the account balance during the month, such as purchases made using a debit card, funds transferred into the checking account from a savings account, or even accrual of any interest, if the checking account carries that particular feature.

Most vendors will also issue a statement of account to each customer on a regular basis, usually monthly. Like the checking account, vendor statements will show the balance owed at the beginning of the statement period, any transactions that took place during the period, and the total balance on the account as of the closing date of the statement. If the vendor has provided the customer with a line of credit, the statement will also show the minimum payment due along with the total balance on account.

In all its forms, a statement of account helps the account holder to manage the account more efficiently. Various statements are also important when it comes to managing all financial resources under the control of the account holder, since they provide important documentation of all types of financial transactions associated with the account in question. In general, consumers are encouraged to read the detail on each statement carefully, to make sure all line items on the document are accurate, and that the balance owed does match with the client's other financial records.

4. REMITTANCE ADVICE

A remittance advice is a letter sent by a customer to a supplier, to inform the supplier that their invoice has been paid. If the customer is paying by cheque, the remittance advice often accompanies the cheque.

Remittance advices are not mandatory; however they are seen as a courtesy because they help the accounts-receivable department match invoices with payments. The remittance advice should therefore specify the invoice number(s) for which payment is tendered.

In countries where cheques are still used, most companies' invoices are designed so that customers return a portion of the invoice, called a remittance advice, with their payment. In countries where wire transfer is the predominant payment method, invoices are commonly accompanied by standardized bank transfer order forms which include a field into which the invoice or client number can be encoded, usually in a computer-readable way. The payer fills in his account details and hands the form to a clerk at, or mails it to, his bank, which will then transfer the money.

The employee who opens the incoming mail should initially compare the amount of cash received with the amount shown on the remittance advice. If the customer does not return a remittance advice, an employee prepares one. Like the cash register tape, the remittance advice serves as a record of cash initially received.

Modern systems will often scan a paper remittance advice into a computer system where data entry will be performed. Modern remittance advices can include dozens, or hundreds of invoice numbers, and other information. .

5. RECEIPTS

A receipt is raised by the firm and-issued to customers or debtors when they make payments in the form of cash or cheques.

It shows:

The name and address of the firm

- i. The date of the receipt
- ii. Amount received (cash or cheque or other means of payment)
- iii. Receipt number.

6. PETTY CASH VOUCHERS

Petty cash is a small amount of discretionary funds in the form of cash used for expenditures where it is not sensible to make any disbursement by cheque, because of the inconvenience and costs of writing, signing and then cashing the cheque.

A petty cash voucher is usually a small form that is used to document a disbursement (payment) from a petty cash fund. Petty cash vouchers are also referred to as petty cash receipts and can be purchased from office supply stores.

The petty cash voucher should provide space for the date, amount disbursed, name of person receiving the money, reason for the disbursement, general ledger account to be charged, and the initials of the person disbursing the money from the petty cash fund. Some petty cash vouchers are pre-numbered and sometimes a number is assigned for reference and control. Receipts or other documentation justifying the disbursement should be attached to the petty cash voucher.

When the petty cash fund is replenished, the completed petty cash vouchers provide the documentation for the replenishment check.

7. SALES INVOICE

A sales invoice in financial accounting is a tool that a company uses to communicate to clients about the sums that are due in exchange for goods that have been sold. A sales invoice should include information about which items the customer has purchased, the quantities he has bought, discounts he has received, and the total amount he owes. In addition, a sales invoice should contain a brief summary of the terms of the transaction, such as the acceptable lag time between the sale and the payment.

The sales invoice contains the following:

- i) Name and address of the firm
- ii) Name and address of the buying firm
- iii) Date of making the sale — invoice date.
- iv) Invoice number

- v) Amount due (net of trade discount)
- vi) Description of goods sold
- vii) Terms of sale

8. PURCHASES INVOICE

A purchase invoice is raised by the creditor and sent to the firm when the firm makes a credit purchase. It shows the following:

- i. Name and the address of the creditor/seller
- ii. Name and address of the firm
- iii. Date of the purchase (invoice date)
- iv. Invoice number
- v. Amount due
- vi. Description of goods sold
- vii. Terms sale

9. CREDIT NOTES

A credit note is raised by the firm and issued to the debtor when the debtor returns some goods back to the firm. Its contents include:

- i. Name and address of the firm
- ii. Name and address of the debtor
- iii. Amount of credit
- iv. Credit note number
- v. Reason for credit e.g. if the goods sent but of the wrong type

The purpose of the credit note is to inform the debtor or customer that the debtor's account with the firm has been credited i.e. the amount due to the firm has been reduced or cancelled.

The credit note may also be issued when the firm gives an allowance of the amount due from the debtors. From the context we can assume that all credit notes are issued when goods are returned

10. DEBTORS NOTE

This is raised by the creditor and issued to the firm when the firm returns some goods to the creditor. It includes the following items:

- i) Name and address of the firm
- ii) Name and address of the creditor
- iii) Amount of debit
- iv) Debit Note number
- v) Reason for the debit

The purpose of the debit note is to inform the firm that the amount due to the creditor has been reduced or cancelled.

11. BANK STATEMENT

A **bank statement** or **account statement** is a summary of financial transactions which have occurred over a given period on a bank account held by a person or business with a financial institution.

Bank statements have historically been and continue to be typically printed on one or several pieces of paper and either mailed directly to the account holder, or kept at the financial institution's local branch for pick-up. In recent years there has been a shift towards paperless, electronic statements, and some financial institutions offer direct download into account holders accounting software.

Some ATMs offer the possibility to print, at any time, a condensed version of a bank statement, commonly called a **transaction history**, or a transaction history may be viewed on the financial institution's website or available via telephone banking.

Paper statements

Historically, bank statements were paper statements produced monthly, quarterly or even annually. Since the introduction of computers in banks in the 1960s, bank statements have generally been produced monthly. Bank statements for accounts with small transaction volumes, such as investments or savings accounts, are usually produced less frequently. Depending on the financial institution, bank statements may also include certain features such as the cancelled cheques (or their images) that cleared through the account during the statement period.

Some financial institutions use the occasion of posting bank statements to include notices such as changes in fees or interest rates or to include promotional material.

Today, the monthly mailing of bank statements is the norm in many countries. It is not customary in some countries, such as Japan, where individual account holders are expected to keep track of deposits, withdrawals, and balances using their own passbooks at ATMs.

Electronic statements

With the wider access to the Internet and online banking, bank statements (also known as electronic statements or e-statements) can be viewed online, and downloaded or printed by the customer. To reduce the cost of postage and the generation of paper bank statements, some financial institutions encourage their customers to receive bank statements electronically, for example by charging a fee for paper statements. This may be as attachments to emails or, as a security measure, as a reminder that a new statement is available on the financial institution's website. Whether such statements are transmitted as attachments or from the website, they are commonly generated in PDF format, to reduce the ability of the recipient to electronically alter the statement.

Due to identity theft concerns, an electronic statement may not be seen as a dangerous alternative against physical theft as it does not contain tangible personal information, and does not require extra

safety measures of disposal such as shredding. However, an electronic statement can be easier to obtain than a physical one through computer fraud, data interception and/or theft of storage media.

BOOKS OF ORIGINAL ENTRY

A **Books of original entry** (also referred to as Journal) is an accounting record that is used to record the different types of transactions in chronological order or date order. The reason for being called books of original entry is that this is the first place that business transactions are formally recorded. You can think of a Journal as a Financial Diary.

Specialized Journals are journals used to initially record special types of transactions such as sales and purchases. All these journals are designed to record special types of business transactions and post the totals accumulated in these journals to the General Ledger periodically (usually once a month).

Sales Journal

The Sales Journal is a special journal where Credit sales to customers are recorded. Another name for this journal is the Sales Book or Sales Day Book.

Purchases Journal

The Purchases Journal is a special journal where Credit purchases from customers are recorded. Another name for this journal is the Purchases Book or Purchases Day Book.

Returns Inwards Journal

The Returns Inwards Journal is a special journal that is used to record the returns from debtors and allowances of goods sold on credit. Another name for this journal is the Sales Returns Book.

Returns Outwards Journal

The Returns Outwards Journal is a special journal that is used to record the returns to creditors and allowances of goods purchased on credit. Another names for this journal is the Purchases Returns Book.

The Cash Book

The Cash Book is used to record the receipt and payment of money by the business in the form of cash, or through the business bank account. It contains the cash and bank accounts.

The Petty Cash Book

This is just a fancy name that describes a special fund that is set up and used for minor and unanticipated cash expenses where a cheque can't be written or the amount is so small that you don't want to write a cheque. The petty cash account is based on the Imprest System which is a system of cash disbursement, cash expenditure and reimbursement of that expenditure.

The General Journal

The Journal is a textual record of events (Debit and Credit) that is characterized by the fact that all the records it contains are in a sequential chronological order. The General Journal is used to record unusual or infrequent types of transactions. Type of entries normally made in the general journal include depreciation entries, correcting entries, and adjusting and closing entries.

Recording Transactions from Source Documents

Journals use the information from the source documents to create a chronological listing of all business transactions and detailed information about each transaction.

Journals are preliminary records where business transactions are first entered into the accounting system. The journal is commonly referred to as the book of original entry. Specialized Journals are journals used to initially record special types of transactions such as sales and purchases in their own journal

Why Use Special Journals

- Groups and records transactions of a like nature. A familiar example is recording all cash received by a business in one place.
- Saves time with summary and less frequent postings to the General Ledger.
- Allows a business to have different individuals responsible for different journals thereby increasing internal controls and allocating the record keeping workload.

SALES JOURNAL (DAY BOOK)

The sales day book records details of all credit sales by the business. The details are obtained from copy sales invoices.

It is also called a sales day book. It records all the sales invoices issued by the firm during a particular financial period

The format is as follows (with simple records of invoice).

Sales journal			
Date	Detail	Folio	Amount sh
Total			

Each entry shows the date of the sale, name of the customer, the invoice number and the amount of the transaction entered in the money column of the book.

At the end of the period, the last column is totaled and an entry made in the ledger

The individual entries in the sales journal are posted to the debit side of the debtor's accounts in the sales ledger and the total is posted on the credit side of the sales account in the general ledger,

As follows:

Dr. Debtors account
Cr, Sales account

Illustration

You are to enter up the sales journal from the following details.

2010

March 1	Credit sales to J. Omondi	Sh.1,870
March 3	Credit sales to G. Achieng	Sh. 1,660
March 6	Credit sales to V. Charles	Sh 120
March 10	Credit sales to J. Njoroge	Sh.550
March 17	Credit sales to F. Mwangi	Sh. 2,890
March 19	Credit sales to U. Aketch	Sh. 660
March 27	Credit sales to V, Sarah	Sh. 280
March 31	Credit sales to L. Cate	Sh. 780

Solution

Sales journal			
Date 2010	Detail	Folio	Amount (sh)
1/3	1, Omondi		1,870.00
3/3	G. Achieng		
6/3	V. Charles		
10/3	J. Njoroge		550.00
17/3	F. Mwangi		2,890.00
19/3	U. Aketch		
27/3	V. Sarah		
31/3	L. Cate		780.00
Total			8,810.00

PURCHASES JOURNAL

Purchases journal is also called a purchases day-book. It records all the purchase invoices received by the firm during a particular financial period, it has the following format (including records of voices) it is used to record credit purchases

Purchases journal			
Date	Detail	Folio	Amount sh
Total			

The individual entries in the purchases journal are posted to the credit side of the creditor's accounts in the purchases ledger and the total is posted to the debit side of purchases account of the general ledger.

Dr. Creditors account
Cr. Purchases account

Illustration

You are to enter up the purchases journal from the following details;-

2010

March	1	Credit Purchases from J. James	Sh.1,880
March	3	Credit Purchases from G. Njoroge	Sh. 670
March	6	Credit Purchases from V. Virginia	Sh. 200
March	10	Credit Purchases from J. James	Sh.-350
March	7	Credit Purchases from F. Oluoch	Sh. 3,890
March	19	Credit Purchases from U. Ouma	Sh. 750
March	27	Credit Purchases from V. Agnes M	Sh.390
March	31	Credit Purchases from L. Ken	Sh. 980

Purchases journal			
Date 2010	Detail	Folio	Amount (sh)
1/3	J. James		1,880
3/3	G. Njoroge		670
6/3	V. Virginia		200
10/3	J. James		350
17/3	F. Oluoch		3,890
19/3	U. Ouma		750
27/3	V. AgnesM		390
31/3	L. Ken		980
Total			9,110

SALES RETURNS/RETURNS INWARDS DAYBOOK

It is also called the returns inwards day-book. it records all the credit notes raised by the firm and sent to customers during a particular financial period.

Where, for some reason, a person who has purchased goods wishes to return them, and the seller agrees to take them back, he (the seller) enters the purchases of the goods returned in his sales returns book (sometimes called sales returns journal inwards book).

The sales returns account is used to record the value of goods returned to a business by its customers. When goods are returned, the debtor's account is credited in order to decrease the asset and the sales returns account is debited.

We record in the sales returns day book details of all credit notes which we have sent to our customers for goods which they returned to us.

A format of a sales returns book is shown below:

Return inwards journal				
Date	Credit note No.	Description/Detail	Folio	Amount sh
Total				

Individual entries in a return inwards journal are posted to the credit of the debtors accounts in the sales ledger and the total is posted to the debit side of the return-inwards account of the general ledger

At the end of the period, the book will be totalled and an entry made in the ledger as follows:

Dr. Sales Returns account

Cr. Debtors account

PURCHASES RETURNS/RETURNS OUTWARDS JOURNAL.

The purchases returns day book is sometimes referred to as the returns outward book, or purchases returns journal.

A purchases returns account is used to "record 'the value of goods returned by a business to its suppliers.

When goods are returned, the creditor's account is debited in order to decrease the liability to him and the purchases returns account is credited.

We record in the purchases returns day book details from credit notes given to us by suppliers in respect of goods which we have returned to them.

The details recorded will be similar to those in the purchases day book. An example of purchases return book is shown below.

Return outwards journal				
Date	Debit note No.	Description/Detail	Folio	Amount sh
Total				

At the end of the period the book will be totaled and an entry made in the ledger as follows:

Dr. Creditors account

Cr. Purchases returns account.

Illustration

You are to enter the following items in the books 2011

July 1 Credit purchases from: K. Amos Sh.380; M. Ochieng Sh.500; N. Oluoch Sh.106.

July 3 Credit sales to: E. Ken Sh11.510; E. Rose Sh.246; F. Ton Sh.356.

July 5 Credit purchases from: R. Kyule Sh.200; J. Wanja Sh.180; D. Mwangi Sh.410; C. Kange Sh.66,

July 8 Credit sales to: A. Ben Sh.307; H. Kim Sh.250; J. Tony Sh.185.

July 12 Returns outwards to: M. Ocheing Sh.30; N. Oluoch Sh.16.

July 14 Returns inwards from: E. Rose Sh.18; F. Tom Sh.22,

July 20 Credit sales to: E. Rose Sh.188; F. Paul Sh.310; E. Dan Sh.420.

July 24 Credit purchases from: J. Tony Sh.550; K. Musiu Sh.900.

July 31 Returns inwards from: E. Rose Sh.27; E. Ken Sh-.30.

July 31 Returns outwards to: J. Wanja Sh.13; C. Kange Sh.11.

Solution

Sales journal		
Date	Detail	Amount sh
3 July	E. Ken	510
3 July	E. Rose	246
3 July	F. Tom	356
8 July	A. Ben	307
8 July	H. Kim	250
8 July	J. Tony	185
20 July	E. Rose	188
20 July	F. Paul	310
20 July	E. Dan	420
Total		2,772

Purchases journal		
Date	Detail	Amount sh
1 July	K. Amos	380
1 July	M. Ochieng	500
1 July	N. Oluoch	106
5 July	R. Kyule	200
5 July	J. Wanja	180
5 July	D. Mwangi	410
5 July	C. Kange	66
24 July	C. Tony	550
24 July	K. Musiti	900
Total		3,292

Return inwards journal		
Date	Description/Detail	Amount sh
14 July	E. Rose	18
14 July	F. Torn	22
31 July	E. Rose	27
31 July	E. Ken	30
Total		97

Return outwards journal		
Date	Description/Detail	Amount sh
12 July	M. Ochieng	30
12 July	N. Oluoch	16
31 July	J. Wanja	13
31 July	C. Kange	11
Total		70

THE CASH BOOK

The cash book is meant to record all cash transactions — whatever is their nature. It is divided into two sides — one, the left hand side, for receipts of cash: and the other, the right hand side, for payments. Since in a modern business, transactions with or through bank are even more numerous than strictly cash transactions, each side has two columns.— one to record cash transactions and the other to record bank transactions payments into the bank being entered on the left hand side and payments out of bank being entered on the right hand side.

(The left hand side is known as the debit side and the right hand side is called the credit side.) Sometimes, cash is deposited in bank and sometimes, cash is withdrawn from the bank for use in office. In this case, entries both for receipt and payment will appear in the cash book itself in appropriate columns.

Such transactions are known as ‘contra’ transactions.

There are two types of cashbooks:

- i. Two-column cashbook
- ii. Three-column cashbook

Two-column cashbook

The cash at bank cashbook and cash in hand cashbook are combined together to get a two-column cashbook. The format is as follows:

Date	Details	Cash Sh.	Bank Sh.		Date	Details	Cash Sh.	Bank Sh.

Illustration

Write up a two-column cashbook from the following details, and balance off as of the end of the month:

2003

- May 1 Started business with capital in cash Sh 1,000
- May 2 Paid rent by cash Sh 100.
- May 3 F. Atieno lent us Sh 5,000; paid by cheque.
- May 4 We paid B Omolo by cheque Sh 650.
- May 5 Cash sales Sh 980.
- May 7 N Mwangi paid us by cheque Sh 620.
- May 9 We paid B. Musau in cash Sh 220.
- May 11 Cash sales paid direct into the bank Sh 530.
- May 15 G, Mugaka paid us in cash Sh 650.
- May 16 We took Sh 500 out of the cash till and paid it into the bank account.
- May 19 We repaid F. Atieno Sh 1,000 by cheque.
- May 22 Cash sales paid direct into the bank Sh 660.
- May 26 Paid motor expenses by cheque Sh 120.
- May 30 Withdrew Sh 1,000 cash from the bank for business use.
- May 31 Paid wages in cash Sh 970.

Cash Book							
Date May	Details	Cash Sh	Bank Sh	Date May	Details	Cash Sh	Bank Sh
1	Capital	1,000	-		Rent	100	-
3	F. Atieno -loan-	-	5,000		B Omolo	-	650
5	Sales	980	-		B Musau	220	-
7	N. Mwangi	-	620		Bank C	500	-
11	Sales	-	530		F Atieno (Loan)	-	1,000
15	G. Mugaka	650	-		Motor Expenses	-	120
16	Cash C	-	500		Cash C	970	1,000
22	Sales	-	660		Wages	1,840	-
30	Bank C	<u>1,000</u>	<u>-</u>		Balances c/d	<u>3,630</u>	<u>4,540</u>
		<u>3,630</u>	<u>7,310</u>			<u>3,630</u>	<u>7,310</u>

Three-column cashbook

Additional columns for discounts allowed and discounts received can be included with the cash at bank columns to get a 3 - column cashbook. The format is as follows:

Cash book										
Date	Details	Discount Allowed	Cash Sh.	Bank Sh.		Date	Details	Discount Received	Cash Sh.	Bank Sh.

Illustration

A three-column cashbook is to be written up from the following details, balanced off, and the relevant discount accounts in the general ledger shown.

19x8

- Mar 1 Balances brought forward: Cash Sh 230; Bank. Sh 4,756.
- 2 The following paid their accounts by cheque, in each case deducting 5 percent discounts: R. Ken Sh 140; E. Mwaura Sh 220; R. 1-laffen Sh 300.
- 4 Paid rent by cheque Sh 120.
- 6 J. Aluoch lent us Sh 1,000 paying by cheque.
- 8 We paid the following accounts by cheque in each case deducting 2'17 per cent cash discount: N. White Sh 60; P. Paul Sh 480; C. Moses Sh 800.
- 10 Paid motor expenses in cash Sh 44.
- 12 H. Moraa pays his account of Sh 77, by cheque Sh 74, deducting Sh 3 cash discount.
- 15 Paid wages in cash Sh 160.
- 18 The following paid their accounts by cheque, in each case deducting 5 per cent cash discount: C. Mwangi Sh 260; R Wilson & Son Sh 340; H. Njoroge Sh 460.

- 21 Cash withdrawn from the bank Sh 350 for business use
 24 Cash Drawings Sh 120.
 25 Paid T. Koech his account of Sh 140, by cash Sh 133, having deducted Sh 7 cash discount.
 29 Bought fixtures paying by cheque Sh 650.
 31 Received commission by cheque Sh 88.

Cash book

Date	Details	Disc All	Cash Sh.	Bank Sh.	Date	Details	Disc Rec	Cash Sh.	Bank Sh.
Mar	Bal b/d		230	4756	4	Rent			120
2	R. Ken	7		133	8	N White	9		351
2	E. Mwaura	11		209	8	P Paul	12		468
2	R. Hatton J.	15		285	8	C Moses	20		780
6	Aluoch Loan			1000	10	Motor exp.		44	
12	H. Moraa C.	3		74	15	Wages		160	
18	Mwangi R.	13		247	21	Cash			350
18	Wilson & Son	17		323	24	Drawings		120	
18	H. Njoroge	23		437	25	T Koech	7	133	140
21	Bank		350		29	Fixtures			650
31	Commission			88	31	Bal c/d		123	4,893
		<u>89</u>	<u>580</u>	<u>7552</u>			<u>48</u>	<u>580</u>	<u>7,552</u>

Discount received

Sh.	Sh.
	Creditors
	<u>48</u>

Discount Allowed

Sh.	Sh.
Debtors	<u>89</u>

DISCOUNTS**Accounting for drawings, discounts allowed and discounts received****Drawings**

The owner makes drawings from the firm in various ways:

i) Cash or bank withdrawals

When the owner withdraws money from the business we debit drawings and credit cashbook (cash in hand or cash at bank).

ii) Taking goods for own use and

When the owner takes out some of the goods for his own use, we debit drawings and credit purchases.

iii) Personal expenses, paid by the business

Here we debit the drawings and credit expense account

Taking some of the other assets from the business e.g. motor vehicles or using-part of the premises.

Sometimes the owner may take over some of the assets of the business e.g. vehicle or, converting business premises into living quarters or not paying into the business cash collected personally from the customers. When this happens we debit drawings and credit the relevant asset e.g. motor vehicles, premises or some building or even debtors.

Discounts Received

A discount received is an allowance by the creditors to the firm to encourage the firm to pay the amount dues within the agreed time. It is an amount deducted from the invoice price.

When a discount is given by the supplier then we debit creditor's account and credit discounts received e.g. A. Ltd sells some goods on credit to B Ltd. Sh.1,000,000 under the terms of sale, B Ltd, will receive s discount of 5% if they pay the amount due within one month. B decides to take up the: offer and pays the amount within the given time. B will record the transaction as follows.

Debit: Creditor -A Ltd
Credit: Discounts Received

Creditor A Ltd a/c			
	Sh.		Sh.
Bank	950	Purchases	1,000
Disc. Received	50		
	<u>1,000</u>		<u>1,000</u>

Purchases a/c			
	Sh.		Sh.
A ltd	1,000		

Discount received a/c			
	Sh.		Sh.
Balance	<u>50</u>	A ltd	<u>50</u>

Bank a/c			
	Sh.		Sh.
		A ltd	950

Discount Allowed

These are the allowances made by a firm on the amounts receivable from the customers to encourage prompt payment. The amounts deducted from the sales invoice. In the previous example when A Ltd issued the discount and was taken up by B the entries in the books of A ltd will be;-

- i. Debit- discount allowed
- ii. Credit-debtors -B ltd

Debtors B Ltd a/c			
	Sh.		Sh.
Sales	1,000	Bank	950
		Discount	50
	<u>1,000</u>		<u>1,000</u>

Sales a/c			
	Sh.		Sh.
		Debtors	1,000

Discount Allowed a/c			
	Sh.		Sh.
Debtors B ltd	50	Bank	50

Bank a/c			
	Sh.		Sh.
Debtors B ltd	950		

PETTY-CASH BOOK

The petty cash book is used to record small payments of cash. As with the main cash book, it may or not be part of the double-entry system.

Petty- Cash Book is a record of all the petty cash vouchers raised and kept by the cashier. The petty cash vouchers will show summary- expenses paid by the cashier and this information is listed and classified in the petty cash book under the headings of the relevant expenses such as:

- Postage and stationery
- Traveling
- Cleaning expenses.

Companies normally use cheque to pay their obligations because cheques provide a record of each payment, Companies also maintain a petty cash fund to pay for-small, miscellaneous expenditures such as stamps, Small delivery charges, or emergency supplies. The size of a petty cash fund varies depending on the needs of the business. A petty cash book should be small enough so that it does not unnecessarily tie up- Company assets or become a target for theft, but it should be large enough to lessen the inconvenience associated with frequently replenishing the fund. For this reason, companies typically establish a petty cash fund that needs to be replenished every two to four weeks.

Companies assign responsibility for the Petty cash fund to a person called the petty cash custodian or petty cashier. To establish a petty cash fund, someone must write a check to the petty cash custodian, who cashes the check and keeps the money in a locked file or cash box.

Whenever someone in the company requests petty cash, the petty cash custodian prepares a voucher that identifies the date, amount, recipient, and reason for the cash disbursement. For control purposes, vouchers are sequentially pre-numbered and signed by both the person requesting the cash and the custodian. After the cash is spent, receipts or other relevant documents should be returned to the petty cash custodian, who attaches them to the voucher. All vouchers are kept with the petty cash fund until the fund is replenished, so the total amount of the vouchers and the remaining cash in the fund should always equal the amount assigned to the fund.

When the fund requires more cash or at the end of an accounting period, the petty cash custodian requests a check for the difference between the cash on hand and the total assigned to the fund. At this time, the person who provides cash to the custodian should examine the vouchers to verify their legitimacy. The transaction that replenishes the petty cash fund is recorded with a compound entry that debits all relevant asset or expense accounts and credits cash.

The petty cash account is debited or credited only when the fund is established or when the size of the fund is increased or decreased, not when the fund is replenished.

If the voucher amounts do not equal the cash needed to replenish the fund, the difference is recorded in an account named cash over and short. This account is debited when there is a cash shortage and credited when there is a cash overage. Cash over and short appears on the income statement as a miscellaneous expense if the account has a debit balance or as miscellaneous revenue if the account has a credit balance.

The format for a petty cash book is as shown:-

PETTY CASH BOOK

Receipts	Date	Detail	Payment Amount	Expenses			The ledger
				Postage	Stationery	Travelling	

The balance c/d of the petty cash book will signify the balance of cash in hand or form part of cash in hand. The totals of the expenses are posted to the debit side of the expense accounts. If a firm operates another cashbook in addition to the petty cash book, then the totals of the expenses will also be posted on the credit side of the cash in hand cashbook.

The Imprest system

This system of accounting operates on a simple principle that the cashier is refunded the exact amount spent on the expenses during a particular financial period. At the beginning of each period, a cash float is agreed upon and the cashier is given this amount to start with. Once the cashier makes payments for the period he will get a total of all the payments made against which he will claim a reimbursement of the same amount that will bring back the amount to the cash float at the beginning of the period.

Illustration

The following is a summary of the petty cash transactions of Mmboga Ltd for May 2010

May		Ksh
1	Received from cashier Ksh300,000 as petty float	
2	Postage	18,000
3	Travelling	12,000
4	Cleaning	15,000
7	Petrol for delivery van	22,000
8	Travelling	25,000
9	Stationery	17,000
11	Cleaning	18,000
14	Postage	5,000
15	Travelling	8,000
18	Stationery	9,000
18	Cleaning	23,000
20	Postage	13,000
24	Delivery van 5,000 mile service	43,000
26	Petrol	18,000
27	Cleaning	21,000
29	Postage	5,000
30	Petrol	14,000

You are required to:

Rule up suitable petty cash book with analysis columns for expenditure on cleaning, motor expenses, Postage, stationery, travelling.

Solution

Mmboga Ltd
Petty Cash Book

Receipts		Total Ksh '000'	Cleaning Ksh'000'	Motor expenses Ksh'000'	Postage Ksh'000'	Stationery Ksh '000'	Travelling Ksh '000'
300	1. Bal b/d						
	2. Postage	18	-	-	18	-	-
	3. Travelling	12	-	-	-	-	12
	4. Cleaning	15	15	-	-	-	-
	7. Petrol	22	-	22	-	-	-
	8. Travelling	25	-	-	-	-	25
	9. Stationery	17	-	-	-	17	-
	11. Cleaning	18	18	-	-	-	-
	14. Postage.	5	-	-	5	-	-
	15. Travelling	8	-	-	-	-	8
	18. Stationery	9	-	-	-	9	-
	18. Cleaning	23	23	-	-	-	-
	20. Postage	13	-	-	13	-	-
	24. Motor serv.	43	-	43	-	-	-
	26. Petrol	18	-	18	-	-	-
	27. Cleaning	21	21	-	-	-	-
	29. Postage	5	-	-	5	-	-
	30. Petrol	14	-	14	-	-	-
		286	77	97	41	26	45
286	31. Cash						
	31. Balance c/d	<u>300</u>					
286		586					

THE GENERAL JOURNAL / JOURNAL PROPER

It records information from other correspondence (information that is not recorded in books of prime entry). It explains the type of entries that will be made in the ledger accounts giving a reason for these entries.

The type of transactions recorded here are:

- i. Writing off of assets from the accounts e.g. bad-debts.
- ii. Purchase or sale of non-current assets on credit.
- iii. Correction of errors

The word 'journal' means 'daily'. A journal is a 'day-to-day' record, showing for each transaction the debit and credit entries in a specific ledger.

It contains lists of individual transactions added as they occur. No amount is posted into the ledger without also appearing in a journal.

Every money figure appearing in a journal that represents the amount of the transaction-must also appear in some account in a ledger.

In a journal referred to here we record all transaction which is not entered into one of the other day books. This journal is also referred to as journal proper.

In the journal proper we record purchase and sales of fixed assets, transfers between accounts; correction of errors; writing off bad debts; and opening entries needed to open a new set of books.

We keep the journal in order to have some control over entries in the ledger and also to make it easier to locate any differences which we may discover as a result of taking out a trial balance. Although the rulings of the lines is the same as the other journal (specific journals), the transactions are recorded differently. In the journal proper we show the date, the name of the account(s) to be debited and the amount(s), the name of the account(s) to be debited and the amount(s), the name of the account(s) to be credited and the amount(s) and the description of the transaction.

A reference number (or folio number) should be given for the documents giving evidence of the transaction.

For example, the form of the journal to record the purchase of a motor vehicle might be as follows:

Date Oct 3		Folio	Dr.(Shs.)	Cr.(Shs.)
	Motor vehicles Onze Motors (Being purchase of van on credit from Onze Motors)			

DOUBLE ENTRY AND THE LEDGER

A double-entry bookkeeping system is a set of rules for recording financial information in a financial accounting system in which every transaction or event changes at least two different nominal ledger accounts.

The name derives from the fact that financial information used to be recorded using pen and ink in paper books -- hence "bookkeeping" (whereas rii5wjt is recorded mainly in computer systems) and that these books were called journals and ledgers (hence nominal ledger, etc.) — and that each transaction was entered twice (hence "double-entry"), with one side of the transaction being called a debit and the other a credit.

It was first codified in the 15th century by the Franciscan Friar, Luca Pacioli. In deciding which account has to be debited and which account has to be credited, the golden rules of accounting are used. This is also accomplished using the accounting equation: $\text{Equity} = \text{Assets} - \text{Liabilities}$. The accounting equation serves as an error detection tool. If at any point the sum of debits for all accounts does not equal the corresponding sum of credits for all accounts, an error has occurred. It follows that the sum of debits and the sum of the credits must be equal in value.

Double-entry bookkeeping is not a guarantee that no errors have been made — for example, the wrong ledger account may have been debited or credited, or the entries completely reversed.

ACCOUNTING ENTRIES

In the double-entry accounting system, each accounting entry records related pairs, of financial transactions for asset, liability, income, expense, or capital accounts. Recording of a debit amount to one or more accounts and an equal credit amount to one or more accounts results in **total debits being equal to total credits** for all accounts in the general ledger. If the accounting entries are recorded without error, the aggregate balance of all accounts having positive balances will be equal to the aggregate balance of all accounts having negative balances. Accounting entries that debit and credit related accounts typically include the same date and identifying code in both accounts, so that in case of error, each debit and credit can be traced back to a journal and transaction source document, thus preserving an audit trail. The rules for formulating accounting entries are known as "Golden Rules of Accounting". The accounting entries are recorded in the "Books of Accounts". Regardless of which accounts and how many are impacted by a given transaction, the fundamental accounting equation $A = L + OE$ will hold, i.e. assets equals liabilities plus owner's equity.

T- ACCOUNT

The simplest account structure is shaped like the letter T. The account title and account number appear above the T. Debits (abbreviated Dr.) always go on the left side of the T and credits (abbreviated Cr.) always go on the right.

Account title					
Debit side (Dr)			Credit side (Cr)		
Date	Details	Amount Sh.	Date	Details	Amount Sh.

Accountant's record increases in asset, expense, and owner's drawing accounts on the debit side, and they record increases in liability, revenue, and owner's capital accounts on the credit side. An account's assigned normal balance is on the side where an increase goes because the increases in any account are usually greater than the decreases. Therefore, asset, expense, and owner's drawing accounts normally have debit balances. Liability, revenue, and owner's capital accounts normally have credit balances. To determine the correct entry, identify the accounts affected by a transaction, which category each account falls into, and whether the transaction increases or decreases the account's balance.

THE DOUBLE ENTRY FOR ASSETS, LIABILITIES AND CAPITAL

As we mentioned earlier, every transaction affects two accounts. This is to mean that for every transaction there is a debit entry and a corresponding credit entry. This is the bookkeeping stage of accounting known as the double entry.

Transactions may increase or decrease assets, liabilities or capital.

- To increase an asset, we debit the asset account
- To decrease an asset, we credit the assets account.
- To increase a liability/capital account, we credit the liability/Capital account.
- To decrease a liability /capital account, we debit the liability /capital account.

It should be noted from the above analysis that the double entry rules for liabilities and capital are the same but they are the opposite of those of assets.

Dr	Asset a/c	Cr

When risking double entries, there are two important points to note;

- Determine the accounts that are affected by each transaction.
- Figure out which account should be debited and which account should be credited

Illustration

1. A trader starts a business with Shs. 500,000 in cash on 1 January 2014.

Accounts affected	Effect of transaction	Debit or Creditor
Cash account	Increase in asset	Debit
Capital account	Decrease in capital	Credit

Dr	Cash a/c	Cr
2014	Sh.	
January 1	capital 500,000	

Dr	Capital a/c	Cr
	2014	Sh.
	January 1	cash 500,000

2. Furniture is bought For sh. 50,000 cash on 2 January 2014.

Accounts affected	Effect of transaction	Debit or Creditor
Furniture account	Increase in asset	Debit
Cash account	Decrease in asset	Credit

Dr	Furniture a/c	Cr
2014		
Sh.9509		
January 2	Cash 50,000	

Dr	Cash a/c	Cr
	2014	Sh.
	January 2 Furniture	50,000

3. A motor vehicle is bought on credit from Tamim motor for Shs 200,000 on 3 January, 2014.

Accounts affected	Effect of transaction	Debit or Creditor
Motor vehicle	Increase in asset	Debit
Tamim motors	Increase in liabilities	Credit

Dr	Motor vehicle account a/c	Cr
2014	Sh.	
January 3 Tamim	200,000	

Dr	Tamim motors a/c	Cr
	2014	Sh.
	January 3 Motor vehicle	200,000

4. The trader paid the amount owing in cash to Tamim Motors on 20 January 2014.

Accounts affected	Effect of transaction	Debit or Creditor
Cash	Decrease in asset	Credit cash a/c
Tamim motors	Decrease in liability	Debit Tamim motors a/c

Dr	Cash a/c	Cr
	2014	Sh.
	January 20 Tamim Motors	200,000

Dr	Tamim motors a/c	Cr
2014	Sh.	
January 20 Cash	200,000	

5. On combining all the four transactions, the accounts will appear

Accounts affected	Effect of transaction	Debit or Creditor
Cash account	Increase in asset	Debit
Capital account	Decrease in capital	Credit

Dr	Cash a/c	Cr
2014	Sh.	2014
January 1 Capital	500, 000	January 2 Furniture
		50, 000
		January 2 Tamim motors
		200,000

Dr	Capital a/c	Cr
	2014	Sh.
	January 1 cash	500,000

Dr	Furniture a/c	Cr
2014	Sh.	
January 2 Cash	50,000	

Dr	Motor vehicle account a/c	Cr
2014	Sh.	
January 3 Tamim	200,000	

Dr	Tamim motors a/c	Cr
2014	Sh.	2014
January 20 Cash	200,000	January 3 Motor vehicle 200,000

DOUBLE ENTRIES FOR EXPENSES AND REVENUES

Expenses and revenues must be entered into appropriate accounts' in order to calculate profits and losses.

You need to know which expense account should be debited or credited with the amounts involved. As shown earlier, assets involve expenditure by the business hence shown as debit entries. Expenses also involve expenditure by the business and should be shown as debit entries. The reason is that both assets and expenses must be paid for. When this payment is Made, the bank or cash account is credited and therefore the original entry in the asset account or expense account must be a debit.

Revenues on the other hand are treated in the opposite way. When revenue is received, it is initially debited in the bank account or cash account and the corresponding credit entry made in the revenue account.

In summary

Debit expense account with **increase in expense**.

Credit expense account with **decrease in expense**.

Credit revenues account with **increase in revenues**.

Debit revenue account with **decrease in revenues**.

Illustrations

1. A stationer of Shs.10, 000 is paid in cash on 2 February, 2014.

Accounts affected	Effect of transaction	Debit or Creditor
Stationery a/c	Increase in Expense	Debit stationery a/c
Cash a/c	Decrease in asset	Credit Cash a/c

Dr		Stationery a/c	Cr
2014		Sh.	
February 2	Cash	10,000	

Dr		Cash a/c	Cr
		2014	Sh.
		February 2	Stationery
			10,000

2. Shs 15,000 is received in cash for rent earned by the business in 10 February 2014

Accounts affected	Effect of transaction	Debit or Creditor
Rent received a/c	Increase in rent received	Credit
Cash a/c	Decrease in asset	Debit

Dr		Rent received a/c	Cr
		2014	Sh.
		February 10	Cash
			15,000

Dr		Cash a/c	Cr
2014		Sh.	
February 10	Rent received	15,000	

3. On 28 February 6, salary amounting to Shs. 56,000 was paid by cheque

Accounts affected	Effect of transaction	Debit or Creditor
Salaries a/c	Increase in Expense	Debit
Bank a/c	Decrease in asset	Credit

Dr		Salaries a/c	Cr
2014		Sh.	
February 28	Bank	56,000	

Dr		Bank a/c	Cr
2014		Sh.	
		2014	Sh.
		February 28	Salaries
			56,000

THE LEDGER

The ledger, which is the most important and indeed the only essential book used in Bookkeeping, is a classified record of transactions.

Items are grouped in various 'accounts' according to their nature. The term "account" in Bookkeeping means a record showing in Dr. and Cr.

It is usually shown in 'T' form.

Thus an account headed with the name of James Rutto would contain a record of transactions with him and with him only; an account in the name of Motor Vehicles would contain a record of purchases and sales in motor vehicles only.

Types of ledger accounts

The accounts kept in a ledger fall into two categories, 'Personal' and 'Impersonal' accounts.

a) Personal accounts

Personal accounts are those opened by the trader with various persons with whom he transacts business, the trader's own capital account and drawings accounts being included.

b) Impersonal accounts

They include two types:

- i) **Real accounts** — These are accounts which record transactions in property. They relate to tangible things, e.g. cash, investments, bills, stocks, furniture, motor vehicles, etc.
- ii) **Nominal accounts** — These record revenues and gains and losses which have been taken into account in computing the profit or loss which the business has made; e.g. discounts, bad debts, salaries and wages, rent, commissions, etc.

Preparation of ledger accounts or posting

First of all, the opening entry should be posted, as it indicates the balances of assets and liabilities with which the firm starts the new period. The way to post the opening entry is that on the debit side of various assets (which have to be debited according to the opening entry) one writes "To Balance brought down, or just "To Balance b/d"; and then the amount.

In the case of liabilities and the capital account, the entry is: By Balance b/d and then the amount on the credit side. In the case of cash and balances, balances will be written in the Cash Book and no separate accounts will be opened. –

SALES LEDGER AND PURCHASES LEDGER

SALES LEDGER

A sales ledger is an accounting tool used in business to keep track of sales made or invoices sent to customers. A sales ledger can be very simple or complex, depending on the size and the nature of the business. Sales ledgers were at one time handwritten in notebooks, with various columns, but now it is much more common to keep track of expenses using an electronic spreadsheet or accounting computer programs, which are easier to organize, sort, and change if needed. Generally, this type of

ledger will feature a number of different columns including the date, invoice number if applicable, a description of the product or service, and the amount received for it.

Keeping a thorough sales ledger is important for a business for a number of reasons. Not only does it help to keep track of profits and losses, but it can help to reveal purchasing trends, or other types of sales data that may give clues to successful advertising campaigns or store displays, for example. In addition, the ledger can be a helpful tool for preparing tax returns at the end of the year, and can also be invaluable for detailing profits and expenses if the company is ever audited.

Illustration

You are to enter up the sales journal from the following details. Post the items to the relevant accounts in the sales ledger and then show the transfer to the sales account in the general ledger.

2010

March	1	Credit sales to J. Omondi	Sh.1,870
March	3	Credit sales to G. Achieng	Sh. 1,660
March	6	Credit sales to V. Charles	Sh. 120
March	10	Credit sales to J. Omondi	Sh. 550
March	17	Credit sales to F. Mwangi	Sh. 2,890
March	19	Credit sales to U. Aketch	Sh. 660
March	27	Credit sales to V. Sarah	Sh.280
March	31	Credit sales to L. Cate	Sh. 780

Solution

Sales Journal			
Date 2010	Detail	Folio	Amount (sh)
1/3	J. Omondi		1,870.00
3/3	G. Achieng		1,660.00
6/3	V. Charles		120.00
10/3	J. Omondi		550.00
17/3	F. Mwangi		2,890.00
19/3	U. Aketch		660.00
27/3	V. Sarah		280.00
31/3	L. Cate		780.00
			8,810.00

Sales ledger

Omondi a/c			
2010	sh.	2010	sh.
1/3 sales	1,870		
10/3 sales	550		

Achieng a/c

2010	sh.	2010	sh.
3/3 sales	1,620		

Charles a/c

2010	sh.	2010	sh.
6/3 sales	120		

Mwangi a/c

2010	sh.	2010	sh.
17/3 sales	2,890		

Aketch a/c

2010	sh.	2010	sh.
19/3 sales	660		

Cate a/c

2010	sh.	2010	sh.
31/3 sales	780		

Sales a/c

Date	2010	Sh	Date	2010	Sh
			1/3	J. Omondi	1,870
			3/3	G. Achieng	1,660
			6/3	V. Charles	120
			10/3	J. Omondi	550
			17/3	F. Mwangi	2,890
			19/3	U. Aketch	660
			27/3	V. Sarah	280
			31/3	L. Cate	<u>780</u>
					<u>8,810</u>
				Bal.b/d	8,810

PURCHASES LEDGER

A purchases ledger is a system in accountancy by which a business records and monitors its creditors. The purchase ledger contains the individual accounts of suppliers from whom the business has made purchases on credit. Information on invoices and credit notes received and payments

made. are recorded in the supplier's account using the debits and credits system, with the balance of each account at a given moment representing the amount currently owed to that supplier.

Historically, the purchase ledger was maintained in book form, hence the term ledger, but in modern practice it is much more likely to be held on computer using accountancy software or a spreadsheet. The purchase ledger will ordinarily hold a credit balance, unless credit notes or over-payments exceed the credit balance. An example of a purchases ledger is shown below

Xyz Account					
Date 2010	Details	Amount Shs	Date 2010	Details	Amount Shs
1.8	Cash	xx	3.8	Balance b/d	xx
30.8	Balance c/d	<u>xx</u>	1.9	Purchase	<u>xx</u>
		<u>xx</u>		Balance b/d	xx

Illustration

You are to enter the following items in the books, post to personal accounts, and show transfers to the general ledger.

2011	
July 1	Credit purchases from: K. Amos Sh.380; M. Ochieng Sh.500; N: Oluoch Sh.106.
July 3	Credit sales to: E. Ken Sh.510; E. Rose Sh.246; F. Tom Sh.356.
July 5	Credit purchases from; R.Kyule Sh.200; J.Wanja Sh.1 80; D.Mwangi Sh.410; C.Kange Sh.66.
July 8	Credit sales to: A. Ben Sh.307;11 Kim Sh.250; J. Tony Sh.185.
July 12	Returns outwards to: M. Ocheing Sh.30; N. Oluoch.Sh.16,
July 14	Returns inwards from: E. Rose Sh.18; F. Tom Sh.22.
July 20	Credit sales to: E. Rose Sh.188; F. Paul Sh.310; E. Dan Sh.420.
July 24	Credit purchases from: J.Tony Sh.550; K. Musiu 511.900
July 31	Returns inwards from: E. Rose Sh.27; E. Ken Sh.30.
July 31	Returns outwards to: J. Wanja Sh.13; C, Kange Sh.11.

Purchases ledger

N. Oluoch a/c			
2011	Sh.	2011	Sh.
12/7 Returns out	16	1/7 Purchases	106
J. Wanja a/c			
2011	Sh.	2011	Sh.
12/7 Returns out	13	5/7 Purchases	180

K. Amos a/c

2011	Sh.	2011	Sh.
		1/7 Purchases	380

D.Mwangi a/c

2011	Sh.	2011	Sh.
		5/7 Purchases	410

K. Musiu a/c

2011	Sh.	2011	Sh.
		24/7 Purchases	900

M. Ochieng a/c

2011	Sh.	2011	Sh.
30/7 Returns out	30	1/7 Purchases	500

C.Kange a/c

2011	Sh.	2011	Sh.
31/7 Returns out	11	5/7 Purchases	66

R. kyule

2011	Sh.	2011	Sh.
		5/7 Purchases	200

J. Tony a/c

2011	Sh.	2011	Sh.
		24/7 Purchases	550

Purchases a/c

2011	Sh.	2011	Sh.
1/7 K. Amos	380		
1/7 M. Ochieng	500		
1/7 N. Oluoch	106		
5/7 R. Kyule	200		
5/7 J. Wanja	180		
5/7 D. Mwangi	410		
5/7 C. Kange	66		
24/7 J. Tony	550		
24/7 K. Musiu	900	31/7 Balance c/d	3,292
	<u>3,292</u>		<u>3,292</u>
Balance b/d	3,292		

THE TRIAL BALANCE

It has been seen how every amount that is placed on the debit side of an account has a corresponding entry on the credit side of some other account.

This is the technical aspect of the principle of double entry system. This being the case, it is but natural that the total of all the debit balances should agree with the total of all credit balances.

In fact, all businesses periodically tabulate the debit and credit balances separately in a statement to see whether the total of debit balances agrees with the total of credit balances or not. Such a statement is known as the Trial Balance.

The accountant heaves a sigh of relief, when the total of the debit balances agrees with the total of credit balances, because it is quite a good proof that the ledger has been correctly written up. However, it is not a conclusive proof of accuracy. Many mistakes may remain even if a trial balance agrees.

After posting all transactions from an accounting period, accountants prepare a trial balance to verify that the total of all accounts with debit balances equals the total of all accounts with credit balances. The trial balance lists every open general ledger account by account number and provides separate debit and credit columns for entering account balances.

The trial balance format is as follows,

Trial balance as at 31 December 2013		
Rent — income		xxx
Debtor — U Francis	xxx	-
Motor vehicle	xxx	-
Bank	xxx	-
Purchases	xxx	-
Wages	xxx	-
Capital	-	xxx
Creditor — M Anthony	-	xxx
Furniture & Fittings	xxx	-
Sales		xxx
Cash in hand	xxx	-
Creditor - P James	-	xxx
Expenses — Rent	xxx	-
Expenses — Stationery	xxx	-
Returns Outwards	-	xxx
Drawings	xxx	-
	xxx	xxx

Illustration

Writ up the following transactions in the books of S Grace

2003

March 1	Started business with cash Sh.1,500,000
March 2	Bought goods on credit from A. Agnes Sh296,000
March 3	Paid rent by cash Sh.28,000 - .
March 4	Paid Sh.1,000 of the cash of the firm into a bank
March 5	Sold goods on credit to 7. Sarah Sh.54,000
March 7	Bought stationery Sh15 paying by cheque
March 11	Cash sales Sh.49,000
March 14	Goods returned by S. Grace to A. Agnes Sh.17,000
March 17	Sold goods on credit to P. Lutz Sh.29,000
March 20	Paid for repairs to the building by cash Sh.18,000
March 22	3. Sarah returned goods to us Sh.14,000
March 27	Paid A. Agnes by cheque Sh.279,000
March 28	Cash purchases Sh.125,000 .
March 29	Bought a motor vehicle paying by cheque Sh395,000
March 30	Paid motor expenses in cash Sh.15,000
March 31	Bought fixtures Sh.120,000 on credit from R. Robert

Required;

- Prepare ledger accounts
- Extract trial balance from the ledger accounts

Solution:**Capital a/c**

2003		sh. '000'	2003		sh. '000'
31/3	Balance	<u>1,500</u>	1/3	Cash	<u>1,500</u>
				Bal c/d	1,500

Cash in hand a/c

2003		sh. '000'	2003		sh. '000'
1/3	Capital	1,500	3/3	Rent	28
11/3	Sales	49	4/3	Bank	1,000
			28/3	Repairs	18
			28/8	Purchases	125
			30/3	Motor expenses	15
			31/3	Balance c/d	<u>363</u>
		<u>1,549</u>			<u>1,549</u>
	Balance b/d	363			

Purchases a/c

2003		sh. '000'	2003		sh. '000'
2/3	A Agnes	296	31/3	Bal c/d	421
28/3	Cash	<u>125</u>			
		<u>421</u>			<u>421</u>
	Balance	421			

Creditor- A Agnes a/c

2003		sh. '000'	2003		sh. '000'
14/3	Return	17	2/3	Purchases	296
27/3	Bank	<u>279</u>			
		<u>296</u>			<u>296</u>

Rent-Expenses a/c

2003		sh. '000'	2003		sh. '000'
3/3	Cash	<u>28</u>	31/3	Bal c/d	<u>28</u>
	Balance b/d	28			

Bank a/c

2003		sh. '000'	2003		sh. '000'
4/3	Cash	1,000	5/3	Stationery	15
			27/3	A Agnes	279
			30/3	Motor Van	395
			31/3	Balance c/d	<u>311</u>
		<u>1,000</u>			<u>1,000</u>
	Balance b/d	311			

Debtor- J Sarah a/c

2003		sh. '000'	2003		sh. '000'
3/3	Sales	54	22/3	Returns I/W	14
		<u>54</u>	31/3	Balance c/d	<u>40</u>
					<u>54</u>

Sales a/c

2003		sh. '000'	2003		sh. '000'
31/3	Balance c/d	132	5/3	J Sarah	54
			11/3	Sales	49
			17/3	P Lutz	<u>29</u>
					<u>132</u>
			Balance b/d		132

Stationery a/c

2003		sh. '000'	2003		sh. '000'
7/3	Bank	<u>15</u>	31/3	Balance c/d	15
	Balance b/d	15			

Return outwards a/c

2003		sh. '000'	2003		sh. '000'
31/3	Balance c/d	<u>17</u>	14/3	Agnes	<u>17</u>
				Balance c/d	17

P Lutz-Debtor a/c

2003		sh. '000'	2003		sh. '000'
17/3	Sales	<u>29</u>	21/3	Balance c/d	29
	Balance b/d	29			

Building repairs - expenses a/c

2003		sh. '000'	2003		sh. '000'
20/3	Cash	<u>18</u>	31/3	Balance c/d	18
	Balance b/d	18			

Return-Inwards a/c

2003		sh. '000'	2003		sh. '000'
22/3	J Sarah	<u>14</u>	31/3	Balance c/d	14
	Balance b/d	14			

Motor vehicle a/c

2003		sh. '000'	2003		sh. '000'
29/3	Bank	<u>395</u>	31/3	Balance c/d	<u>395</u>
	Balance b/d	395			

Robert- Creditor (others) a/c

2003		sh. '000'	2003		sh. '000'
31/3	J Balance c/d	<u>120</u>	31/3	Fixtures	<u>120</u>
				Balance c/d	120

Motor vehicle Expenses a/c

2003		sh. '000'	2003		sh. '000'
30/3	Cash	<u>15</u>	31/3	Balance c/d	<u>15</u>
	Balance b/d	15			

Fixtures a/c

2003		sh. '000'	2003		sh. '000'
31/3	R Robert	<u>120</u>	31/3	Balance c/d	120
	Balance b/d	120			

S. Grace Trial Balance As At March 2003		
	Debit (Sh)	Credit (Sh)
Capital		1500
Purchases	421	
Cash in hand	363	
Bank	311	
Rent expense	28	
Sales	-	132
Fixtures	120	
Debtor -7 Sarah	40	
Debtor- P Lutz	29	
Motor vehicle	395	
Creditors	-	
Motor expenses	15	
Returns inwards	14	
Creditors others — R	-	120
Robert	15	
Stationery	-	17
Returns outwards	18	
Building repairs	<u>1769</u>	<u>1769</u>

COMPUTERISED ACCOUNTING

Role of Computers in Accounting:

The manual system of recording accounting transactions requires maintaining books of accounts such as journal, cash book, special purpose books, and ledger and so on. From these books summary of transactions and financial statements are prepared manually.

The advanced technology involves various machines, which can perform different accounting functions, for example a billing machine. This machine is capable of computing discount, adding net total and posting the requisite data to the relevant accounts.

With substantial increase in the number of transactions, a new machine was developed to store and process accounting data with greater speed and accuracy. A computer, to which it was connected, operated this machine.

As a result, the maintenance of accounting data on a real-time basis became almost essential. Now maintaining accounting records become more convenient with the computerized accounting.

Objects of Introduction of Computers in Accounting:**Labor Saving:**

Labor saving is the main aim of introduction of computers in accounting. It refers to annual savings in labor cost or increase in the volume of work handled by the existing staff.

Time Saving:

Savings in time is another object of computerization. Computers should be used whenever it is important to save time. It is important that jobs should be completed in a specified time such as the preparation of pay rolls and statement of accounts. Time so saved by using computers may be used for other jobs.

Accuracy:

Accuracy in accounting statements and books of accounts is the most important in business. This can be done without any errors or mistakes with the help of computers. It also helps to locate the errors and frauds very easily.

Minimization of Frauds:

Computer is mainly installed to minimize the chances of frauds committed by the employees, especially in maintaining the books of accounts and handling cash.

Effect on Personnel:

Computer relieves the manual drudgery, reduces the hardness of work and fatigue, and to that extent improves the morale of the employees.

Need for Computerized Accounting:

The need for computerized accounting arises from advantages of speed, accuracy and lower cost of handling the business transactions.

Numerous Transactions:

The computerized accounting system is capable of large number of transactions with speed and accuracy.

Instant Reporting:

It is capable of offering quick and quality reporting because of its speed and accuracy.

Reduction in Paper Work:

Manual accounting system requires large storage space to keep accounting records/books, and vouchers/documents. The requirement of books and stationery and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond certain point. There is a dire need to reduce the paper work and dispense with large volume of books of account. This can be achieved with the help of computerized accounting system.

Flexible Reporting:

The reporting is flexible in computerized accounting system. It is capable of generating reports of any balance as when required and for any duration which is within the accounting period.

Accounting Queries:

There are accounting queries, which are based on some external parameters. For example, a query relating to overdue customers' accounts can be easily answered by using the structured query language [SQL] support of database technology in the computerized accounting system. Such an exercise would be quite difficult and expensive in manual accounting system.

Online Facility:

Computerized accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.

Accuracy:

The information and reports generated are accurate and quite reliable for decision-making. In manual accounting system, as many people do the job and the volume of transactions is quite large, such information and reports are likely to be distorted and unreliable and inaccurate.

Security:

This system is highly secured and the data and information can be kept confidential, when compared to manual accounting system.

Scalability:

The system can cope easily with the increase in the volume of business. It requires only additional data operators for storing additional vouchers.

Special Features of Computerized Accounting System:

1. It leads to quick preparation of accounts and makes available the accounting statements and records on time.
2. It ensures control over accounting work and records.
3. Errors and mistakes would be at minimum in computerized accounting.
4. Maintenance of uniform accounting statements and records is possible.
5. Easy access and reference of accounting information is possible.
6. Flexibility in maintaining accounts is possible.
7. It involves less clerical work and is very neat and more accurate.
8. It adapts to the current and future needs of the business.
9. It generates real-time comprehensive MIS reports and ensures access to complete and critical information instantly.

Requirements of the Computerized Accounting System:**Accounting Framework:**

A good accounting framework in terms of accounting principles, coding and grouping structure is a pre-condition. It is the application environment of the computerized accounting system.

Operating Procedure:

A well-conceived and designed operating procedure blended with suitable operating environment is necessary to work with the computerized accounting system. The computer accounting is one of the database-oriented applications, wherein the transaction data is stored in well-organized database.

The user operates on such database using the required interface. And he takes the required reports by suitable transformations of stored data into information. Hence, it includes all the basic requirements of any database-oriented application in computers.

BENEFITS/ADVANTAGES OF COMPUTERIZED ACCOUNTING:**1. Better Quality Work:**

The accounts prepared with the use of computers are usually uniform, neat, accurate, and more legible than manual job.

2. Lower Operating Costs:

Computer is a labor and time saving devise. Hence, the volume of job handled with the help of computers results in economy and lower operating costs.

3. Improved Efficiency:

Computer brings speed and accuracy in preparing the records and accounts and thus, increases the efficiency of employees.

4. Facilitates Better Control:

From the management point of view, greater control is possible and more information may be available with the use of computer in accounting. It ensures efficient performance in accounting work.

5. Greater Accuracy:

Computerized accounting ensures accuracy in accounting records and statements. It prevents clerical errors and omissions.

6. Relieve Monotony:

Computerized accounting reduces the monotony of doing repetitive accounting jobs, which are tiresome and time consuming.

7. Facilitates Standardization:

Computerized accounting facilitates standardization of accounting routines and procedures. Therefore, standardization in accounting is ensured.

8. Minimizing Mathematical Errors:

While doing mathematics with computers, errors are virtually eliminated unless the data is entered improperly in the first instance.

DISADVANTAGES OF COMPUTERIZED ACCOUNTING:**1. Reduction of Manpower:**

The introduction of computers in accounting work reduces the number of employees in an organization. Thus, it leads to greater amount of unemployment.

2. High Cost:

A small firm cannot install a computer accounting system because of its high installation and maintenance cost. To be more economical there should be large volume of work. If the system is not used to its full capacity, then it would be highly uneconomical.

3. Require Special Skills:

Computer system calls for highly specialized operators. The availability of such skilled personnel is very scarce and very costly.

4. Other Problems:

Frequent repair and power failure may affect the accounting work very much. Computers are prone to viruses. Often time's people will assume the computer is doing things correctly and problems will go unchecked for long period of time.

CHALLENGES/PROBLEMS FACED IN COMPUTERIZED ACCOUNTING SYSTEM:**1. User Training:**

The user, for using computer accounting software, needs to understand the concepts of the software. Hence, he should undergo proper training. A computer operator must learn the basics of computer, concepts of software, working with the operating system software [such as Windows/DOS] and the accounting software.

2. System Dependency:

Using a computer solution makes the user to depend fully on the computer system and necessitates the availability of computer at all times. If the system is not available [due to hardware failure or power cut], it would be difficult to verify the accounts.

3. Hardware Requirements:

A full-fledged computer system with a printer is required to operate the computerized accounting system. Most small organizations may not afford to have such facility with necessary software.

4. System Failure:

When there is a system crash [hard disk crash], there is high risk of losing the data available on the hard disk drive at any point of time. It would be highly painful, if the problem occurs at end of the financial year, when the financial statements should be ready.

5. Backups and Prints:

Backups of the data should be done regularly so that, when the data is lost, it can be restored from floppies [backups]. Regular print outs of the system information would be useful as manual records.

6. Voucher Management:

Accounting software allows easy alteration of data. If a voucher is wrongly placed in a wrong head, it would be very difficult to sort out and bring back the voucher. A good voucher management is very essential.

7. Security:

Additional security has to be provided because improper handling of the system [hardware/software] could be dangerous. Passwords, locks, etc., have to be set so that no unauthorized person can handle the system.

REVISION EXERCISE

QUESTION 1

a) The following transactions relate to Makinga Resort Club.

2007

May 1	Purchased goods on credit from Malewa	Sh 120,000
May 4	Bought goods on credit from	
	D. Songa	Sh 98,000
	Simbuna	Sh 114,000
	Mateta	Sh 100,000
May 10	Sold goods on credit to:	
	Mbaraka	Sh 97,000
	Ndigiri	Sh 120,000

b) The following transactions relate to Moongo traders for the month of March 2005.

March 1	Bought goods for Sh 15,000 on credit from Kamau enterprises.
5	Returned goods Sh3,000 to Kamau Enterprises.
20	Sold goods to Beshir Sh20,000 on credit.
25	Bashiri returned goods Sh 1,500
28	Bought goods from Mbaka Sh30,000 and was allowed 20% trade discount.
31	Sold goods to Mukulima Sh 15,000 and was allowed a 10% trade discount.

- Record the above transactions in the books of original entry.
- Post the entries to the General ledger.

Solution:

a)

Purchases Daybook		
Date 2007	Details	Amount (sh)
May 1	Malewa	120,000
4	D. Songa	98,000
4	Simbuna	114,000
4	Mateta	100,000
		<u>432,000</u>

Sales Daybook		
Date 2007	Details	Amount (sh)
May 10	Mbaraka	97,000
	Ndigiri	120,000
		<u>217,000</u>

b)

Purchases Daybook		
Date	Details	Amount (sh)
May 1	Kamau enterprises	15,000
	Mbaka 30,000	
28	T. Discount (6,000)	<u>24,000</u>
		<u>39,000</u>

Sales Daybook		
Date	Details	Amount (sh)
May 20	Bashiri Ltd	20,000
31	Mukulima 15,000	
	T. Discount (1,500)	<u>13,500</u>
		<u>33,500</u>

Purchases Daybook		
Date	Details	Amount (sh)
May 5	Kamau enterprises	<u>3,000</u>
		<u>3,000</u>

Sales Daybook		
Date	Details	Amount (sh)
May 25	Bashiri Ltd	<u>1,500</u>
		<u>1,500</u>

ii)

Purchases a/c

Shs.000		Shs.000	
Kamau Ent.	15,000		
Mbaka	<u>24,000</u>	Balance c/d	<u>39,000</u>
	<u>39,000</u>		<u>39,000</u>

Sales a/c

Shs.000		Shs.000	
		Bashiri Ltd	20,000
Balance c/d	<u>35,500</u>	Mukulima	<u>13,500</u>
	<u>35,500</u>		<u>35,500</u>

Purchases a/c

Shs.000		Shs.000	
Kamau Ent.	<u>3,000</u>	Balance c/d	<u>3,000</u>
	<u>3,000</u>		<u>3,000</u>

Purchases a/c

	Shs.000		Shs.000
Balance c/d	<u>1,500</u>	Bashiri Ltd	<u>1,500</u>
	<u>1,500</u>		<u>1,500</u>

QUESTION 2

The following transactions relate to Kanja Hotel for the month of April 2007:

- April 1 Bought fixtures on credit from Kamau Sh. 18,000
 4 Kanja took goods worth Sh5,000 for personal use.
 10 Onyango, a debtor for Sh. 15,000 was declared bankrupt. The debt was written off
 15 Some of the fixtures bought on 15th April worth Sh. 1,500 were found unsuitable and were returned to Kamau
 18 Purchased office equipment on credit from Super Ltd for Sh. 21,900
 25 Sold some of the old kitchen equipment for Sh. 25,000 on credit to Wanyanga.
 28 The proprietor brought in personal furniture of Sh. 25,000 for business use.
 30 Received a loan from ASK Bank of sh.800,000 by cheque

Prepare a:

- Purchase daybook
- Sales daybook

Solution:

Kanja**Journal Entries April 2007**

DATE		DR	CR
April 1	Fixture a/c	18,000	
	Kamau a/c		18,000
April 4	Drawings a/c	5,000	
	Stock a/c -		5,000
April 10	Bad debt a/c	15,000	
	Debtor Onyango a/c		15,000
April 15	Kamau a/c	1,500	
	Fixtures a/c		1,500
April 18	Office Equipment a/c	21,900	
	Super Ltd a/c		21,900
April 25	Wanyanga a/c	25,000	
	Kitchen Equipment a/c		25,000
April 28	Furniture	80,000	
	Capital		80,000
April 30	Bank	800,000	
	ABK bank		800,000

QUESTION 3

Nochad Hotels maintains a petty cash book on an imprest system with a monthly cash float of Sh 25,000. The float is reimbursed at the beginning of the month.

The balance brought forward as at 1 May, 2007 was Sh 1,200.

The following payments were made during the month of May, 2007. -

		Sh
May	4	Airtime
		2,000
	9	Otieno-a creditor
		8,000
	17	Cooking gas
		8,000
	25	Bus fare
		3,000

Prepare a petty cash book using the following analysis columns:

- Telephone
- Travelling
- Cooking
- Ledger

Solution:

Receipts Sh.	Date 2006 May	Particulars	Total Sh.	Expenses Telephone Sh.	Travelling Sh	Cooking Sh.	Ledger Sh.
1,200	1	Bal b/d					
23,800		Bank					
	4	Air time	2,000	2,000			
	9	Creditor	8,000				8,000
	16	C. gas	8,000			8,000	
	25	Bus fare	3,000		3,000		
	30		21,000	2,000	3,000	8,000	
		Bal. c/d	4,000				8,000
<u>25,000</u>			<u>25,000</u>				

QUESTION 4

- Why do some businesses keep a petty cashbook as well as a cashbook?
- Kathryn Rochford keeps her petty cashbook on the imprest system, the imprest being Sh.25. For the month of April 20X9 her petty cash transactions were as follows:

		Sh.000
Apr 1	Petty cash balance	113
" 2	Petty cashier presented vouchers to cashier and obtained cash to restore the imprest	2387
" 4	Bought postage stamps	850
" 9	Paid to Courtney Bishop, a creditor	235
" 11	Paid bus fares	172
" 17	Bought envelopes	70
" 23	Received cash for personal telephone call	68

- " 26 Bought petrol 1000
- i) Enter the above transactions in the petty cashbook and balance the petty cashbook at 30 April, bringing down the balance on 1 May.
- ii) On 1 May Kathryn Rochford received an amount of cash from the cashier to restore the imprest. Enter this transaction in the petty cashbook.

Solution:

i)

- To keep detail out of cashbook
- To reduce postings to expense accounts.
- To enable petty cash to be kept by someone other than the main cashier.

ii)

Receipts Sh. 000		Total Sh. 000	Post and stationary Sh. 000	Travel expenses Sh. 000	Ledger accounts Sh. 000
113	(1) Balance b/d				
2,387	(2) Cash				
	(4) Postages	850	850		
	(9) Courtney Bishop	235			235
	(11) Bus fares	172		172	
	(17) Envelopes	70	70		
68	(23) Telephone reimbursed				
	(26)	<u>1000</u>	<u>=</u>	<u>1000</u>	<u>=</u>
		2,327	920	1,172	235
	(30) Balance c/d	241			
<u>2,568</u>		<u>2,568</u>			
241	(1) Balance b/d				
2,259	(1) Cash				

QUESTION 5

The following is a summary of the petty cash transactions of Sing'ornbe Ltd for May 2010

May**Ksh**

1	Received from cashier Ksh300,000 as petty float	
2	Postage	18,000
3	Travelling	12,000
4	Cleaning	15,000
7	Petrol for delivery van	22,000
8	Travelling	25,000
9	Stationery	17,000
11	Cleaning	18,000
14	Postage	5,000
15	Travelling	8,000
18	Stationery	9,000
18	Cleaning	23,000
20	Postage	13,000

24	Delivery van 5,000 mile service	43,000
26	Petrol	18,000
27	Cleaning	21,000
28	Postage	5,000
29	Petrol	14,000

You are required to:

- Rule up suitable petty cash book with analysis columns for expenditure on cleaning, motor expenses. Postage, stationery, travelling.
- Enter the receipt of the amount necessary to restore the imprest and carry down the balance for the commencement of the following month

Solution:

Receipts		Total Ksh'000'	Cleaning Ksh'000'	Motor exp Ksh '000'	Postage Ksh'000'	Stationery Ksh '000'	Travelling Ksh '000'
300	1. Bal b/d						
	2. Postage	18		-	18		-
	3. Travelling	12	-		-	-	12
	4. Cleaning	15	15	-	-	-	
	7. Petrol	22	-	22	-		
	8. Travelling	25	-	-	-	-	25
	9. Stationery	17	-	-	-	17	-
	11. Cleaning	18	18	-	-	-	
	14. Postage	5		-	5	-	
	13. Travelling	8	-	-	-		8
	18. Stationery	9	-	-	-	9	
	15. Cleaning	23	23	-	-	-	
	20. Postage	13	-	-	13	-	-
	24. Motor serv.	43	-	43		-	
	26. Petrol	18		18	-	-	-
	27. Cleaning	21	21	-	-	-	-
	29. Postage	5	-	-	5	-	
	30. Petrol	14	-	14	-	-	-
		286	77	97	41	26	45
286	31. Cash						
	31. balance c/d	300					
286		586					

QUESTION 6

Joseph Onyango opened a shop in Homa Bay on 1 July 2005. The following transactions took place during the month of July 2005:

July

- Introduced Sh.200,000 in cash into the business from his private bank account.
- Opened a business bank account by transferring Sh. 180,000 from the business cash into the account
- Paid Sh.5,000 in cash being rent for the month

- 6 Bought second-hand shop equipment at Sh.3,000 and paid by cheque.
 9 Purchased goods for resale at Sh.10,000 paying them in cash.
 11 Purchased goods for resale on credit worth Sh.20,000 from Selina Wambui.
 20 Returned goods worth Sh.2,000 to Selina Wambui
 23 Made cash sales of Sh. 15,000.
 25 Paid Selina Wambui Sh.16,200 by cheque.
 26 Sold on credit goods worth Sh.10,000 to Frida Atieno.
 27 Frida, Atieno returned goods worth Sh.5,000.
 28 Received a cheque of Sh4,500 from Frida Atieno in settlement of her account, the balance being treated as a cash discount
 30 Sold some of the second-hand office equipment at Sh.1,000 in cash. There was no profit or loss on disposal.
 30 Made a cash withdrawal Sh1,500 for his private use

Required:

- a) Ledger accounts (including the three-column cash book) to record the above transactions.
 b) Trial balance as at 31 July 2005).

Solution:

Date	Details	Disc	Cash	Bank	Date	Details	Disc	Cash	Bank
2005		Sh	Sh	Sh	2005		Sh	Sh	Sh
July 1	Capital		200,000		July 2	Bank		180,000	
2	Cash			180,000	5	Rent		5,000	
23	Sales		15,000		6	Shop equip			3,000
28	F. Atieno	500		4,500	9	Purchases Selina		10,000	
30	Office equip		1,000		25	Drawings			16,200
					30	Bal. c/d		1,500	
								19,500	165,300
			<u>216,000</u>	<u>184,500</u>				<u>216,000</u>	<u>184,000</u>
	Bal. b/d		19,500	165,380					

Equipment a/c

	Shs		Shs
Balance c/d	<u>200,000</u>	Cash	<u>200,000</u>
	<u>200,000</u>		<u>200,000</u>
		Balance b/d	200,000

Rent a/c

	Shs		Shs
Cash	<u>5,000</u>	Balance c/d	<u>5,000</u>
	<u>5,000</u>		<u>5,000</u>
Balance b/d	5,000		

Shop a/c

			Shs
Bank	3,000	Cash	1,000
		Balance c/d	<u>2,000</u>
	<u>3,000</u>		<u>3,000</u>
Balance b/d	3,000		

Purchases a/c

	Shs		Shs
Cash	10,000	Balance c/d	<u>30,000</u>
Selina	<u>20,000</u>		<u>30,000</u>
	<u>30,000</u>		
Balance b/d	30,000		

Selina a/c

	Shs		Shs
Ret	2,000	Purchases	20,000
Bank	16,200		
Balance c/d	<u>1,800</u>		
	<u>20,000</u>		<u>20,000</u>

Return outwards a/c

	Shs		Shs
Balance c/d	<u>2,000</u>	Selina	<u>2,000</u>
	<u>2,000</u>		<u>2,000</u>
		Balance b/d	2,000

Sales a/c

	Shs		Shs
Balance b/d	<u>25,000</u>	Cash	15,000
	<u>25,000</u>	F.ATieno	<u>10,000</u>
			<u>25,000</u>
		Balance b/d	25,000

F. Atieno a/c

			Shs
Sales	10,000	Ret. Out	5,000
		Bank	4,500
		Discount	<u>500</u>
	<u>10,000</u>		<u>10,000</u>

Return inwards a/c

	Shs		Shs
F.ATieno	5,000		
	<u>5,000</u>	Balance b/d	<u>5,000</u>
	<u>5,000</u>		<u>5,000</u>
Balance b/d	5,000		

Drawings a/c

	Shs		Shs
Cash	<u>1,500</u>	Balance c/d	<u>1,500</u>
	<u>1,500</u>		<u>1,500</u>

Trial Balance

	Debit (Sh)	Credit (Sh)
Shop Equipment		
Bank	2,000	
Cash	165,300	
Rent	19,500	
Purchases	5,000	
Returns Inwards	30,000	
Drawings	5,000	
Discount Allowed	1,500	
Capital	500	
Creditors	-	200,000
Returns Outwards	-	1,800
Sales	-	2,000
		<u>25,000</u>
	<u>228,000</u>	<u>228,800</u>

TOPIC 3

ACCOUNTING FOR ASSETS AND LIABILITIES

ASSETS

PROPERTY, PLANT AND EQUIPMENT - IAS 16,

The objective of this Standard is to prescribe the accounting treatment for property, plant and equipment so that users of the financial statements can discern information about an entity's investment in its property, plant and equipment and the changes in such investment. The principal issues in accounting for property, plant and equipment are the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to them.

Property, plant and equipment are tangible items that:

- (a) Are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and
- (b) Are expected to be used during more than one period.
- (c) The cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:
 - i) It is probable that future economic benefits associated with the item will flow to the entity; and
 - ii) The cost of the item can be measured reliably.

Measurement at recognition: An item of property, plant and equipment that qualifies for recognition as an asset shall be measured at its cost. The cost of an item of property, plant and equipment is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as interest over the period of credit unless such interest is recognised in the carrying amount of the item in accordance with the allowed alternative treatment in IAS 23.

The cost of an item of property, plant and equipment comprises:

- (a) Its purchase price, including import duties and non-refundable purchase taxes. After deducting trade discounts and rebates
- (b) Any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.
- (c) The initial estimate of the costs of dismantling and removing the item, and restoring the site on which it is located, the obligation for which an entity incurs either when the item is acquired or as a consequence of having used the item during a particular period for purposes other than to produce inventories during that period.

Measurement after recognition: An entity shall choose either the cost model or the revaluation model as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.

Cost model: After recognition as an asset, an item of property, plant and equipment shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses.

Revaluation Model: After recognition as an asset, an item of property, plant and equipment whose fair value can be measured reliably shall be carried at a revalued amount, being its fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Revaluations shall be made with sufficient regularity to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date.

If an asset's carrying amount is increased as a result of a revaluation, the increase shall be credited directly to equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. If an asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item shall be depreciated separately. The depreciation charge for each period shall be recognised in profit or loss unless it is included in the carrying amount of another asset. The depreciation method- used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.

The **residual value** of an asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life.

To determine whether an item of property, plant and equipment is impaired, an entity applies IAS 36 Impairment of Assets.

The carrying amount of an item of property, plant and equipment shall be derecognized:

- (a) on disposal; or
- (b) When no future economic benefits are expected from its use or disposal. ,

MEANING OF DEPRECIATION

Depreciation is the diminution in the value of assets due to wear and tear or due to just passage of time. In actual practice, both of these factors operate.

True profits of a business cannot be ascertained unless depreciation has been allowed for.

Depreciation means a fall in the quality or value of an asset. The net result of an asset's depreciation is that sooner or later, the asset will become useless. The factors that cause depreciation are:

1. Wear and tear due to actual use
2. Efflux of time — mere passage of time will cause a fall in the value of an asset even if it is not used,
3. Obsolescence — a new invention or a permanent change in demand may render the asset useless.
4. Accidents
5. Fall in market prices.

The fact to remember is that except in a few cases (e.g. land and 'old paintings) all assets depreciate. Though current assets may also lose value, the term depreciation is used only in respect of fixed assets and is usually confined to the fall in value caused by factors one and two mentioned above.

THE BASIC FACTORS IN DEPRECIATION

For calculating depreciation, the basic factors are:

- i. The cost of the asset
- ii. The estimated residual or scrap value at the end of its life
- iii. The estimated number of years of its life (not the actual but the number of years it is likely to be used by the firm). Machinery maybe capable of running for thirty years, but, say, due to new inventions, it will be in use only for ten years, then the estimated life is ten years and • not thirty years.

So much depreciation has to be provided as will reduce the value of the asset to its scrap value at the end of its estimated life. The Companies Act requires companies to write off or provide for depreciation in a specified manner.

Objectives of Providing Depreciation

1. **To ascertain true value of assets and financial position:** The value of assets diminishes over a period of time on account of various factors. In order to present a true state of affairs of the business, the assets should be shown in the Balance Sheet, at their true and fair values. If the depreciation is not provided, the asset will appear in the Balance Sheet at the original

value. So, in order to show the true financial position of a business, it is imperative to charge depreciation on the assets. If depreciation is not provided, the value of assets will be shown at inflated value in the Balance Sheet. By this means, fixed assets will not represent true and correct state of affairs of business.

2. **To make provision for replacement of worn out assets:** All the fixed assets used in the business require replacement after the expiry of their useful life. The need for replacement can be due to many reasons like change in technology, taste, fashion or demand, which makes a particular asset useless causing permanent loss in its value. To provide requisite amount for replacement of this depreciating asset, annual depreciation is charged to Profit & Loss Account. The amount so provided may be retained in business by ploughing back or invested in outside securities to make the funds available for replacement purposes. Practically, the provisions so provided for depreciation help to recoup the expired cost of the assets used, depleted or exhausted.
3. **To calculate correct amount of profits or loss:** Matching principles states that the expenses or costs incurred to earn revenue must be charged to Profit & Loss Account for the purpose of correct computation of profit. When an asset is purchased, it is nothing more than a payment in advance for the use of asset. Depreciation is the cost of using a fixed asset. To determine true and correct amount of profit or loss, depreciation must be treated as revenue expenses and debited to Profit & Loss Account. Like any other operating expenses, if depreciation is not provided, the profits will be inflated and losses understated.
4. **To compute cost of production:** depreciation not only facilitates financial accounting in computation of profits but it is also an important element of cost determination process. In the absence of depreciation, it is very difficult to ascertain the actual cost of production, process, batch, contract and order of a product. Although the method of charging depreciation is entirely different, without depreciation, no costing system is complete.
5. **To comply with legal provisions:** Section 205 of the Companies Act 1956 provides that depreciation on fixed assets must be charged and necessary provision should be made before the company distributes dividends to its shareholders, Hence, depreciation is charged to comply with the provisions of the Companies Act.
6. **To avail of tax benefits;** The income statement of Account will show more profits if depreciation is not charged on assets. In this case, the business needs to pay more income tax to the government. Depreciation charges on assets save the amount of tax equivalent to tax rate. Since it is shown as expense in the income statement of Account, it shrinks the amount of profit.

METHODS FOR PROVIDING DEPRECIATION

The following are the various methods for providing depreciation —

- (a) Fixed percentage on Original or Fixed Installment or Straight Line Method
- (b) Fixed percentage on Diminishing Balance or Reducing Balance Method
- (c) Sum of the Digits Method
- (d) Annuity Method
- (e) Depreciation Fund Method
- (f) Insurance Policy Method
- (g) Revaluation Method
- (h) Depletion Method
- (i) Machine Hour Rate Method
- (j) Repairs Provision Method

(a) Fixed Percentage on Original Cost

Under this method, a suitable percentage of original cost is written off the asset every year. Thus, if an asset costs Shs.20, 000 and ten percent depreciation is thought proper, Shs.2, 000 would be written off each year.

The amount to be written off every year is arrived at as under;

$$\frac{\text{Cost minus — Estimated Scrap Value}}{\text{Estimated Life}}$$

In the case of companies, the scrap value is assumed to be five percent of the original cost of the asset. In other words, ninety five percent of the cost-of an asset is to be written off over its life.

The tile oldie asset is to be reckoned by reference to the rate recognized by the Income-tax Rules. The Rules lay down that depreciation is to be provided by applying the prescribed rate to the reducing book figure or the asset as a result of the depreciation charge.

The period for which the asset is used in a particular year should also be taken into account, Thus, if the asset is purchased on first April, and the books are closed on thirty first December, only nine months' depreciation should be written off in the first year, though income tax authorities will permit depreciation for a full year even if the asset is used only for a short while.

This method is useful when the service rendered by the asset is uniform from year to year. It is desirable, when this method is in use, to estimate the amount to be spent by way of repairs during the whole life of the asset and provide for repairs each year at the average, actual repairs being debited against the provision.

(b). Fixed Percentage on Diminishing Balance

Under this method, the rate or percentage of depreciation is fixed, but it applies to the Value at which the asset stands in the books in the beginning of the year.

In the first year, depreciation is written off proportionate to the actual period in use. The depreciation on Shs.20,000 - the cost of the asset - at the rate of ten percent will be Shs.2,000 in the first year. This will reduce the book value of the asset to Shs.18,000. Depreciation in the second year will be Shs.1,800, i.e., ten percent of Shs.18,000.

In the third year it will be Shs.1,620. It should be noted that, taking the life of the asset to be the same, the rate of depreciation in the second method will be roughly three times the rate under the first method.

Since the real cost of using an asset is the depreciation to be written off plus the amount spent on repairs of the asset, the second method, viz., Fixed Percentage on Diminishing Balance gives better results.

In the first year of the life of an asset, repairs are light. They rise as the asset gets older: If one follows the first method of depreciation, the total cost of using the asset, viz., depreciation (which is constant every year) plus repairs, will rise.

Later years will show heavier expense. This is not proper because the asset gives the same service in the later years, as in the earlier years.

The charge to Profit and Loss Account should be uniform. If one follows the second method, depreciation in the earlier years will be heavy but will be lighter as the asset gets old.

Repairs, on the other hand, are light in the earlier years and heavier later. The total of the two - depreciation and repairs - will be roughly constant. This method also recognizes on more fact.

As soon as an asset is put to use, its value, for sale purposes, falls heavily. Under this method, the depreciation is heaviest in the first year. Thus, it reduces the book figure to its appropriate value. Further, Income tax authorities recognize this method.

Both methods ignore interest. When an asset is used, one loses ultimately not only the money spent on acquiring the asset but also the interest which could have been earned on it. The amount to be charged by way of depreciation, therefore, should take into consideration not only the cost of the asset but also the interest.

(c). Sum of the Digits Method

Under this method, the amount of the depreciation to be written off each year is calculated by the formula:

$$\frac{\text{Remaining life of the asset (including the current year)}}{\text{Sum of all the life of the asset in years}} \times \text{Cost of the asset}$$

Suppose the He'd an asset costing Shs.50, 000 is ten years. The sum of all the digits one to ten is fifty five. The depreciation to be provided in the first year will be:

$$\frac{10}{55} \times 50,000 = \text{sh. } 9,091$$

In the second year, it will be:

$$\frac{9}{55} \times 50,000 = \text{sh. } 8,181$$

It will be noticed that the method is similar to the Diminishing Value Method stated above.

(d). Annuity Method

As has been pointed out, the first two methods ignore interest. The annuity method takes into account the interest lost on the acquisition of an asset.

Interest is calculated on the book value of the asset at the current rate and debited to the asset account and credited to Interest Account.

The amount to be written off as depreciation is calculated from the annuity tables. The depreciation will be different according to the rate of interest and according to the period, over which the asset is to be written off.

(e). Revaluation Method

This method is used only in case of small items like cattle (livestock) or loose tools where it may be too much to maintain an account of each single item. The amount of depreciation to be written off is determined by comparing the value at the end of the year (valuation being done by someone having knowledge of the asset) with the value in the beginning.

Suppose on first January, 2005 the value of loose tools was Shs. 1, 600 and during the year Shs.2. 000 worth of tools were purchased.

Now, if at the end of the year, the loose tools are considered to be worth only Shs.2, 400, the depreciation comes to Shs.1, 200, i.e. Shs. 1,600 + 2,000 - 2,400

(f). Depletion Method

This method is used in case of mines, quarries etc. where an estimate of total quantity of output likely to be available should be available.

Depreciation is calculated per tonne of output. For example, if amine-is purchased for Shs.2, 00,000 and it is estimated that the total quantity of mineral in the mine is 5, 00,000 tonnes, the depreciation per tonne output comes to 40%. i e.

$$\left[\frac{200,000}{500,000} \right] \times 100$$

If the output- in the first year is 30,000 tonnes, the depreciation to be written off in the first year will be 30.000 x 0.40 or Sh. 12,000, in the second year, the output may be.50,000 tonnes; the depreciation to be written off will be Shs.20, 000 i.e. 50,000 x 0.40

(g). Machine hour Rate Method

This is more or less like the .above. Instead of the usual method of estimating the, life of a machine in years, it is estimated in hours. Then an accurate record is kept recording the number of hours each machine is run and depreciation is calculated accordingly

For example, the effective life of a machine may be 30,000 hours. If the cost of the machine is Shs.45,000, the hourly depreciation is Shs.1.50. The depreciation for a particular year during which the machine runs for 2,500 hours will be 2,500 x1.50 or Sh. 3,750

(h).Repairs Provision Method

Institute of Cost and 'Management Accountants of England and Wales defines this method as follows: " The -method of providing for the aggregate of depreciation and maintenance cost by means of periodic charges each of which is a constant proportion of the aggregate of the cost of the asset depreciated and the expected maintenance cost during its life." ,

It means that to the cost of the asset (less its estimated scrap value), the amount expected to be spent on its repairs and maintenance throughout its life should be added and the sum then divided by its estimated life.

Suppose an asset costs Shs.60, 000 and has an estimated scrap value of Shs.6, 000; it is expected that its life is fifteen years during which period a sum of Shs.30, 000 is likely to be spent on its repairs and maintenance

The total amount to be written off is Shs.'84,000 i.e. Shs.60, 000 — Shs.6, 000 + Shs.30, 000. Dividend by 15 the amount is Shs.5, 600.

If it is debited to the Profit and Loss Account each year, both depreciation and repairs will be taken care of. Of the amount, Shs.2, 000 should be credited to Repairs Provision Account, i.e. 30,000÷15 and the balance Shs.3, 600 credited to Depreciation Provision Account:

Actual repairs will have to be debited to the Repairs Provision Account and not to the Profit and Loss Account. -

ACCOUNTING TREATMENT ON DEPRECIATION

When non-current assets are depreciated, a new account for each type of asset is opened; this account is called a provision for depreciation whereby the following entries will be made;

Debit - P&L a/c

Credit — Provision for depreciation a/c

With the amount of depreciation charged for the period.

Illustration

A company starts a business on 1 January 1999, the financial year end being 31 December.

You are to show:

- The plant account.
- The provision for depreciation account.
- The balance sheet extracts for each of the years 1999, 2000, 2001, 2002.

The machinery bought was:

1999	1 January	1 plant costing shs.8,000
2000	1 July 2	2 plant costing shs.5,000 each
	1 October	1 plant costing shs.6,000
2002	1 April	1 plant costing shs.2,000

Depreciation is at the rate of 10 per cent per annum, using the straight-line method, plant being depreciated for each proportion of a year.

Plant account

Date		Sh.	Date		Sh.
1999					
1/1	Cashbook	8,000	31/12	Balance c/d	8,000
2000					
1/1	Balance b/d	8,000			
	Cashbook	10,000			
	Cashbook	<u>6,000</u>	31/12	Balance c/d	<u>24,000</u>
		<u>24,000</u>			<u>24,000</u>
2001					
1/1	Balance b/d	<u>24,000</u>	31/12	Balance c/d	<u>24,000</u>
2002					
1/1	-				
1/1	Balance b/d.	24,000			
¼	Cashbook	<u>2,000</u>	31/12	Balance old	<u>26,000</u>
		<u>26,000</u>			<u>26,000</u>

Calculation for depreciation

1999 8,000 x 10/100 x 12/12	Shs 800	Accumulated Depreciation 800
2000 10,000 x 10/100 x 6/12 6,000 x 10/100 x 3/12 8,000 x 10/100 x 12/12	500 150 <u>800</u>	1450
2001 24,000 x 10/100 x 12/12	2400	2400
2002 24,000 x 10/100 x 12/12 2,000 x 10/100 x 9/12	2400 <u>150</u>	<u>2550</u> <u>7200</u>

Provision for Depreciation

Date	Details	Amount Shs	Date	Details	Amount Shs
1999 31/12	Balance c/d	<u>800</u>	1999 31/12	Income statement	<u>800</u>
2000 31/12	Balance c/d	2,250	2000 1/1	Balance b/d	800
		-	31/12	Income statement	<u>1450</u>
		<u>2,250</u>			<u>2250</u>
2001 31/12	Balance c/d	4,650	2001 1/1	Balance b/d	2,250
		<u>4,650</u>	31/12	Income statement	<u>2,400</u>
					<u>4,650</u>
2002 31/12	Balance c/d	7,200	2002 1/1	Balance b/d	4,650
		<u>7,200</u>	31/12	Income statement	<u>2,550</u>
					<u>7,200</u>

Balance Sheet (Extract) as at 31/12/99 - 31/12/02

Non-Current Assets	Cost Sh.	Acc Depreciation Sh.	NBV Sh,
1999 Plant	<u>8,000</u>	<u>(800)</u>	<u>7,200</u>
2000 Plant	<u>24,000</u>	<u>(2,250)</u>	<u>21,750</u>
2001 Plant	<u>24,000</u>	<u>(4,650)</u>	<u>19,350</u>
2002 Plant	<u>26,00</u>	<u>(7,200)</u>	<u>18,800</u>

DISPOSALS OF ASSETS

A firm may dispose off its non-current assets in the following 3 ways:

- i) Selling the asset,
- ii) Asset being written-off from damage/accident/theft.
- iii) Asset is scrapped/not used anymore.

When an asset is disposed and is no longer used by the firm, the appropriate entries should be made in the asset account and the total depreciation provided to date on the asset and the entries required will depend on the type of disposal.

When the asset is sold, the following entries will be made:

- (a) Debit - asset disposal a/c
Credit asset a/c

With the cost of the asset being disposed

- (b) Debit - provision for depreciation of asset a/c.
Credit - asset disposal a/c

With the total depreciation provided to date on the asset.

- (c) Debit - cashbook.
Credit asset disposal a/c

With the cash received on disposal.

When an asset is written off as a result of damage/accident/theft

If it was insured and the insurance company accept liability but by the end of the period the insurance Company has not yet paid.

- (a) Debit. - Asset disposal a/c
Credit - asset a/c

With the cost of the asset damaged.

- (b) Debit - provision for depreciation of asset a/c
Credit - asset disposal a/c
- (c) Debit - insurance receivable a/c
Credit - asset disposal a/c

With the amount expected from the insurance.

If the insurance pays before the end of the financial period, it will not be necessary to create an insurance debtor so the following entries will be made:

Debit cashbook.
Credit asset disposal a/c

If the asset is not used anymore or scrapped by the firm, the appropriate entries will be made in the asset account and provision for depreciation a/c only.

Debit - asset disposal a/c
Credit - asset a/c

With the cost of the asset no longer in use

Debit - provision for depreciation for asset
Credit asset disposal a/c

With the total depreciation provided to date.

The balance in the disposal a/c after the above entries will either be a debit balance or a credit balance. A Credit balance represents a profit on disposal, which is reported in the profit and loss a/c together with other incomes. The entry will be:

Debit asset disposal a/c
Credit - P&L a/c

With the balance in the account'

A debit balance in the asset disposal a/c is loss on disposal which is reported in the P&L a/c as an expense and therefore the entry will be.

Illustration

A company depreciates its plant at the rate of 20 per cent per annum, straight line method, for each month of ownership. From the following details draw up the plant account and the provision for depreciation account for each of the years 2005, 2006, 2007 and 2008.

2005 Bought plant costing Sh. 900 on 1 January.

Bought plant costing' 511. 600 on 1 October.

2007 Bought plant costing Sh. 550 on 1 July

2008 Sold plant which had been bought for Sh. 900 on 1 January 2005 for the sum of Sh. 275 on 30 September 2008

You are also required to draw up the plant disposal account and the extracts from the balance sheet as at the end of each year.

Plant a/c

Date		Sh.	Date		Sh,
2005			2005		
1/1	Cashbook	900			
1/10	Cashbook	600	31/12	Balance c/d	<u>1,500</u>
		<u>1,500</u>			<u>1,500</u>
2006			2006		
1/1	Balance b/d	<u>1,500</u>	31/12	Balance c/d	<u>1,500</u>
2007			2007		
1/1	Balance b/d	1,500			
1/7	Cashbook	550	31/12	Balance c/d	<u>2,050</u>
		<u>2,050</u>			<u>2,050</u>
2008			2008		
1/1	Balance b/d	<u>2,050</u>	30/9	Disposal	900
		<u>2,050</u>	31/12	Balance b/d	<u>1,150</u>
					<u>2,050</u>

Plant Provision for Depreciation a/c

Date		Sh.	Date		Sh,
2005			2005		
31/12	Balance c/d	<u>210</u>	31/12	Income Statement	<u>210</u>
2006			2006		
			1/1	Balance b/d	210
31/12	Balance c/d	<u>510</u>		Income Statement	<u>300</u>
		<u>510</u>			<u>510</u>
2007			2007		
			1/1	Balance b/d	510
31/12	Balance c/d	<u>865</u>		Income Statement	<u>355</u>
		<u>865</u>			<u>865</u>
2008			2008		
31/12	Disposal	675	30/9	Balance b/d	865
	Balance b/d	555	31/12	Income Statement	<u>365</u>
		<u>1,230</u>			<u>1,230</u>

Calculation for Depreciation

Date	Cost		Months Depreciation charge	Sh.
2005				
1/1	900	12	$20/100 \times 900 \times 12/12$	180
1/10	600	3	$20/100 \times 600 \times 3/12$	30
2006				
1/1	1,500	12	$20/100 \times 1,500 \times 12/12$	300
2007				
1/1	1,500	12	$20/100 \times 1,500 \times 12/12$	300
1/2	550	6	$20/100 \times 550 \times 6/12$	<u>55</u>
				<u>355</u>
2008				
30/9	900	9	$20/100 \times 900 \times 9/12$	135
31/12	550	12	$20/100 \times 550 \times 12/12$	110
31/12	600	12	$20/100 \times 600 \times 12/12$	<u>120</u>
				<u>365</u>

Plant Disposal a/c

2008		Sh.	2008		Sh.
	Plant a/c	900	30/9	Provision for depreciation	675
	P&L	<u>50</u>	30/9	Cashbook	<u>275</u>
		<u>950</u>			<u>950</u>

Balance Sheet (Extract

	Non-Current Assets	Cost	Total Depreciation	NBV
2005	Plant	1,500	(210)	1,290
2006	Plant	1,500	(510)	990
2007	Plant	2,050	(865)	1,185
2008	Plant	1,150	(555)	595

REVALUATION OF NON-CURRENT ASSETS

In finance, a revaluation of non-current assets is a technique that may be required to accurately describe the true value of the capital goods a business owns. This should be distinguished from planned depreciation, where the recorded decline in value of an asset is tied to its age.

Non-current assets are held by an enterprise for the purpose of producing goods or rendering services, as opposed to being held for resale in the normal course of business. For example, machines, buildings, patents or licenses can be fixed assets of a business.

The purpose of a revaluation is to bring into the books the fair market value of fixed assets. This may be helpful in order to decide whether to invest in another business. If a company wants to sell one of its assets, it is revalued in preparation for sales negotiations.

Reasons for revaluation

It is common to see companies revaluing their fixed assets. It is important to make the distinctions between a 'private' revaluation to a 'public' revaluation which is carried out in the financial reports. The purposes are varied:

- To show the true rate of return on capital employed.
- To conserve adequate funds in the business for replacement of Fixed assets at the end of their useful lives. Provision for depreciation based on historic cost will show inflated profits and lead to payment of excessive dividends.
- To show the fair market value of assets which have considerably appreciated since their purchase such as land and buildings.
- To negotiate fair price for the assets of the company before merger with or acquisition by another company.
- To enable proper internal reconstruction, and external reconstruction.
- To issue shares to existing shareholders (rights issue or follow-on offering).
- To get fair market value of assets, in case of sale and leaseback transaction.
- When the company intends to take a loan from banks/financial institutions by mortgaging its fixed assets. Proper revaluation of assets would enable the company to get a higher amount of loan.
- Sale of an individual asset or group of assets.
- In financial firms revaluation reserves are required for regulatory reasons. They are included when calculating a firm's funds to give a fairer view of resources. Only a portion of the firm's total funds (usually about 20%) can be loaned or in the hands of any one counterparty at any one time (large exposures restrictions).
- To decrease the leverage ratio (the ratio of debt to equity).

PROPERTY PLANT AND EQUIPMENT MOVEMENT SCHEDULE

The property, plant and equipment schedule is a summary report on the balances and transactions of the asset and provision for depreciation account as per the requirements of LAS 16 to be reported in the published accounts of companies.

The format is as follows:

Cost Valuation	Freehold Property	Leasehold Property		Plant and Machinery	Fixture, Furniture & Fittings	Total
		Long Leases	Short Leases			
Bal. as at 1/1/01	xx	xx	xx	xx	xx	xx
Additions	xx	xx	xx	xx	xx	xx
Revaluations (gains)	xx	xx	xx	xx	xx	xx
Reclassifications	-	xx	xx	xx	xx	xx
Disposals	xx	xx	xx	xx	xx	xx
Ba1. as at 31/12/01	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>
Depreciation/Amortization						
Ba1. as at 1/1/10	-	-	xx	xx	xx	xx
Change for year	xx	-	xx	xx	xx	xx
Revaluation	xx	-	xx	xx	xx	xx
Eliminated on Disposal	xx	-	xx	xx	xx	xx
Balance as at 31/12/01	<u>xx</u>	<u>-</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>	<u>xx</u>
N.B. V as at 31/12/01	xx	xx	xx	xx	xx	xx
NBV as at 31/12/01	xx	xx	xx	xx	xx	xx

Additional information is in this schedule called reclassifications where some of the non-current assets are transferred into a different class. (e.g.) some of the properties held under long leases (over 50 years) will be transferred to the short leases classes when their term becomes less than 50 years. This is a reclassification from long lease to short lease and so is shown in the schedule at. the value of transfer as a deduction in the long lease class and on addition in the short lease class

Illustration

Jaba Ltd. started its operations on 1 January 2008. The company acquired several items of plant for its use. The amounts for the plant acquisitions, disposals and depreciation for the years 2008, 2009 and 2010 are shown below.

The amounts for the year 2011 have not yet been computed.

Plant movement extracts for the years ended:

	2008	2009	2010	2011
	Sh '000'	Sh '000'	Sh '000'	Sh '000'
Plant at cost	80,000	80,000	90,000	?
Accumulated depreciation	<u>(16,000)</u>	<u>(28,800)</u>	<u>(36,700)</u>	<u>?</u>
Net book value	<u>64,000</u>	<u>51,200</u>	<u>53,300</u>	<u>?</u>

Additional information:

- Disposals took place at the beginning of the financial years as follows:

	Date of disposal	Plant cost Sh '000'	Sales proceeds Sh '000'
Disposal of plant A	2010	15,000	8,000
Disposal of plant B	2011	15,000	21,000

- Plant A and plant B were sold and replaced on the same date when plant C and plant D were acquired. Plant D cost Sh.50 million while the value of plant 'C is to be derived.
- Depreciation is charged at 20% on reducing balance.

Required:

- Extract of the plant movement schedule for the years ended 2008, 2009, 2010 and 2011
- Profit or loss arising on disposal of plant A and plant 13.

Solution

b) Movement schedule

Jaba limited

Schedule of movements of plant for the year ended 2008, 2009, 2010 and 2011

	2008 Sh '000'	2008 Sh '000'	2008 Sh '000'	2008 Sh '000'
Asset cost				
as at 1 st January	80,000	80,000	80,000	90,000
Additions	-	-	25,000 (w1)	50,000
Disposals	-	-	(15,000)	(30,000)
Cost as at 31 st December	<u>80,000</u>	<u>80,000</u>	<u>90,000</u>	110,000
Depreciation				
At start	-	16,000	28,800	36,700
Annual charge	16,000	12,800	15,220 (w1)	20,660 (w4)
On disposal	-	-	(7,323)	(17,712)
Cumulative for the year	<u>16,000</u>	<u>28,800</u>	<u>36,700</u>	<u>39,648</u>
NBV as at 31.12	<u>64,000</u>	<u>51,200</u>	<u>53,300</u>	<u>70,352</u>

W1

Plant 2010 account A

	Sh '000'		Sh '000'
Balance b/d	80,000	Disposal	15,000
Bank	<u>25,000</u>	Balance c/d	<u>90,000</u>
	<u>105,000</u>		<u>105,000</u>

W2

Provision for depreciation on plant A

	Sh '000'		Sh '000'
Disposal	7,320	Balance b/d	28,800
Bank	<u>36,700</u>	Depreciation	<u>15,220</u>
	<u>44,020</u>		<u>44,020</u>

For 2008: $20\% \times 15,000 = 3,000$ For 2009: $20\% \times 12,000 = 2,400$ For 2010: $20\% \times 9,600 = 1,920$ **7,320**

W3

Plant 2011 account B

	Sh '000'		Sh '000'
Balance b/d	90,000	Disposal	30,000
Bank	<u>50,000</u>	Balance c/d	<u>110,000</u>
	<u>140,000</u>		<u>140,000</u>

W4

Provision for depreciation on plant B

	Sh '000'		Sh '000'
Disposal	17,712	Balance b/d	36,700
Bank	<u>39,648</u>	Depreciation	<u>20,660</u>
	<u>57,360</u>		<u>57,360</u>

 $20\% \times 30,000 = 6,000,000$ $20\% \times 24,000 = 4,800,000$ $20\% \times 19,200 = 3,840,000$ $20\% \times 15,360 = 3,072,000$ **17,712,000**

Gain or loss on disposal of plant A and B

Plant A a/c

	Sh '000'		Sh '000'
Balance c/d	<u>15,000</u>	Disposal	<u>15,000</u>
	<u>15,000</u>		<u>15,000</u>

Disposal of plant A a/c

	Sh '000'		Sh '000'
Plant A	15,000	Bank	8,000
Gain on disposal	<u>320</u>	Acc. Depreciation	<u>7,320</u>
	<u>15,320</u>		<u>15,320</u>

Plant B a/c

	Sh '000'		Sh '000'
Balance c/d	<u>30,000</u>	Disposal	<u>30,000</u>
	<u>30,000</u>		<u>30,000</u>

Disposal of plant B a/c

	Sh '000'		Sh '000'
Plant B	30,000	Bank	21,000
Gain on disposal	<u>7,712</u>	Acc. Depreciation	<u>17,712</u>
	<u>37,712</u>		<u>37,712</u>

Illustration

The chief accountant of Jivunie Ltd has encountered difficulties while accounting for fixed assets and the related depreciation in the company's draft accounts for the year ended 30 April 2011. He has decided to seek your professional advice and presented the following balances of fixed assets as at 1 May 2010:

	Acquisition Cost	Accumulated Depreciation	Depreciation Rates
	Sh.	Sh.	%
Furniture	900,000	300,000	12.5
Trucks	3,525,000	1,470,000	25
Plant and machinery	7,387,500	4,462,500	10
Land	2,775,000	-	Nil
Buildings	2,925,000	292,500	2.5

The following additional information was also available:

1. It is the company's policy to write off cost of the assets using above percentages on cost.
2. Depreciation is fully charged in the year of acquisition and none in the year of disposal.
3. A three year old machine acquired for sh.187,500 was sold for sh.15,750.
4. It has been decided to adjust and charge depreciation on buildings at 4%.
5. A used delivery truck purchased three years ago for sh.248,250 was traded in during the year at a value of sh.157,500 in part exchange of the new delivery truck costing sh.450,000.
5. Land, buildings and machinery were acquired for sh.1,350,000 from a company that went out of business. At the time of acquisition sh.90,000 was paid to have the assets revalued by a professionally qualified valuer. The revaluation indicated the following market values.

	Sh.
Land	900,000
Buildings	600,000
Machinery	300,000

Required:

A schedule of movement of fixed assets as requested by the Chief Accountant for inclusion in the company's accounts for the year ended 30 April 2011.

Cost/Valuation	Land building & Machinery	Furniture	Motor	Total
Bal. as at 1/5/2010	13,087,500	900,000	3,525,000	17,512,500
Additions	1,350,000	-	450,000	1,800,000
Revaluations (gains)	450,000	-	-	450,000
Disposals	(187,500)	-	(248,250)	(435,750)
Ba1. as at 30/04/2011	14,700,000	900,000	3,726,750	19,326,750
Depreciation				
Ba1. as at 1/5/10	4,755,000	300,000	1,470,000	6,525,000
Charge for year	1,066,500	112,500	931,687.5	2,110,687.5
Eliminated on Disposal	(37,500)	-	(124,125)	(161,625)
Balance as at 30/4/2011	<u>5,784,000</u>	<u>412,500</u>	<u>2,277,562.5</u>	<u>8,474,062.5</u>
N.B. V as at 1/5/2010	8,332,500	600,000	2,055,000	10,987,500
NBV as at 30/4/2011	8,916,000	487,500	1,449,187.5	10852,687.8

Workings:

Depreciation on Furniture = $900,000 \times 12.5\% = \underline{112,500}$

Depreciation on disposed delivery truck $25\% \times 248.250 \times 2 = \underline{\text{sh.}124, 125}$

Motor vehicle — $3,726,750 \times 25\% = \underline{931,587.5}$

Buildings - $(2,925,500 + 600,000) \times 4\% = \underline{141,000}$

At $4\% = 2,925,500 \times 4\% \times 4 = \underline{468,000}$

$2.5\% = 2,925,000 \times 2.5\% \times 4 = \underline{292,500}$

175,500

Machinery: = Cost + Additions — Disposals = Balance $\times 10\%$

$7,387,500 + 300,000 \text{ L. } (187,500) = 7,500,000 \times 10\%$

= A. 750,000

Depreciation on disposed machine $10\% \times 187,500 \times 2 = 37,500$

INTANGIBLE ASSETS

RECOGNITION, (AMORTIZATION, IMPAIRMENT AND DISPOSALS AND DISCLOSURES

The objective of this Standard is to prescribe the accounting treatment for intangible assets that are not dealt with specifically in another Standard. This Standard requires an entity to recognise an intangible asset if, and only if, specified criteria are met. The Standard also specifies how to measure the carrying amount of intangible assets and requires specified disclosures about intangible assets.

An intangible asset is an identifiable non-monetary, asset without physical substance.

Recognition and measurement

The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:

- a) The definition of an intangible asset; and
- b) The recognition criteria.

This requirement applies to costs incurred initially to acquire or internally generate an intangible asset' and those incurred subsequently to add to, replace part of, or service it.

An asset meets the identifiability criterion in the definition of an intangible asset when it:

- a) is separable, i.e. is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability; or
- b) Arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

An intangible asset shall be recognised if, and only if: -

- a) It is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and
- b) The cost of the asset can be measured reliably.

The probability recognition criterion is always considered to be satisfied for intangible assets that are acquired separately or in a business combination.

An intangible asset shall be measured initially at cost.

The cost of a separately acquired intangible asset comprises:

- a) Its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates; and

- a. Any directly attributable cost of preparing the asset for its, intended use.

In accordance with IFRS 3 Business Combinations, if an intangible asset is acquired in a business combination, the cost of that intangible asset is its fair value at the acquisition date. The only circumstances in which it might not be possible to measure reliably the fair value of an intangible asset acquired in a business combination are when the intangible asset arises from legal or other contractual rights and either:

- a) is not separable; or
- b) is separable, but there is no history or evidence of exchange transactions for the same or similar assets, and otherwise estimating fair value would be dependent on immeasurable variables.

Internally generated intangible assets

Internally generated goodwill shall not be recognised as an asset.

No intangible asset arising from research (or from the research phase of an internal project) shall be recognised. Expenditure on research (or on the research phase of an internal project) shall be recognised as an expense when it is incurred.

An intangible asset arising from development (or from the development phase of an internal project) shall be recognised if and only if, an entity can demonstrate all of the following:

- a) The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- b) Its intention to complete the intangible asset and use or sell it.
- c) Its ability to use or Sell the intangible asset.
- d) How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- e) The availability- of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- f) Its ability to measure reliably the expenditure attributable to the intangible asset during its development

Internally generated brands, mastheads, publishing titles, customer lists and items similar in substance shall not be recognised as intangible assets.

The cost of an internally generated intangible asset is the sum of expenditure incurred from the date when the intangible asset first meets the recognition criteria. Reinstatement of expenditure previously recognised as an expense is prohibited.

Expenditure on an intangible item shall be recognised as an expense when it is incurred unless:

- (a) It forms part of the cost of an intangible asset that meets the recognition criteria; or

- (b) The item is acquired in a business combination and cannot be recognised as an intangible asset. If this is the case, this expenditure (included in the cost of the business combination) shall form part of the amount attributed to goodwill at the acquisition date (see IFRS 3 Business Combinations).

An active market is a market in which all the following conditions exist:

- a) The items traded in the market are homogeneous;
- b) Willing buyers and sellers can normally be found at any time; and
- c) Prices are available to the public.

If an intangible asset's carrying amount is increased as a result of a revaluation, the increase shall be credited directly to equity under the heading of revaluation surplus. However, the increase shall be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset previously recognised in profit or loss. If an intangible asset's carrying amount is decreased as a result of a revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance in the revaluation surplus in respect of that asset.

Useful life

An entity shall assess whether the useful life of an intangible asset is finite or indefinite and, if finite, the length of, or number of production or similar units constituting, that useful life. An intangible asset shall be regarded by the entity as having an indefinite useful life when, based on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity.

Useful life is:

- a) The period over which an asset is expected to be available for use by an entity; or
- b) The number of production or similar units expected to be obtained from the asset by an entity.

The useful life of an intangible asset that arises from contractual or other legal rights shall not exceed the period of the contractual or other legal rights, but may be shorter depending on the period over which the entity expects to use the asset. If the contractual or other legal rights are conveyed for a limited term that can be renewed, the useful life of the intangible asset shall include the renewal period(s) only if there is evidence to support renewal by the entity without significant cost.

To determine whether an intangible asset is impaired; an entity applies TAS 36 Impairment of Assets.

Intangible assets with finite useful lives

The depreciable amount of an intangible asset with a finite useful life shall be allocated on a systematic basis over its useful life. Depreciable amount is the cost of an asset, or other amount substituted for cost, less its residual value. Amortisation shall begin when the asset is available for

use; i.e., when it is in the location and condition necessary for it to be capable of operating in the manner intended by management. Amortisation shall cease at the earlier of the date that 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 Non-current Assets Held for Sale and Discontinued Operations and the date that the asset is derecognised. The amortisation method used shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity. If that pattern cannot be determined reliably, the straight-line method shall be used. The amortisation charge for each period shall be recognised in profit or loss unless this or another Standard permits or requires it to be included in the carrying amount of another asset. •

The residual value of an intangible asset is the estimated amount that an entity would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. The residual value of an intangible asset with a finite useful life shall be assumed to be zero unless:

- (a) There is a commitment by a third party to purchase the asset at the end of its useful life; or
- (b) There is an active market for the asset and:
 - (i) Residual value can be determined by reference to that market; and
 - (ii) It is probable that such a market will exist at the end of the asset's useful life.

The amortisation period and the amortisation method for an intangible asset with a finite useful life shall be reviewed at least at each financial year-end. If the expected useful life of the asset is different from previous estimates, the amortisation period shall be changed accordingly. If there has been a change in the expected pattern of consumption of the future economic benefits embodied in the asset, the amortisation method shall be changed to reflect the changed pattern. Such changes shall be accounted for as changes in accounting estimates in accordance with IAS 8.

Intangible assets with indefinite useful lives

An intangible asset with an indefinite useful life shall not be amortised.

In accordance with IAS 36 Impairment of Assets, an entity is required to test an intangible asset with an indefinite useful life for impairment by comparing its recoverable amount with its carrying amount

- (a) Annually, and
- (b) Whenever there is an indication that the intangible asset may be impaired,

The useful life of an intangible asset that is not being amortised shall be reviewed each period to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite shall be accounted for as a change in an accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors.

FINANCIAL ASSETS

A financial asset is an asset whose value comes from a contractual claim. These assets are frequently traded. According to the International Financial Reporting Standards (IFRS), a financial asset can be:

- Cash or cash equivalent,
- Equity instruments of another entity,
- Contractual right to receive cash or another financial asset from another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity,
- Contract that will or may be settled in the entity's own equity instruments and is either a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments, or a derivative that will or may be settled other than by exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments

Examples of financial assets are cash, investments in the bonds and equity issued by other entities, receivables and derivative financial assets.

INVENTORY

Inventories In A Firm Include:

- a) Finished goods (assets held for sale)
- b) Work in progress (assets still in production for purposes of sale)
- c) Raw -materials (to be used in production process).

The cost of inventories should include all costs of purchase. (Purchase price and other taxes like import duties), costs of conversion (e.g. direct labour) and other costs incurred in bringing the inventories into their present location and condition (carriage inwards).

Inventories or stock is a 'sensitive area, as it does not form part of the double entry. In most cases either carrying out stocktaking or checking the stock records that the firm is kept determines the value of stock at the end of the financial period. Stocktaking involves counting the number of units of finished goods, work in progress or raw materials available or in the stores/warehouse/saleroom.

The value of stock to the final accounts is then derived by multiplying the cost per unit to the total number of units available.

Illustration

A firm has three products A, B and C whose costs are shs.200, shs.300 and shs.400 each respectively. At the end of year 2002, stocktaking was carried out and the following units were available:

Product A 200,000 units

Product B 20,000 units

Product C 30,000 units

Required

Compute the cost of stock to be included in the final accounts.

Solution

$$(200,000 \times 200) + (20,000 \times 300) + (30,000 \times 400) = \text{shs.}58,000,000$$

IAS 2 Inventories

The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realizable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Inventories shall be measured at the lower of cost and net realizable value.

Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred, in bringing the inventories to their present location and condition.

The cost of inventories shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formula. An entity shall, use the same cost formula for all inventories having a similar nature and use to the entity: For inventories with a different nature or use, different cost formulas may be justified. However, the cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.

When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realizable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of

inventories, arising from all increase in net realizable value, shall be recognized as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

VALUATION USING SPECIFIC COST METHOD

The cost of the different units of stock that a firm has should be assigned to each unit as far as the business can be able to identify each item.

For those units that the business cannot identify the specific cost, due to the number of transactions and changes in the cost price, 1AS 2 on inventories recommends the use of the following estimates:

- i. First in First Out (FIFO)
- ii. Weighted Average Cost (AVCO)
- iii. Last in First Out (LIFO)

FIRST IN FIRST OUT (FIFO)

The business assumes that items of stocks that were purchased first are sold first and therefore, items left as part of closing stock were purchased recently.

With the FIR) (first-in, first-out) method for cost of goods sold, you charge out product costs to cost of goods sold expense in the chronological order in which you acquired the goods. It's like the first people in line to see a movie get in the theater first. The ticket-taker collects the tickets in the order in which they were purchased.

Suppose that you acquire four units of a product during a period, one unit at a time, with unit costs as follows (in the order in which you acquire the items): shs. 100, shs 102, shs104, and shs.106, By the end of the period, you have sold three of these units. Using FIFO, you calculate the cost of goods sold expense as follows:

$$\text{Shs.100} + \text{shs.102} + \text{shs.104} = \text{shs.306}$$

In short, you use the first three units to calculate cost of goods sold expense. The cost of the ending inventory asset, then, is shs.106, which is the cost of the most recent acquisition.

The shs.412 total cost of the four units is divided between shs.306 cost of goods sold expense for the three units sold and the shs.106 cost of the one unit in ending inventory. The total cost has been accounted for nothing has fallen between the cracks.

FIFO works well for two primary reasons:

1. Products generally move into and out of inventory in a first-in, first-out sequence. The earlier acquired products are delivered to customers before the later acquired products are delivered,

so the most recently purchased products are the ones still in ending inventory to be delivered in the future.

Using FIFO, the inventory asset reported in the balance sheet at the end of the period reflects recent purchase (or manufacturing) costs, which means the balance in the asset is close to the current replacement costs of the products.

2. When product costs are steadily increasing, many businesses follow a first-in, first-out sales price strategy and hold off raising sales prices as long as possible. They delay raising sales prices until they have sold their lower-cost products. Only when they start selling from the next batch of products, acquired at a higher cost, do they raise sales prices.

WEIGHTED AVERAGE COST

Under this method, the cost of each item -it determined from the weighted average of the cost or similar items at the beginning of the period and the cost of similar items purchased during the period. The average cost method takes the average of all units available for sale during the accounting period. The average cost method uses the average cost to determine the value' of the, cost of goods sold and ending inventory. .

LAST IN FIRST OUT (LIFO)

This method assumes that items of stock which were purchased last are sold first and therefore, the closing stock shows items that were bought first.

LIFO is an inventory valuing method that assumes that the last items placed in inventory are the first sold during an accounting year. Therefore, when the LIFO method is applied, the inventory at the end of a year consists of the goods placed in inventory at the beginning of the year, rather than at the end. During inflation, when prices are rising, the LIFO method yields a lower ending inventory. a higher cost of goods sold, a lower gross profit, and a lower taxable income. The LIFO Method is preferred by many companies because it has the effect of reducing a company's taxes and therefore increasing cash flow.

Net Realizable Value (SP- Expenses)

This is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

In some cases, the value of stock may decline where below the cost price (either actual or estimated under the different methods) and if the firm was to sell the stock, then it will fetch an amount below this cost.

IAS 2 requires that closing stock should be stated at the lower of cost or net realizable value.

TRADE RECEIVABLES

BAD DEBTS AND ALLOWANCE FOR DOUBTFUL DEBTS AND RECEIVABLES CONTROL ACCOUNTS

Accounts receivables

The term accounts receivables refer to the amounts due to a business following the sale of goods or services to another company. It is a subcategory of Accounts Receivable. Trade receivables are considered a current asset on a company's balance sheet as they can be readily converted into cash.

Bad Debts

Some debtors may not pay up their accounts for various reasons e.g. a debtor may go out of business. When a debtor is not able to pay up his/her account this becomes a bad debt. Therefore the business/firm should write it off from the 'accounts and thus it becomes an expense that should be charged in the profit & loss account.

In practice a firm may also be, unable to collect all the amounts due from debtors. This is because a section of the debtors will not honor their obligations. The problem posed by this situation is that it is difficult to identify the debtors who are unlikely to pay their accounts. Furthermore the amount that will not be collected may also be difficult to ascertain. These debts that the firm may not collect are called doubtful debts. A firm should therefore provide for such debts by charging the provision in the income statement account. Provision for doubtful debts may be specific or general; Specific relate to a debtor whom we can identify and we are doubtful that he may pay the debt (if one of our debtor goes out of business).

Provision for Bad-Debts

A provision for doubtful debts can either be for a specific or a general provision. A specific provision is where a debtor is known and chances of recovering the debt are low.

The general provision is where a provision is made on the balance of the total debtors i.e. Debtors less Bad debts and specific provision,

Accounting For Bad and Doubtful Debts

Bad debts

When a debt becomes bad the following entries will be made:

- i. Debit bad debts account
Credit debtors account with the amount owing.
- ii. Debit Profit and Loss Account.

Credit bad debts account to transfer the balance on the bad debts account to the income statement account

Accounting treatment for provision of doubtful debts

The accounting treatment of provision for doubtful debts depends on the year of trading and the entries will be as follows. If it is the 1st year of trading (1st year of making provision)

- i. Debit P&L a/c.
- ii. Credit provision for doubtful debts (with total amount of the provision).

In the subsequent periods, it will depend on whether if it is an increase or decrease required on the provision.

If it is an increase:

- iii. Debit P&L a/c.
- iv. Credit provision for doubtful debts (with increase only).

If it is a decrease:

- i. Debit provision for doubtful debts.
- ii. Credit P&L a/c (with the decrease in provision only).

Illustration

Minim Ltd. started trading on 1 January 2013. It has been adjusting its doubtful debt provision at the end of each year on percentage basis, but each year the percentage rate is adjusted in accordance with the economic performance in the country.

The following details are available for the years ended 31 December 2013, 2014 and 2015.

Year	Bad debts Witten off at year end	Debtors at year end	Provision for bad and doubtful debts
2013	656,000	22,000,000	5%
2014	1,805,000	40,000,000	7%
2015	3,817,000	60,000,000	6%

Required;

- i. Had debts account for the three years
- ii. Provision for bad and doubtful debts for the years 2013, 2014 and 2015
- iii. The balance sheet extracts for the years 2013, 2014 and 2015.

Solution**i. Bad debts account for the three years**

Bad debts account			
	Sh.		Sh.
31.12.2013 Debtors	<u>656,000</u>	31.12.2013 Profit and loss	<u>656,000</u>
31.12.2014 Debtors	<u>1,805,000</u>	31.12.2014 Profit and loss	<u>1,805,000</u>
31.12.2015 Debtor	<u>3,847,000</u>	31.12.2015 Profit and loss	<u>3,847,000</u>

ii. Provision for bad and doubtful debts for the years 2013, 2014 and 2015

Year	Debtors at year end	Provision for bad and doubtful debts
2013	22,000,000	$5\% \times 22,000,000 = 1,100,000$
2014	40,000,000	$7\% \times 40,000,000 = 2,800,000$
2015	60,000,000	$6\% \times 60,000,000 = 3,600,000$

Bad debts account			
	Sh.		Sh.
31.12.2013 balance c/d	<u>1,100,000</u>	31.12.2013 Profit and loss	<u>1,100,000</u>
31.12.2014 balance c/d	2,800,000	1.1.2014 balance b/d	1,100,000
-	-	31.12.2014 P&L (Bal. figu)	<u>1,700,000</u>
<u>2,800,000</u>			<u>2,800,000</u>
31.12.2015 balance c/d	<u>3,847,000</u>	1.12.2015 Balance b/d	2,800,000
-	-	31.12.2015 P&L (Bal. figu)	<u>800,000</u>
<u>3,600,000</u>			<u>3,600,000</u>

iii. The balance sheet extracts for the years 2013, 2014 and 2015.

	Sh.	Sh.
31.12.2013 Debtors	22,000,000	
Less Provisions for doubtful debts	<u>(1,100,000)</u>	20,900,000
31.12.2014 Debtors	40,000,000	
Less Provisions for doubtful debts	<u>(2,800,000)</u>	37,200,000
31.12.2014 Debtors	60,000,000	
Less Provisions for doubtful debts	<u>(3,600,000)</u>	56,400,000

CONTROL ACCOUNTS

Control accounts are so called because they control a section of the ledgers. By control we mean that the total on the control accounts should be the same as the totals on the ledger accounts. Control accounts are used in accounts debtors and creditors. Day books reduce the necessity of posting several transactions in our ledger.

It is the problems associated with a large number of transactions in the ledger that control accounts seek to resolve.

If we consider the problem with a business which has a large number of debtors, we need to have a record of the amounts due from individual debtors in order that we can chase up unpaid debtors for payment.

With regard to our final accounts — that is, the balance sheet we only need a total figure for debtors and that is what control accounts will tell us, since they are nothing more than accounts containing totals.

In fact, an alternative name for them is 'total accounts'. The control account contains totals of posting to the individual or personal accounts which it is controlling.

For example, a **trade receivables control account** or **total debtors account** contains entries for the total of all items posted to the individual debtor's accounts.

Similarly, a creditors control account or total creditors account will contain entries for the total of all items posted to the individual creditors accounts.

Trade receivables control Account — also called **total debtors**. The balance on the sales ledger control account should be the same as the total of the balances in the sales ledger.

FORMAT OF A SALES LEDGER CONTROL

	Sh.		Sh.
Balance b/d of the total debit balances from previous period	xxx	Total credit balances of the sales ledger brought forward	xxx
Final credit sales for the period (from the sales journal)	xxx	Total cash received from credit customers/debtors (from cash book)	xxx
Refunds to customers (from cashbook)	xxx	Total cheques received from credit customers/debtors (from cash book)	xxx
Dishonored cheques (from cashbook)	xxx	Total returns-inwards (returns-inwards journal)	xxx
Bad debts recovered (from general journal)	xxx	Total cash discount allowed to customers (from cash book)	xxx
Total credit balances of the sales Ledger carried forward	xxx	Bad debtors written-off (from general journal)	xxx
		Cash received from bad debtors recovered (cash book)	xxx
		Purchases Ledger contra	xxx
		Allowances to customers (price reduction in excess to discounts allowed)	xxx
		Total debit balance carried down to the next period — to be derived after posting all those transactions	xxx
	xxx		xxx

Control accounts and double-entry

To give a simple example of control accounts, let us take the following transactions of a new business for the month of January.

	Shs.
Total Sales	105,000
Cash receipts from debtors	91,000

The debtors control account would appear as follows:

Debtors control Account

Debtors control a/c					
Date	Details	shs.	Date	Details	shs.
Jan 31	sales	105,000	Jan 31	cash	91,000
		-	Jan 31	Balance c/d	14,000
		<u>105,000</u>			<u>105,000</u>
Feb 1	Balance c/d	14,000			

Meanwhile the individual debtor's accounts will be debited with the separate sales transactions which make up the Shs.105, 000, and individual accounts credited with cash receipts making up Shs.91, 000. If this process is followed accurately, at any one time the balances on the individual accounts will total the balance on the control account — in this case Shs. 14,000.

At first sight it may appear that we are contravening the rules of double-entry book-keeping, since the transactions are being posted to the individual accounts and the control accounts.

That is to say, in the above example we credit sales with Shs.105, 000 and debit the control account and the individual debtor's accounts with Shs.105, 000.

The answer to this apparent inconsistency is that only one of either the control accounts or the individual accounts is part of the double- entry System.

Unfortunately for the student, it may be either of these which is part of the double-entry system, but never both. You must read the examination question carefully to ascertain which system is in use

It may be that the control account is part of the double-entry system, in which case the individual accounts will be a subsidiary record.

Alternatively, the individual accounts maybe part of the double-entry system and the control account will be only a memorandum account.

Refunds to Customers

Sometimes a firm can refund some cash on the customer's account. This takes place when there is a credit balance on the debtor's a/c and the customer is not a creditor too.

The entry will be:

Dr. Debtor's a/c
Cr. Cashbook

Contra against the purchases ledger balances:

Some debtors may also be creditors in the same firm and therefore, if the amount due to them as creditors is less than what they owe as debtors, then the credit balance is transferred from their creditors' a/c to their debtors a/c as a contra entry.

NOTES:

The following notes should be taken into consideration:

1. Cash received from CASH SALES should NOT be included in sales ledger control a/c.
2. Only cash discounts (allowable & receivables) should be included. Trade discounts should NOT be included.
3. Provision for doubtful debts is NOT included in the sales ledger control a/c, i.e. increase or decrease in provisions for doubtful debts will not affect this account.

Illustration

ABC Ltd. maintains control accounts in its business records. The balances and transactions relating to the company's control accounts for the month of December 2014 are listed below:

	Sh.
Balance at 1 December 2014:	
Sales ledger	6,185,000 (debit)
	52,500 (credit)
Purchases ledger	16,500 (debit)
	4,285,000 (credit)
Transactions during December 2014:	
Sales on credit	8,452,000
Purchases on credit	5,687,500
Returns inwards	203,500
Returns c utwards	284,000
Bills of Exchange payable	930,000
Bills of Exchange receivable	615,000
Cheques received from customers	7,985,000
Cheques paid to suppliers	4,732,000
Cash paid to suppliers	88,500
Bill payable dishonoured	400,000
Charges on bill payable dishonoured	10,000
Cash received from credit customers	153,000
Bad debts written-off	64,500
Cash discounts allowed	302,000
Bill receivable dishonoured	88,500
Balances at 31 December 2014:	
Sales ledger	44,000 (credit)
Purchases ledger	23,500 (debit)

Required:

Post the trade receivables ledger control accounts for the month of December 2010 and derive the respective debit and credit closing balances on 31 December 2014.

Solution

ABC			
Trade receivable ledger control account			
	Sh '000'		Sh '000'
Balance b/d	6,185,000	Balance b/d	52,500
Credit sales	8,452,000	Returns inwards	203,500
Bills receivable dishonored	88,500	Bills receivable	615,000
		Cheques received	7,985,000
		Cash received	153,000
		Bad debts written off	64,500
		Discount allowed	302,000
		Balance c/d	5,394,000
	<u>14,769,500</u>		<u>14,769,500</u>

ACCRUED INCOME

Accrued income is an amount that has been

1. Earned,
2. There is a right to receive the amount, and
3. It has not yet been recorded in the general ledger accounts. One example of accrued income is the interest earned on a bond investment.

To illustrate, let's assume that a company invested shs.100,000 on December 1 in a 6% shs.100,000 bond that pays shs.3,000 of interest on each June 1 and December 1. On December 31, the company will have earned one month's interest amounting to shs.500 ($\text{shs.100,000} \times 6\% \text{ per year} \times 1/12 \text{ of a year}$, or $1/6 \text{ of the semiannual shs.3,000}$). No interest will be received in December since it will be part of the shs.3,000 to be received on June 1..

The shs.500 of interest earned during December, but not yet received or recorded as of December 31 is known as accrued income. -

Under the accrual basis of accounting, accrued income is recorded with an adjusting entry prior to issuing the financial statements. In our example, there will need to be an adjusting entry dated December 31 that debits Interest Receivable (a balance Sheet account) for shs.500, and credits Interest Income (an income statement account) for shs.500.

Accrued income will be presented in an income statement as follows;-

Income account					
Date	Details	Amount	Date	Details	Amount
1.1	Accrued at start	xx	1.1	Prepaid at start	xx
	Balance to income statement	xx		Cash/bank	xx
31.1	Prepaid at end (to statement of financial position as a liability)	<u>xx</u>	31.1	Accrued at end (to statement of financial position as an asset)	<u>xx</u>
		<u>xx</u>			<u>xx</u>

PREPAID EXPENSES

Prepaid expenses are assets that become expenses as they expire or get used up. For example, office supplies are considered an asset until they are used in the course of doing business, at which time they become an expense. At the end of each accounting period, adjusting entries are necessary to recognize the portion of prepaid expenses that have become actual expenses through use or the passage of time.

Prepaid expenses in one company's accounting records are often—but not always—unearned revenues in another company's accounting records. Office supplies provide an example of a prepaid expense that does not appear on another company's books as unearned revenue.

Accounting records that do not include adjusting entries to show the expiration or consumption of prepaid expenses overstate assets and net income and understate expenses.

Let us consider a situation where a business pays an annual insurance premium on April 1 of Shs.10,000. If at December 31 we transferred the balance of Shs.10,000 to the profit and loss account, it would not reflect the true expense of the accounting period, since Shs.2,500 ($\frac{3}{12} \times 10,000$) relates to the next accounting period.

In order that the profit and loss account show the true expense of Shs.7,500, we need to carry down a debit balance on the account for the Shs.2,500 prepaid.

The insurance account would then appear as:

Insurance Account					
2010	Details	Sh.	2010	Details	Sh.
April 1	Bank	10,000	Dec.31	Profit & Loss a/c	7,500
		-	Dec.31	Balance c/d	<u>2,500</u>
2011		<u>10,000</u>			<u>10,000</u>
Jan 1	Bal. b/d	2,500			

The balance of Shs.2, 500 brought down into 2011 will then be transferred to the profit and loss account at end of 2011 together with any further expense paid, and after adjusting for any accrual or prepayment at December 31, 2011.

In the balance sheet at December 31, 2010 the debit balance of Shs.2, 500 will appear under current assets as a prepayment.

The reason for this is that it represents value due to the business at that date.

Prepaid expenses will be presented in an expense account statement as follows;-

Expenses account					
Date	Details	Amount	Date	Details	Amount
1.1	Prepaid at start	xx	1.1	Accrued at start	xx
	Balance to income statement	xx		Cash/bank	xx
31.1	Accrued at end (to statement of financial position as a liability)	<u>xx</u>	31.1	Prepaid at end (to statement of financial position as an asset)	xx
		<u>xx</u>			<u>xx</u>

CASH AT BANK

CASH BOOK AND BANK RECONCILIATION STATEMENT

The cashbook for cash at bank records all the transactions taking place at the bank i.e. the movements of the account held with the bank. The bank will send information relating to this account using a bank statement for the firm to compare.

Ideally, the records as per the bank and the cashbook should be the same and therefore the balance carried down in the cashbook should be the same as the balance carried down by the bank in the bank statement.

In practice however, this is not the case and the two (balance as per the bank and firm) are different. A bank reconciliation statement explains the difference between the balance at the bank as per the cashbook and balance at bank as per the bank statement.

Items Appearing In the Cashbook and Not Reflected In the Bank Statement

Unpresented Cheques: Cheques issued by the firm for payment to the creditors or to other supplies but have not been presented to the firm's bank for payment.

Uncredited deposits/cheques: These are cheques received from customers and other sources for which the firm has banked but the bank has not yet availed the funds by crediting the firm's account.

Errors made in the cashbook These include:

- Payments over/understated
- Deposits over/understated
- Deposits and payments misposted
- Overcasting and under casting the Balance c/d in the cashbook.

BANK RECONCILIATION

Banks usually send customers a monthly statement that shows the account's beginning balance (the previous statement's ending balance), all transactions that affect the account's balance during the month, and the account's ending balance.

The ending balance on a bank statement almost never agrees with the balance in a company's corresponding general ledger account. After receiving the bank statement, therefore, the company prepares a bank reconciliation statement, which identifies each difference between the company's records and the bank's records. The normal differences identified in bank reconciliation will be discussed separately. These differences are referred to as reconciling items. Bank reconciliation begins by showing the bank statement's ending balance and the company's balance (book balance) in the cash account on the same date:

Deposits in transit

Most companies make frequent cash deposits. Therefore, company records may show one or more deposits, usually made on the last day included on the bank statement, which do not appear on the bank statement. These deposits are called deposits in transit and cause the bank statement balance to

understate the company's actual cash balance. Since deposits in transit have already been recorded in the company's books as cash receipts, they must be added to the bank statement balance.

Outstanding cheques

A check that a company mails to a creditor may take several days to pass through the mail, be processed and deposited by the creditor, and then clear the banking system. Therefore, company records may include a number of cheques that do not appear on the bank-statement. These cheques are called outstanding cheques and cause the bank statement balance to overstate the company's actual cash balance. Since outstanding cheques have already been recorded in the company's books as cash disbursements, they must be subtracted from the bank statement balance.

Automatic withdrawals and deposits

Companies may authorize a bank to automatically transfer funds into or out of their account. Automatic withdrawals from the account are used to pay for loans (notes or mortgages payable), monthly utility bills, or other liabilities. Automatic deposits occur when the company's checking account receives automatic fund transfers from customers or other sources or when the bank collects notes receivable payments on behalf of the company,

Banks use debit memoranda to notify companies about automatic withdrawals, and they use credit memoranda to notify companies about automatic deposits. The names applied to these memoranda may seem confusing at first glance because the company credits (decreases) its cash account upon receiving debit memoranda from the bank, and the company debits (increases) its cash account upon receiving credit memoranda from the bank. To the bank, however, a company's checking account balance is a liability rather than an asset. Therefore, from the bank's perspective, the terms debit and -credit are correctly applied to the memoranda.

Unlike deposits in transit or outstanding cheques, which are already recorded in the company's books, automatic withdrawals and deposits are often brought to the company's attention for the first time when the bank statement is received. On the bank reconciliation, add unrecorded automatic deposits to the company's book balance, and subtract unrecorded automatic withdrawals,

Interest earned

Banks often pay interest on checking account balances. Interest income reported on the bank statement has usually not been accrued, by the company and, therefore, must be added to the company's book balance on the bank reconciliation,

Bank service charges

Banks often require customers to pay monthly, account fees, check printing fees, safe-deposit box rental fees, and other fees. Unrecorded service charges must be subtracted from the company's book balance on the bank reconciliation.

NSF (not sufficient funds) cheques

A check previously recorded as part of a deposit may bounce because there are not sufficient funds in the issuer's checking account. When this happens, the bank returns the check to the depositor and deducts the check amount from the depositor's account. Therefore, NSF cheques must be subtracted from the company's book balance on the bank reconciliation.

Errors

Companies and banks sometimes make errors. Therefore, each transaction on the bank statement should be double-checked. If the bank incorrectly recorded a transaction, the bank must be contacted, and the bank-balance must be adjusted on the bank reconciliation. If the company incorrectly recorded a transaction, the book balance must be adjusted on the bank reconciliation and a correcting entry must be journalized and posted to the general ledger.

When all differences between the ending bank statement balance and book balance have been identified and entered on the bank reconciliation, the adjusted bank balance and adjusted book balance are identical,

CAUSES FOR DIFFERENCE BETWEEN THE BALANCE AS PER CASH BOOK AND THE BALANCE AS PER BANK STATEMENT

The balance shown by the bank statement should agree with the bank balance shown by the Cash Book.

However, often there is a difference even if there is no mistake. The difference is due to the following reasons:-

1. Cheques received are entered in the Cash Book as soon as they are received. .
2. There may be a delay of a day or two in sending the cheque to the bank. Moreover, the bank usually, does not credit the customer until the cheque is realized; if they are on other banks, it means delay.
3. In the meantime, therefore, the Cash Book will show more balance than what the bank shows in its Own books.
4. As soon as cheques are issued, they are entered in the Cash Book, but the bank, again, makes no entry until the cheques are actually presented for payment and are paid.
5. This means that the bank shows a higher balance in favor of the client than what the Cash Book of the client shows.
6. The bank often makes charges for services it renders; these are known as bank charges.
7. 'If there is an overdraft, the bank will also- charge interest. These bank charges and interest are entered in the Pass Book and the entry is'-generally made in-the Cash Book only when, the Pass Book is received. -

8. The bank is often entrusted with the task of collecting interest on securities or dividends on shares or even the collection of amounts due on bills of exchange or promissory notes.
9. The bank will credit the customer as soon as the amounts are received but the entry by the customer in the Cash Book must await receipt of information by the customer.
10. The bank may also make payments. According to the standing instructions of the client or in respect of 'any special instruction such as on presentation of documents for supply of goods for which a letter of credit has been opened previously.

Entries in the Cash Book in such cases are made on receipt of advice from the bank.

FORMAT 1

Bank Reconciliation Statement as at 31/12

	Sh.	Sh.
Balance at bank as per cashbook (updated)		xx
Add: un presented cheques	xx	
Errors on bank Statement (see note 1)	<u>xx</u>	<u>xx</u>
		xx
Less: Uncredited deposits	xx	
Errors on Bank Statement (see note 2)	<u>xx</u>	<u>xx</u>
Balance at bank as per Balance Sheet		<u>xx</u>

Note 1: These types of errors will have an effect of increasing the balance at bank e.g. an overstated deposit or an understated payment by the bank.

Note 2: These types of errors will have an effect of decreasing the balance at bank e.g. an understated deposit or an overstated payment by the bank, or making an unknown payment..

FORMAT 2

Bank Reconciliation Statement as at 31/12

	Sh.	Sh.
Balance at bank as per bank statement		xx
Add: Uncredited deposits	xx	
Errors on bank statement (note 2)	<u>xx</u>	<u>xx</u>
		xx
Less: Unpresented cheques	xx	
Errors on bank statement (note 1)	<u>xx</u>	<u>xx</u>
Balance at bank as per cashbook (updated)		<u>xx</u>

Illustration

On 10 January 2006, Joseph Kahiga, a sole trader, received his monthly bank statement for December 2005.

The statement showed the following:

Date 2005	Particulars	Debit Sh.	Credit Sh.	Balance Sh.
Dec 1	Balance			186,200
5	Cheque No.417864 (Electricity)	24,300		161,900
5	Dividend		2,600	164,500
5	Local cheque deposit (Solomon Otieno)		21,200	185,700
8	Cheque No.417866 (Jemima Nyarnbura)	17,400		168,300
10	Cheque No.4 17867 (Young Traders)	1,700		166,600
13	Miscellaneous credit (Kevin Kagai)		18,500	185,100
14	Standing order	3,200		181,900
20	Cheque No.417865 (Janet Aoko)	30,700		151,200
20	Local cheque deposit (Donald Korir)		11,800	163,000
21	Cheque No.417868 (David Okoth)	9,500		153,500
21	Cheque No.417870 (Rent)	16,100		137,400
24	Bank charges	1,800		135,600
27	Local cheque deposit (Joy Nduta)		4,700	140,300
28	Direct debit	8,800		131,500
29	Cheque No.417873 (Daniel Wambua)	1,200		130,300
29	Local cheque deposit (Joseph Ondieki)		27,900	158,200
3	Cheque No.417871 (Moses Siringi)	2,500		155,700

Joseph Kahiga's cashbook for the month of December 2005 was as follows:

CASH BOOK						
2005		Sh.	2005		Cheque No.	Sh.
Dec 1	Balance b/d	186,200	Dec 1	Electricity	417864	24,300
4	Solomon Otieno	21,200	2	Janet Aoko	417865	30,700
9	Kevin kagai	18,500	5	Jemimah Nyambura	417866	17,400
19	Donald Korir	11,800	6	Young Traders	417867	1,700
24	Joy Nduta	4,700	10	David Okoth	417868	9,500
27	Joseph Ondieki	27,900	14	Victor Karanja	417869	7,100
29	Owen Ndumbi	9,800	16	Rent	417870	16,100
30	Walter Oyugi	13,400	20	Moses Siringi	417871	2,500
			21	Steve Maithya	417872	3,700
			22	Daniel Wambua	417873	1,200
			31	Bal		179,300
		<u>293,500</u>				<u>293,500</u>

Required:

- i) Joseph Kahiga 's updated cash book. as at 31 December 2005.
- ii) Joseph Kahiga's bank reconciliation statement as at 31 December 2005.

John Kahiga
Updated Cash Book as at 31 December 2005

	Sh '000'		Sh '000'
Balance b/d	179,300	Standing order	3,200
Dividend	2,600	Bank charges	1,800
		Direct debit	8,800
	<u>181,900</u>	Bal. c/d	<u>168,100</u>
			<u>181,900</u>

Balance reconciliation statement as at 31 december 2005

	Sh.	Sh.
Balance as per cashbook (updated)		168,000
Add: un presented cheques:		
Victor Karanja No.417869	7,100	
Steve Maithya No.417872	<u>3,700</u>	<u>10,800</u>
		178,900
Less: Uncredited cheques:		
Owen Ndubi	9,800	
Walter Oyugi	<u>13,400</u>	<u>23,200</u>
Balance at bank as per bank statement		<u>155,700</u>

Illustration

Mwambi, a sole trader received his bank statement for the month of June 2001. At that ,date the bank balance was. Sh.706,500 whereas his cash book balance was Sh.2,366,500. His accountant investigated the matter and discovered the following discrepancies:

1. Bank charges of Sh.3, 000 had not been entered in the cashbook.
2. Cheques drawn by Mwambi totaling Sh.22,500 had not yet been presented to the bank
3. He had not entered receipts of Sh.26,500 in his cashbook.
4. The bank had not credited Mr. Mwambi with receipts of Sh.98, 500 paid into the bank on 30 June 2001.
5. Standing order payments amounting to Sh.62, 000 had not been entered into the cashbook,
6. In the cash book Mwambi had entered a payment' of Sh.74, 900 as Sh.79400.
7. A cheque for Sh. 15,000 from a debtor had been returned by the bank marked "refer to drawer" but had not been written back into the cashbook.
8. Mwambi had brought forward the opening cash balance of Sh.329,,250 as a debit balance instead of a credit balance. . . .

9. An old cheque payment amounting to S11.44, 000 had been written back in the cashbook but the bank had already honoured it.
10. Some of Mwarphi's customers had agreed to settle their debts by paying directly into his bank account. Unfortunately, the bank had credited some deposits amounting to Sh.832, 500 to another customer's account. However, acting on information from his customers, Mwambi had actually entered the expected receipts from the debtors in his cashbook.

Required:

- i. A statement showing Mwambi's adjusted cash book balance as at 30 June 2001.
- ii. A bank reconciliation statement as at 30 June 2001.

Solution

i.

Adjusted Cash book			
	Sh '000'		Sh '000'
Balance b/d	2,366,500	Bank charges	3,000
Receipts	26,500	Standing order	62,000
Overcast in payment	4,500	Overcast in opening bal.	658,500
		Dishonoured cheque	15,000
		Cheque paid by bank	44,000
		Balance c/d	<u>1 615 000</u>
	<u>2,397,500</u>		<u>2,397,500</u>

ii.

Bank reconciliation statement
Bank statement as at 30 June 2001

	Sh.
Balance as per cashbook	1,615,000
Add:	
Unpresented cheques	22,500
	<u>1,637,500</u>
Less: Uncredited cheques	(98,500)
Error	<u>(832,500)</u>
Sal as per bank statement	<u>706,500</u>

CASH IN HAND - CASH BOOK AND PETTY CASH BOOKS

Cash in hand

These are funds that are immediately available to a business, and can be spent as needed, as opposed to assets that must be sold to generate cash. The amount of cash on hand determines what projects a company can undertake, or what financial hardships can be absorbed, without going into debt or arranging other financing.

The cash in hand will be accounted for in the cash book and the petty cashbook.

LIABILITIES

BANK OVERDRAFT

CASH BOOK AND BANK RECONCILIATION STATEMENT

An overdraft occurs when money is withdrawn from a bank account and the available balance goes below zero. In this situation the account is said to be "overdrawn". If there is a prior agreement with the account provider for an overdraft, and the amount overdrawn is within the authorized overdraft limit, then interest is normally charged at the agreed rate. If the negative balance exceeds the agreed terms, then additional fees may be charged and higher interest rates may apply.

Reasons for overdraft

Overdrafts occur for a variety of reasons. These may include:

- **Intentional short-term loan** - The account holder may find himself short of money and knowingly makes an insufficient-funds debit. They accept the associated fees and cover the overdraft with their next deposit.
- **Failure to maintain an accurate account register** - The account holder doesn't accurately account for activity on their account and overspends through negligence.
- **ATM overdraft** - Banks or ATMs may allow cash withdrawals despite insufficient availability of funds. The account holder may or may not be aware of this fact at the time of the withdrawal. If the ATM is unable to communicate with the cardholder's bank, it may automatically authorize a withdrawal based on limits preset by the authorizing network.
- **Temporary Deposit Hold** - A deposit made to the account can be placed on hold by the bank. The funds may not be immediately available and lead to overdraft fees.
- **Unexpected electronic withdrawals** - At some point in the past the account holder may have authorized electronic withdrawals by a business. This could occur in good faith of both parties if the electronic withdrawal in question is made legally possible by terms of the contract, such as the initiation of a recurring service following a free trial period: The

debit could also have been made as a result of a wage garnishment, an offset claim for a taxing agency or a credit account or overdraft with another account with the same bank, or a direct-deposit chargeback in order to recover an overpayment.

- **Authorization holds** - When a customer makes a purchase using their debit card without using their PIN, the transaction is treated as 'a credit transaction. The funds are placed on hold in the customer's account reducing the customer's available balance. However the merchant doesn't receive the funds until they process the transaction batch for the period during which the customer's purchase was made. Banks do not hold these funds indefinitely, and so the bank may release the hold before the merchant collects the funds thus making these funds available again. If the customer spends these funds, then barring an interim deposit the account will overdraw when the merchant collects for the original purchase.
- **Bank fees** - The bank charges a fee unexpected to the account holder, creating a negative balance or leaving insufficient funds for a subsequent debit from the same account.
- **Playing the float** - The account holder makes a debit while insufficient funds are present in the account believing they will be able to deposit sufficient funds before the debit clears. While many cases of playing the float are done with honest intentions, the time involved in cheques clearing and the difference in the processing of debits and credits are exploited by those committing check kiting.
- **Returned check deposit** - The account holder deposits a check or money order and the deposited item is returned due to non-sufficient funds, a closed account, or being discovered to be counterfeit, stolen, altered, or forged: As a result of the check chargeback and associated fee, an overdraft results or a subsequent debit which was reliant on such funds causes one. This could be due to a deposited item that is known to be bad, or the customer could be a victim of a bad check or a counterfeit check scam. If the resulting overdraft is too large or cannot be covered in a short period of time, the bank could sue or even press criminal charges.
- **Intentional Fraud** - An ATM deposit with misrepresented funds is made or a check or money order known to be bad is deposited (see above) by the account holder, and enough money is debited before the fraud is discovered to result in an overdraft, once the chargeback is made. The fraud could be perpetrated against one's own account, another person's account, or an account set up in another person's name by an identity thief.
- **Bank Error** - A check debit may post for an improper amount due to human or computer error, so an amount much larger than the maker intended may be removed from the account. Some bank errors can work to the account holder's detriment, but others could work to their benefit.
- **Victimization** - The account may have been a target of identity theft. This could occur as the result of demand-draft, ATM-card, or debit-card fraud, skimming, check forgery, an "account takeover," or phishing. The criminal act could cause an overdraft or cause a subsequent debit to cause one. The money or cheques from an ATM-deposit could also

have been stolen or the envelope lost or stolen, in which case the victim is often denied a remedy.

- **Intraday overdraft** - A debit occurs in the customer's account resulting in an overdraft which is then covered by a credit that posts to the account during the same business day. Whether this actually results in overdraft fees depends on the deposit-account holder agreement of the particular bank

Illustration

Lotus Ltd. operated two bank accounts with its banker, account number 1 and account number 2. As at March 2004, the balances as per the bank statement and the cash book were as follows:

Account	Balance as per bank statement	Balance as per cash book
	Sh.	Sh.
Number 1	323,600 (Cr)	34,000 (Dr)
Number 2	156,400 (Dr)	277,600 (Dr)

Investigations revealed the following:

1. Cheques lodged but not yet credited:

	Sh
Account No. 1	80,000
Account No. 2	56,000

2. Cheque No.F30 I for .8,000 deposited into account No.2 was dishonored but it is has not been reflected in the cash book.
3. A cheque No.M420 for Sh.8,800 paid direct into bank account No.1 has not been recorded in the cash book
4. A cheque No.K341 for Sh.6,400 was deposited into account No.2 but ,this was wrongly recorded in the cash book as Sh.8,000.
5. A cheque No.A21 0 for Sh.29,200 paid out from account No.1 and recorded as such in the cash book, was erroneously paid out 0 account NO.2 by the bank.
6. A cheque No.B308 for Sh.12,800 paid out from account NO.2 was erroneously entered in account No.1 in the cash book.
7. A transfer of Sh.400,000 from account No.1 to account No.2 had been entered in the cash book but the bank had not been instructed to effect the transfer.
8. A standing order payment of Sh.4.000 from account No.2 has not been recorded in the cash book.
9. A cheque No.BJ48 for Sh.8,400 paid from account No.2 was incorrectly entered in the cash book as Sh4,800.

10. Bank charges not yet entered in the cash book are Sh.1 ;200 for account No.1 and Sh.1 .600 for account No.2
11. A cheque No,D720 for Sh.80,000 received in respect of account No.2 and subsequently credited to account N0,2 by the bank, was incorrectly entered in account No. 1 in the cash book.
12. 18. A cheque No.H78J for Sh.7,200 received in respect of account No.2 was incorrectly recorded in the cash book as Sh.6,800. •
13. There was an unrepresented cheque of Sh2,400 in respect of account No.2.

Required:

- i) Adjusted cash book for each of the two accounts
- ii) Bank reconciliation statement for each of the IWO accounts, for the month of March 2004.

Solution**Updated Cash Book No. 1**

	Sh '000'		Sh '000'
Balance b/d	34,000	Bank	1,200
Direct credit	8,800	Cheque-error	80,000
Cheque No. B308 paid	12,800		
Bal c/d	25.600		
	<u>81,200</u>		<u>81,200</u>

Updated Cash Book No. 2

	Sh '000'		Sh '000'
Balance b/d	277,600	Dishonoured cheque No. F301	8,000
Direct cheque No. D720	80,000	Cheque No. K341 overstated	1,600
Cheque No. H785 understated	400	Cheque No. B308 paid	12,800
		Standing order	4,000
		Cheque No. BJ48 understand	3,600
		Bank charges	1,600
		Balance c/d	326,400
	<u>358.000</u>		<u>358,000</u>

Bank Reconciliation statement No. 1

	Sh.	Sh.
Balance as per adjusted cashbook		(25,600)
Add: Cheque No. A210 (error)	29,200	
Transfer	<u>400,000</u>	<u>429,200</u>
		403,600
Less: Uncredited cheques		<u>(80,000)</u>
Balance as per bank statement		<u>323,600</u>

Bank Reconciliation statement No. 2		
	Sh.	Sh.
Balance as per adjusted cashbook		326,400
Add: Unpresented cheque		2,400
		328,800
Less: Cheque No. A210(error)	29,200	
Transfer	400,000	
Uncredited cheques	<u>56,000</u>	<u>(485,200)</u>
Balance as per bank statement		<u>156,400</u>

TRADE PAYABLES - CONTROL ACCOUNTS

Trade payables are also known as accounts payable and refers to money owed to creditors, lenders, vendors or suppliers for products or services rendered. Payables are considered short-term if due within 12 months whereas payables due longer than 12 months are considered long-term.

CONTROL ACCOUNTS

Control accounts are so called because they control a section of the ledgers. By control we mean that the total on the control accounts should be the same as the totals on the ledger accounts.

Trade payables Control Account/ purchases ledger control accounts

The balance carried down (Balance c/d) on the purchases Ledger Control Account should be the same as the total of the balances in the purchases ledger.

Purpose of Control Accounts

1. Provide for arithmetical check on the postings made in the individual accounts (either in the sales ledger or purchases ledger.)
2. To provide for a quick total of the balances to be shown in the trial balance as debtors and creditors.
3. To detect and prevent errors and frauds in the customers and suppliers account.
4. To facilitate delegation of duties among the debtors and creditors clerks.

FORMAT OF A TRADE PAYABLES LEDGER CONTROL ACCOUNT

	Sh.		Sh.
Total debit balances from purchases ledger brought forward from previous period.	xxx	Total credit balances of the purchases ledger brought forward	xxx
Total cash paid to creditors (from cash book)	xxx	Total credit purchases for the period (from purchases journal)	xxx
Total cheques paid to creditors (from cash book)	xxx	Refunds from suppliers (from cashbook)	xxx
Total cash discount received (froth cash book)	xxx	Total debit balances (of the of the purchases Ledger carried forward)	xxx
Allowances by suppliers	xxx		
Sales Ledger contra	xxx		
Total returns outwards (from returns-outwards journal)	xxx		
Total credit balance (to be derived after posting entries)	<u>xxx</u>		—
	<u>xxx</u>		<u>xxx</u>

Transferring accounts

Examination questions on control accounts often involve transfers between sales and purchases ledgers.

If an account in the sales ledger has a debit balance and is to be transferred to purchase ledger. we credit sales ledger control and debit the purchase ledger control. Conversely, a credit balance being transferred from purchase ledger to sales ledger requires an entry debiting sales ledger and crediting purchase ledger.

The important features to remember are that the control account is a general ledger account and that all entries therein are made on the same side as in the personal account.

Debits in the personal accounts are debited to the control account and credits in personal accounts are credited to the control account.

Thus a customer is debited for goods sold to him, so that all sales are debited to a sales ledger control account.

Cash received from a customer is credited to him so that the-control account is likewise credited.

The effect is that the control account takes the place in the General Ledger of the various accounts in the Sales Ledger.

Illustration

XML Ltd, maintains control accounts in its business records. The balances and transactions relating to the company's control accounts for the month of December 2014 are listed below:

	Sh.
Balance at 1 December 2014:	
Sales ledger	6,185,000 (debit)
	52,500 (credit)
Purchases ledger	16,500 (debit)
	4,285,000 (credit)
Transactions during December 2014:	
Sales on credit	8,452,000
Purchases on credit	5,687,500
Returns inwards	203,500
Returns outwards	284,000
bills of Exchange payable	930,000
Bills of Exchange receivable	615,000
Cheques received from customers	7,985,000
Cheques paid to suppliers	4,732,000
Cash paid to suppliers	88,500
Bill payable dishonoured	400,000
Charges on bill payable dishonoured	10,000
Cash received from credit customers	153,000
Bad debts written-off	64,500
Cash discounts allowed	302,000
Bill receivable dishonoured	88,500
Balances at 31 December 2014:	
Sales ledger	44,000 (credit)
Purchases ledger	23,500 (debit)

Required:

Post the trade payables ledger control accounts for the month of December 2014 and derive the respective debit and credit closing balances on 31 December 2014.

Solution

Trade payables Ledger Control Account

Trade payables Ledger Control Account

	Sh '000'		Sh '000'
Balance b/d	16,500	Balance b/d	4,285,000
Returns outwards	284,000	Credit purchases	5,687,500
Bills payable	930,000	Bills dishonoured	400,000
Cheques paid	4,732,000	Charges on bills dishonoured	10,000
Cash paid to supplier	88,500	Balance c/d	23,500
Bal c/d	<u>4,355,000</u>		
	<u>10,406,500</u>		<u>10,406,500</u>

LOANS

ACCOUNTING TREATMENT OF REPAYMENT OF PRINCIPLE AND INTEREST

In finance, a loan is a debt evidenced by a note which specifies, among other things, the principal amount, interest rate, and date of repayment. A loan entails the reallocation of the subject asset(s) for a period or time, between the lender and the borrower. In a loan, the borrower initially receives or borrows an amount of money, called the principal, from the lender, and is obligated to pay back or repay an equal amount of money to the lender at a later time. Typically, the money is paid back in regular instalments, or partial repayments; in an annuity, each instalment is the same amount.

The loan is generally provided at a cost, referred to as interest on the debt, which provides an incentive for the lender to engage in the loan. In a legal loan, each of these obligations and restrictions is enforced by contract, which can also place the borrower under additional restrictions known as loan covenants. Although this article focuses on monetary loans, in practice any material object might be lent.

Acting as a provider of loans is one of the principal tasks for financial institutions. For other institutions, issuing of debt contracts such as bonds is a typical source of funding.

Accounting treatment for loans

Do not report loans as expenditures - regardless of the fund type used. Likewise, do not report the repayment of loans as revenues. Instead, report both as balance sheet transactions. If an objective was to present information on loans provided and principal recovered, a proprietary fund type is desirable because of the cash flow statement. When reporting noncurrent loans receivable in the general revenue fund, the noncurrent portion is reported as non-spendable fund balance. It is not appropriate to classify the noncurrent portion to deferred revenues. In other governmental funds, report noncurrent loans receivable as restricted, committed or assigned fund balance, as appropriate.

PREPAID INCOMES AND ACCRUED EXPENSES

Prepaid income

Prepaid Income is an accounting concept that refers to a payment that has been received, but the asset has not yet been fully delivered. The company receives a one-off payment for the asset, but delivers its full value either in the future or over time. Prepaid Income is found on the statement of financial position of a company as a liability (as it is something which is owed), either with its own section or under Other Current Liabilities.

Illustration

A firm receives rent income of Sh. 5,000 per month payable quarterly in advance. Assuming that the firm's rental income began in 1st March and the financial year, end is on 31" Dec. The ledger accounts will be:

Cash Book			
Year 1		Sh '000'	
1/3	Rent	15,000	
1/6	Rent	15,000	
1/9	Rent	15,000	
1/12	Rent	15,000	

Rent - Income			
Year 1		sh.	
	P&L	50,000	
31/12	Bal c/d	10,000	
		<u>60,000</u>	

Year 1		sh.	
1/3	Cash book	15,000	
1/6	Cash book	15,000	
1/9	Cash book	15,000	
1/12	Cash book	15,000	
		<u>60,000</u>	

Rent for the four quarters of 12 months has been received as per the cashbook but because the end of the financial year is at 31 Dec, rent for 2 months is pre-paid. This sh. 10,000 is not charged in the P&L. but is carried forward as current liability in the balance sheet,

Accrued expenses

Money spent or cost incurred in an organization's efforts to generate revenue, representing the cost of doing business.

Expenses may be in the form of actual cash payments (such as wages and salaries), a computed expired portion (depreciation) of an asset, or an amount taken out of earnings (such as had debts). . Expenses are summarized and charged in the income statement as deductions from the income before assessing income tax. Whereas all expenses are costs, not all costs (such as those incurred in acquisition of income generating assets) are expenses.

Most expenses are recorded during the accounting period at the time they are paid. However, when a period ends there may be a few expenses that have been incurred but not paid and recorded because payment is not due.

These unpaid and unrecorded expenses for which payment is not due are called accrued expenses. Similar terms are amounts due, unpaid and outstanding. Examples of accrued expenses are accrued wages and accrued rental expenses.

Illustration

- a) The following cash book was extracted from the books of Fwamba Enterprises as at 31 December 2004.

Cash Book			
	Sh '000'		Sh '000'
Balance b/d	100,000	Purchases	300,000
Sales	500,000	Rent and rates	65,000
Commission	10,000	Insurance	32,000
		Salaries and wages	150,000
		Balance	<u>63,000</u>
	<u>610,000</u>		<u>610,000</u>

The following additional information is available:

- i. On July 1 2004 insurance amounting to Sh 15,000 had been paid for 12 months ending 30 June 2005.
- ii. Commission earned but not yet received as at 31 December 2004 was Sh5,000.
- iii. On 1 January 2004:
 - Rent amounting to Sh13,000 was owing
 - Rates totaling to Sh4,500 had been paid in advance.
- iv. December 2003 salaries of Sh30,000 were paid on 5 January 2005 and wages amounting to Sh35,000 had been paid
- v. On 31 December 2004, rent outstanding amounted to Sh 16,000 and rates paid in advance were Sh2,500

Required:

- i) Insurance account.
- ii) Rent and rates account.
- iii) Salaries and wages account.

Insurance a/c			
	Sh '000'		Sh '000'
Bank	32,000	P&L	24,500
		Balance	<u>7,500</u>
	<u>32,000</u>		<u>32,000</u>

Rent and rates a/c			
	Sh '000'		Sh '000'
Balance	4,500	Balance b/d	13,000
Bank	65,000	P&L	70,000
Balance c/d	<u>16,000</u>	Balance c/d	<u>2,500</u>
	<u>85,500</u>		<u>85,500</u>

Salaries and wages a/c			
	Sh '000'		Sh '000'
Bank	65,000	Balance b/d	30,000
		P&L	85,000
		Balance c/d	<u>35,000</u>
	<u>150,000</u>		<u>150,000</u>

REVISION EXERCISE

QUESTION 1

- a) Citing an example in each case, briefly explain four types of bookkeeping errors which are not disclosed by a trial balance
- b) The trial balance extracted from the books of Benard Masita as at 30 September 2010 failed to agree. The debit difference of Sh. 442,000 was posted to a suspense account. An income statement was prepared which showed a gross profit and a net profit of Sh. 1,985,000 and Sh. 1,229,000 respectively. Upon investigations, the following errors were discovered:
 1. A purchase of Sh 150,000 on credit was correctly posted to the suppliers account but was completely omitted from the purchases day book.
 2. Sales amounting to Sh. 250,000 to Samuel Njuguna were erroneously credited to his account. The sales account had been correctly posted.
 3. Salaries paid for the month of September 2010 amounting to Sh. 230,000 were recorded in the salaries account as Sh 320,000.
 4. Purchases of office stationery for Sh. 125,000 were erroneously debited to purchases account.
 5. A payment of Sh. 45,000 to Daniel Olunya, a creditor, was erroneously debited to the account of Alois Olunya, another creditor.
 6. An entry of Sh. 21,000 for returns outwards was made in error in the sales day book instead of in the purchases return day book.
 7. A bad debt of Sh 22,500 is yet to be written off.
 8. Goods valued at Sh .220,000 were taken for personal use but no entry had been made in the books.
 9. A discount received of Sh. 59,000 was correctly entered in the cashbook but posted to the discounts allowed account.

Required:

- i. A fully balanced suspense account.
- ii. Statement of corrected gross profit.
- iii. Statement of corrected net profit.

Solution:

- a) A bank reconciliation explains the difference between balance at the bank as per cashbook and balance at bank as per the bank statement.

The function is:

- i. To update the cashbook with transactions that have gone through the bank e.g. bank charges.
 - ii. To check and correct any errors in the cashbook.
 - iii. To detect and prevent any frauds that relate to the cashbook and bank transactions.
- b)

Cashbook

	Shs '000'		Shs '000'
Balance b/d	2,366,500	Bank charges	3,000
Receipts	26,500	Standing order	62,000
Overcast in payment	4,500	Overcast in opening bal.	658,500
		Dishonoured cheque	15,000
		Cheque paid by bank	44,000
		Balance c/d	<u>1,615,000</u>
	<u>2,397,500</u>		<u>2,397,500</u>

Bank statement as at 30 June 2001

	Shs
Balance as per cashbook	1,615,000
<i>Add:</i>	
Unpresented cheques	<u>22,500</u>
	1,637,500
Less: Uncredited cheques	(98,500)
Error	<u>(832,500)</u>
Bal as per bank statement	<u>706,500</u>

QUESTION 2

Ben Mogaka prepared the following draft balance sheet for BM Enterprises as at 31 December 2005:

	Cost	Accumulated depreciation	Net book value
Non-current assets	Sh.	Sh.	Sh.
Equipment	450,000	220,000	230,000
Furniture	300,000	150,000	150,000
Motor vehicles	<u>600,000</u>	<u>300,000</u>	<u>300,000</u>
	<u>1,350,000</u>	<u>670,000</u>	<u>680,000</u>
Current Assets:			
Inventory		122,800	

Accounts receivable		19,690	
Deposit account		50,000	
Suspense account		<u>9 000</u>	<u>201,400</u>
			<u>881,400</u>
Financed by:			
Capital		652,000	
Net profit		153,200	
Drawings		<u>(13,200)</u>	792,000
Current liabilities:			
Accounts payable		81,400	
Bank overdraft		<u>8,000</u>	<u>89,400</u>
			<u>881,400</u>

Additional information:

On further investigation, the suspense account was discovered to have resulted from the following errors:

1. The sales of goods on credit to Alex Otis amounting to Sh.19,000 had been recorded in the sales journal as sh.9,000.
2. A receipt of Sh.20,000 from sale of an item of equipment had been credited to sales account.
The equipment was shown in the books of account at costs of account of Sh.90,000 and accumulated depreciation of Sh.72,000.
3. A credit note from a supplier, Simon Masound for Sh.15,000 had been omitted from the books.
4. A bank overdraft for Sh.7,000 reflected in the cash book as at 31 December 2005 was omitted In the trial balance.
5. A payment of Sh. 9,700 to Tom Wambugu, a creditor, was correctly entered in the cabs book but posted to his personal account as Sh.7,900.
6. The debit side of rent expense account had been undercast by Sh.1,000.
7. A provision of Sh.2,000 for sundry expenses outstanding as at 31 December 2004 and debited to sundry expenses at that dated had not been brought forward to the credit of the account in the following period. No credit entry had been made in any other account in respect to this account in respect to this item.
8. Discount received from the supplier of Sh.8,200 had been entered on the wrong side of purchases ledger control account.
9. On 31 December, goods valued at Sh.9,600 (selling price) were returned by Jane Kerubo (a debtor). No entry had been made in the books to reflect this transaction. These goods were not included in the closing stock.
10. Discounts allowed were overcast by Sh.1,200.

Required:

- Journal entries to correct the above errors (Narration not required)
- Suspense account.
- Statement of corrected net profit for the year ended 31 December 2005
- Corrected balance sheet as 31 December 2005.

Solution:

i)

Insurance a/c			
	Shs.000		Shs.000
Bank	32,000	P&L	24,000
		Balance c/d	7,500
	<u>32,000</u>		<u>32,000</u>

ii)

Commission receivable a/c			
	Shs.000		Shs.000
P&L	15,000	Bank	10,000
		Balance c/d	5,000
	<u>15,000</u>		<u>15,000</u>

iii)

Rent and rates a/c			
	Shs.000		Shs.000
Bank	65,000	P&L	78,500
Balance c/d	16,000	Balance c/d	2,500
	<u>81,000</u>		<u>81,000</u>

iv)

Salaries and wages a/c			
	Shs.000		Shs.000
Bank	150,000	Balance b/d	30,000
		P&L	85,000
		Balance c/d	35,000
	<u>150,000</u>		<u>150,000</u>

QUESTION 3

On 1st January 2006 the following balances were extracted from the books of Nairobi Hotel.

Repairs Sh 27,700 Dr.

Insurance Sh 30,700 Dr

During the year ended 31st December 2006, the following transactions took place.

- Paid for repairs Sh 100,000
- Paid insurance Sh 96,000 covering twelve months ending 30th April 2007.
- Received a refund of Sh 10,000 from insurance for the period ended 31st December 2005.

Prepare

- i. Repairs account
- ii. Insurance account

Solution:

i)

Repairs a/c			
	Shs.000		Shs.000
Balance b/d	27,700		
Bank	<u>100,000</u>	P&L	<u>127,000</u>
	<u>127,700</u>		<u>127,700</u>

ii)

Insurance a/c			
	Shs.000		Shs.000
Balance b/d	30,700	P&L	94,000
Bank	<u>96,000</u>	Balance c/c	<u>32,000</u>
	<u>126,700</u>		<u>126,700</u>

QUESTION 4

In a new business during the year ended 31 December 2007 the following debts are found to be bad written - off on the dates shown

31 May	Vidla	Ksh 340,000
30 September	Vukulu	Ksh 463,000
30 November	Vihenda	Ksh 156,000

On 31 December 2008 the schedule of remaining accounts receivable totaling Ksh.14,420,000 is examined and it decided to make an allowance for doubtful debts of Ksh410,000

Your are required to show

- a) The bad debts account and the Provision for doubtful debts account
- b) The charge to the income statement
- c) The relevant extracts from the balance sheet as at 31' December 2007

Solution:

Bad debts a/c			
2007		2007	Shs.000
May 31	Vidija	Dec 31 P and L	959
Sept 30	Vukulu		
Nov 30	Vihenda		
	<u>959</u>		<u>959</u>

Allowance for doubtful debts a/c

2007	Shs.000	2007	Shs.000
		Dec 31 P and L	410

Profit and loss a/c (Extracts)

	Sh '000'
Bad debts	959
Allowance for doubtful debts	410

Balance sheet as at 31 December 2007 (Extracts)

	Sh '000'
Accounts Receivable	14,420
Less allowance for doubtful debts	(410)
	<u>14,010</u>

QUESTION 5

A business had always made an allowance for doubtful debts at the rate of 4 % of debtors. On 1 January 2008 the amount for this brought forward from the previous year was Ksh.320,000

During the year to 31 December 2008 the bad debts written -off amounted to Ksh.680,000.

On 31 December 2008 the accounts receivable balance was sh. 16,800,000 and the usual allowance for doubtful debts is to be made

You are to show;

- The bad debts account for the year ended 31 December 2008
- The allowance for doubtful debts account for the year
- Extract from the income statement for the year
- The relevant extract from the balance sheet as at December 2008

Solution:

a)

Bad debts a/c

2008	Shs.000	2008	Shs.000
Dec 31 various	<u>680</u>	Dec 31	<u>680</u>

b)

Provision for doubtful debts a/c

2008	Shs.000	2008	Shs.000
Dec 31P and L	672	Jan 31 P and L	320
		Dec 31P and L	<u>352</u>
	<u>672</u>		<u>672</u>

c)

Profit and loss a/c (Extracts)

	Sh '000'
Bad debts	680
Allowance for doubtful debts	352

d)

Balance sheet (Extracts)

	Sh '000'	Sh '000'
Accounts Receivable	16,800	
Less allowance for doubtful debts	<u>672</u>	<u>14,010</u>

QUESTION 6

- a) Outline the extent to which a trial balance is an indicator of correct book-keeping by an entity.
- b) After preparation of the trial balance of Bakari Brothers Enterprises as at 31 September 2005, the firm's accountant has been provided with the following additional information for the purpose of preparation of the final accounts:
 1. Due to an oversight, discount has been allowed to a credit customer on the gross invoiced amount of Sh.80,000 at the rate 10%. The firm should have used a rate of 6%.
 2. Electricity accrued amounts to Sh.36,710 while insurance premiums of Sh. 22,450 have been prepaid.
 3. In October 2005, the employees of the firm received a general salary increase, backdated to 1 July 2005. Amounts totalling Sh.126,550 in salary arrears are payable to former employees who left shortly before the salary award was announced and who have not yet been traced. It has been decided that the salary packets will be opened and the cash banked until the ex-employees are traced.
 4. Wages due to casuals amounting to Sh. 464,120 for services rendered in the last week of December 2005 were paid in January 2006 together with the salaries for the month of December 2005 which amounted to Sh.301,700.
 5. During the year, the exterior of the warehouse was repaired and repainted at a cost of Sh.500,000. This amount was erroneously debited to office premises account. It is policy of Bakari Brothers Enterprises to provide for depreciation on the closing balances of non-current assets and this has already been done: The annual rate of depreciation on office premises is 2% calculated on the straight-line basis.
 6. In December 2005, Bakari Brothers Enterprises had bought goods on credit from CB Ltd. for Sh. 452,100 and has also sold goods on credit to the same company for Sh.163,040. These amounts were correctly posted to their respective accounts. However, these accounts are to be offset as at 31 December 2005 and the remaining balance settled by cheque in January 2006.

7. The provision for discounts allowed to debtors, which at present has a balance of Sh.229,530 needs to be reduced to Sh. 157,400.
8. Debts totaling Sh.64,800 are irrecoverable and should be written off. However, amount of Sh.21,440 written off as a bad debt in the previous year has now been recovered in full but the cheque in settlement has not been banked or posted in the accounts.

Required:

Journal entries, including narrations, necessary to record the above transactions in the books of Bakari Bothers Enterprises

Solution:

- a) A trial balance is a memoranda statement of credit and debit balances as they appear in the ledges accounts. The double entry accounting method ensures that for every debit entry there is a corresponding credit entry and vice versa. Therefore all items on the debit side of a trial balance should be equal to the total items on the credit side. It therefore gives a prima facie evidence that the process of bookkeeping has been correct.

b)

No	Details	Dr Sh	Cr Sh
1.	Suspense a/c Discount allowed a/c (To correct discount allowed overstated)	2,000	2,000
2a).	Electricity a/c P&L a/c (To record electricity due)	36,710	36,710
b)	P & L a/c Insurance a/c (To record insurance prepaid)	22,450	22,450
3.	Bank a/c Cash a/c (To record cash deposit)	126,550	126,550
4.	Wages a/c Bank a/c (To record payment of wages)	765,820	765,820
5a).	Repairs a/c Office premises a/c	500,000	500,000
b)	Provision for depreciation a/c P & L a/c (To correct depreciation overcharge)	10,000	10,000
6a)	Creditors CB Ltd a/c Debtor CB Ltd a/c (To record offset accrual)	163,040	163,040
7.	Provision discount allowed P&L (To record reduction in provision of discount allowed)	72,130	72,130
8a)	Bad debts a/c Debtors a/c (To record bad debts)	64,800	64,800
bi)	Debtors a/c Bad debts recovered a/c (To record creation of bad debts recovered)	21,440	21,440
ii)	Bank Debtors (To record cheque from debtor)	21,440	21,440
iii)	Bad, debt recoverable P&L (To record bad debt recovered)	21,440	21,440

TOPIC 4

CORRECTION OF ERRORS AND SUSPENSE ACCOUNT

TYPES OF ACCOUNTING ERRORS AND THEIR CORRECTION

A Trial Balance is said to be a statement of proof done arithmetically to prove that proper double was observed in making accounting entries. The assumption is that the Trial balance totals will not agree whenever there is an accounting error. There are several errors in fact which will not affect the agreement of the trial balance totals. This means that there are two basic types of accounting errors:

- Errors *which do not* affect the Trial balance totals
- Errors *which do* affect the trial balance totals

The correction of all accounting errors must be journalized by way of the General Journal.

Errors which do not affect the Trial balance totals

1. Errors of Omission

This is an error that occurs when a transaction is completely omitted from the books of accounts. For example if we bought a motor van Sh 90 000 cash and we neither debit the motor vehicle account nor credit the cash account the trial balance would not be affected and it would still balance.

2. Errors of Principle

This occurs when we enter a transaction in the wrong class of account, but still observe double entry. For example we purchase furniture (fixed asset) worth Sh 200 000 for cash. We debit purchases account instead of debiting the furniture account and crediting the cash account. In such an instance the trial balance would still balance.

3. Errors of Commission

These types of errors occur when the correct amount is entered but in the wrong persons personal account though the account is in the same class of accounts. For example sales of Sh 20 000 sold to D. Waithaka but posted to P. Waithaka's account in the sales ledger. The transaction would be as follows.

Dr. P. Waithaka 20 000
 Cr. Sales 20 000

The correct entry would have been

Dr. D Waithaka 20 000
 Cr sales 20 000

To correct such an error, the following entry will be passed in the books.

Dr. D. Waithaka 20 000

CR. D Waithaka 20 000

This is just a reversing transaction that transfers the amount from P. Waithaka to the correct account of D Waithaka. You will note that the sales entry is not affected by the reversal and since both P. Waithaka and D. Waithaka are in the sales ledger, the trial balance would still balance.

4. Compensating Errors

These are errors that cancel out each other e.g. an error that overstates both the credits and the debits or an error that understates both the debits and the credits by the same amount. E.g. if the purchases returns was overstated by Sh2000 and the sales return overstated by Sh 2000. Since the purchases returns appear on the credit side and the sales returns appear on the debit side of the trial balance, the two would cancel out each other.

To correct the above error

Dr. Purchases returns	Sh 2 000
Cr. Sales returns	Sh 2 000

Another example would be overstating purchases as well as sales by the same amount; overstating both sides of a particular account by the same amount e.t.c.

5. Errors of Original Entry

These are errors that occur when the original figure is incorrect and yet double entry is still observed using the incorrect figure. The figure could either be understated or overstated.

Example

Purchases worth Sh20 000 recorded as Sh 200 000 in both the purchase account and the cash account.

The incorrect entry would appear as follows

Dr. Purchases	200 000
Cr. Cash/ bank	200 000

The correct entry should have been

Dr. Purchases account	20 000
CR. Cash/bank	20 000

To correct the error, we make the following entries.

Dr. Cash at bank Sh 180 000
 Cr. Purchases Sh 180 000

6. Complete Reversal of Entries

This is an error that occurs when the correct amount is posted in the correct account but in the wrong side of the account. For Example: if we sold goods on credit to D. Kameme worth Sh 100 000 the wrong entry would appear as follows.

Dr. Sales 100 000
 Cr. P. Kameme 100 000

The correct entry would have been

Dr P Kameme 200 000
 Cr. Sales 200 000

Correcting the above error is done in two stages:

- Canceling the initial recording
- Recording the correct entry.

This is done as follows:

Dr P. Kameme 100 000
 Cr. Sales 100 000

(To cancel the initial entry in the accounts)

Dr. P Kameme shsSh 100 000
 Cr. Sales 100 000

(To Record the correct entry)

The accounts would appear as follows:

P. Kameme a/c

2016			Sh	2016			Sh
01/1	Sales (to cancel)		100000	01/1	Sales(to cancel)		100000
01/1	Sales (to enter correct entry)		100000				

Sales	
Sh	Sh
27/5	/5 P. Kameme a/c(to cancel) 100000 P. Kameme a/c(to enter correct entry) 100000

7. Transposition errors

This is a special type of an error of original entry. It occurs when the wrong sequence of individual characters in a figure is entered. Example For example entering, entering shsS870 h 870 as shsS h 780. It is an error that is very difficult to trace, however if it occurs only on one side of the entry then the difference will be a number divisible by nine and hence easier to trace.

Illustration

Cash sales Sh 9 260 entered as Sh 6 290 on both cash book and sales ledger

The wrong entry would appear as follows.

Dr. Cash Sh 6 290
Cr. Sales Sh 6 290

The correct entry would have been

Dr. Cash Sh 9 260
Cr. Sales Sh 9 260

To correct the above entry

Dr. Cash (9260 - 6290) Sh 2 970
Cr. Sales (9260 - 6290) Sh 2 970

Exercise:

Show the journal entries required to correct the following errors. Entries; narratives must be shown.

1. Commissions received Sh 44 000 had been credited to rent receivable account
2. bank Bank charges Sh 3 850 had been debited to rent account
3. Completely omitted from the books of account is a payment of sundry expenses by cheque Sh 1 150
4. purchase Purchase of fixtures Sh 23 700 had been entered in purchases account
5. Return inwards of Sh 41 650 had been entered on the debit side of the return outwards account

6. A loan from R. Simiyu shsSh 25 000 had 25 000 had been entered on the credit side of capital account
7. Loan interest Sh 2 500 had been debited in the premises account
8. Goods taken for own use shs1 250 had worth Sh 1 250 had been debited to purchases account and credited to drawings account.

Suggested solution:

1) Dr Rent received account 44000

Cr. Commissions received 44000

(Correction of an error where commission received was credited to rent received)

2) Dr. bank charges a/c 3850

Cr. rent a/c 3850

(To correct wrong debit of bank charges in the rent account)

3) Dr. Sundry expenses a/c 1150

Cr. Bank a/c 1150

(To record omitted payment of sundry expenses)

4) Dr. Fixtures 23700

Cr. Purchases a/c 23 700

(To correct error of principle where purchases of fixed assets is treated as purchase)

5) Dr. Return outwards 41 650

Cr. Return inwards 41 650

(To correct entry return inwards in the debit of return outwards a/c)

6) Dr Capital account 25 000

Cr. R. Simiyu a/c 25 000

(To correctly record loan received from R. Simiyu)

7) Dr. Loan interest a/c 2500

Cr. Premises a/c 2500

(To correctly record interest on loan)

8) Dr Drawings a/c (1250 x 2) 2500

Cr. Purchases a/c (1250x2) 2500

Note

We double the figures when correcting errors of complete reversal of entries like that in (8) above. This is because if an amount was debited instead of being credited in the same account, a single credit entry would just cancel the initial debit. However the second credit entry will now enter the

required credit entry. Instead of showing the two credit entries separately, the amount involved is doubled and a single entry made but with a double value made.

SUSPENSE ACCOUNT

Due to poor double entry or other errors not falling in the category described above, the trial balance may fail to balance. In most cases the error causing this may take long to be identified. Before then the accountant is allowed to open up an account known as the suspense account.

To this account, he assigns the balance equal to the difference between the credit and debit sides of the trial balance to ensure that the trial balance balances. For example if the debit side exceeds the credit side by Sh100 000, suspense account will be assigned a credit balance equal to Sh100 000 thus balancing the trial balance. Later on when the cause of the error is identified, journal entries are passed against the suspense account till its balance is cleared thus eliminating it from the books.

Basically all errors affecting the balancing of the trial balance necessitate the creation of a suspense account. A few of such are discussed below.

Failure to enter a corresponding entry for every debit or credit entry made

Making a wrong corresponding entry e.g. if cash sales of Sh 20 000 are made and a debit entry correctly made in the cash book. However the sales account is credited with Sh2 000. This means that the credit side of the trial balance will be understated by Sh 18 000. A suspense account will thus be created and assigned accredit balance of Sh 18 000 to make the trial balance appear balanced awaiting identification and correct of the error.

Once the error is identified then journal entries need to be passed to remove the suspense account as follows:

Dr. Suspense account	18 000	
	Cr. Sales account	18 000

(To correct the error understating the credit balances of the trial balance)

Students are however cautioned that the suspense account should not be used to balance the trial balance unless the examiner specifically asks the students to do so.

Illustration 1

Martin is an accountant at Zabiri Ltd. During the year ended 30 June 2014 he prepared a trial balance which did not balance. He posted the difference to the suspense account. He then prepared the financial statement for the year ended 30 June 2014. The net profit for the company was sh. 483,840.

Upon investigating the following errors were later discovered:

1. The total of purchases day book had been under cast by sh. 11,200,000
2. The total of the discount column on the debit side of the cash book amounting to sh. 2,240,000 had been posted to the credit of discount received amount.

3. Motor vehicles repairs amounting to sh. 8,512,000 had been posted to the motor vehicle account.
4. A cheque for sh. 4,368,000 received from Barnabas Bundi a debtor had been debited in the cash book but no other entry had been made.
5. The returns outwards had been overcast by sh. 5,600,000.

Required:

- (i) Journal entries to correct the errors
- (ii) Suspense account
- (iii) Statement of corrected net profit

Solution**a.****i. Journal entries****Journal Entries**

	Dr. "000"	Cr. "000"
Dr. Purchases	11,200	
Cr. Suspense		11,200
(The total purchases had been understated error now corrected).		
Dr. Discount Received	2,240	
Dr. Discount Allowed	2,240	
Cr. Suspense		4,480
(Disc allowed posted in discount received, error now corrected).		
Dr. Motor Vehicle Repairs	8,512	
Cr. Motor Vehicle		8,512
(Motor Vehicle repairs expense posted to Motor vehicle account).		
Dr. Suspense	4,368	
Cr. Barnabas Debtor		4,368
(Receipt from debtor recorded in the ledger in error. Error of omission now corrected).		
Dr. Return outwards	5,600	
Cr. Suspense		5,600
(To correct return outwards overcast).		

ii. Suspense account**Suspense account**

	Shs '000'		Shs '000'
Balance b/d	16,912	Purchases	11,200
Barnabas	4,368	Discount received	4,480
		Returns outwards	5,600
	<u>1,280</u>		<u>21,280</u>

iii. Statement of corrected profit**Statement of Corrected Net Profit**

	Shs '000'
Net profit before adjustment	483,840
Purchases under cast	(11,200)
Discount received	(2,240)
Discount allowed	(2,240)
Motor vehicle expenses	(8,512)
Return outwards	<u>(5,600)</u>
	<u>454,048</u>

Illustration 2

Ali Osman is a sole trader who operates a retail business. His balance sheet as at 30 April 2014 was as follows:

	Sh'000'		Sh'000	Sh'000'
Capital and liabilities:		Fixed assets:		
Capital	420,000	Buildings		200,000
Add: Net profit for the year	<u>105 000</u>	Plant and machinery		<u>150,000</u>
Less: Drawings	525,000			350,000
	<u>(80,000)</u>	Current assets:		
	445,000	Stock	40,000	
Current liabilities:		Debtors	32,220	
Sundry creditors	34,000	Balance at bank	50,000	
		Cash in hand	<u>4,540</u>	<u>126,760</u>
		Suspense account		<u>2,249</u>
	<u>479 000</u>			<u>479,900</u>

Although the trial balance did not agree, the above balance sheet was prepared and a suspense account opened to which the difference was posted. At a later date, an inspection of the books revealed the following:

1. The salaries day book had been overcast by Sh.3,000,000.
2. A payment of Sh. 1,560,000 received from a debtor had been recorded in the cashbook but had not been posted to the personal account.
3. A discount received Sh.150,000 had been posted to the wrong side of the personal account.
4. The stock book had been undercast by Sh.10,000,000 as at 30 April 2014.
5. Bank charges of Sh.850,000 had not been entered into the books.
6. A cash balance of Sh.500,000 had not been included in the trial balance.
7. An invoice for Sh.850,000 for private work commissioned by Ali Osman had been paid by the business and posted to sundry expenses account.

Required:

- a) Suspense account to clear the difference.
- b) Statement showing the correct net profit or the year ended 30 April 2014

a)

Suspense account			
	Sh. 000		Sh. 000
Bal b/d	2,240	Sales	3,000
Debtor	1,560	Cash	500
		Debtor	300
	<u>3,800</u>		<u>3,800</u>

b) Statement showing the correct Net Profit

	Sh.000	Sh.000
Profit as per the balance sheet		105,000
Add: Drawings	850	
Stock undercast	10,000	10,850
Less: Sales overcast	3,000	
Bank charges	<u>850</u>	<u>(3,850)</u>
Corrected Net Profit		<u>112,090</u>

Ali Osman Adjusted Balance Sheet as at 30 April 2014		
	Sh.000	Sh.000
Non-Current assets		
Buildings	200,000	
Plant and machinery	150,000	350,000
Current assets		
Stock (w 1)	50,000	
Debtors (w2)	30,660	
Bank balance (w3)	49,150	
Cash balance (w3)	<u>5,040</u>	<u>134,850</u>
		484,850
Capital and Liabilities		
Creditors (w4)		33,700
Capital account		420,000
Add adjusted profit		112,000
Drawings (w5)		<u>(80,850)</u>
		<u>484,850</u>

Workings:

1.

Adjusted a/c	
	Sh.000
Unadjusted balance	40 000
Add undercast	<u>10 000</u>
	<u>50 000</u>

2.

Debtor's a/c

	Shs '000'		Shs '000'
Balance b/d	32,220	suspense	1,560
		Balance c/d	<u>30,660</u>
	<u>32,220</u>		<u>32,220</u>

3.

Cash Book

	Bank	Cash		Bank	Cash
	Sh '000'	Sh '000'		Sh '000'	Sh '000'
Balance b/d	50,000	4,340	Bank charges	850	-
suspense		<u>500</u>	Bal. c/d	<u>49,150</u>	<u>5,040</u>
	<u>50,000</u>	<u>5,0400</u>		<u>50,000</u>	<u>5,040</u>

4.

Creditor's a/c

	Sh'000'		Sh '000'
suspense	300	Balance b/d	34,000
Balance c/d	<u>33,700</u>		
	<u>34,000</u>		<u>34,000</u>

5.

Drawings a/c	
	Sh.000
Cash	80 000
Expenses	<u>850</u>
	<u>80 850</u>

REVISION EXERCISE

QUESTION I

- a. Citing an example in each case, briefly explain four types of bookkeeping errors which are not disclosed by a trial balance
- b. The trial balance extracted from the books of Benard Masita as at 30 September 2010 failed to agree. The debit difference of Sh. 442,000 was posted to a suspense account. An income statement was prepared which showed a gross profit and a net profit of Sh. 1,985,000 and Sh. 1,229,000 respectively. Upon investigations, the following errors were discovered:
 1. A purchase of Sh 150,000 on credit was correctly posted to the suppliers account but was completely omitted from the purchases day book.
 2. Sales amounting to Sh. 250,000 to Samuel Njuguna were erroneously credited to his account. The sales account had been correctly posted.
 3. Salaries paid for the month of September 2010 amounting to Sh. 230,000 were recorded in the salaries account as Sh 320,000.
 4. Purchases of office stationery for Sh. 125,000 were erroneously debited to purchases account.
 5. A payment of Sh. 45,000 to Daniel Olunya, a creditor, was erroneously debited to the account of Alois Ofunya, another creditor.
 6. An entry of Sh. 21,000 for returns outwards was made in error in the sales day book instead of in the purchases return day book.
 7. A bad debt of Sh 22,500 is yet to be written off.
 8. Goods valued at Sh '220,000 were taken for personal use but no entry had been made in the books.
 9. A discount received of Sh. 59,000 was correctly entered in the cashbook but posted to the discounts allowed account.

Required:

- i. A fully balanced suspense account.
- ii. Statement of corrected gross profit.
- iii. Statement of corrected net profit.

SOLUTION:

a) Four types of bookkeeping errors which are not disclosed by a trial balance

i) Error of Commission

This is an error in which the accountant records a transaction in the correct class of account, in the correct side but in the wrong name of the account.

For example a sale of goods on credit to Kenyani was recorded by debiting Kenyani's account.

ii) Error of Principle

This is an error committed due to lack of accounting principles. That is, a transaction is recorded in the wrong class of account, e.g. if a fixed asset such as motor van is debited to an expense account such as motor vehicle expenses account.

iii) Error of Complete Reversal of Entries

This is where the correct accounts are used to record a transaction but each item is shown on the wrong side of the account. For example, suppose we had paid a cheque to Ondieki for Shs 200, the double entry of which is Cr. Bank Shs 200, Dr. Ondieki Shs 200, Dr. Bank Shs 200. The trial balance totals will still agree.

iv) Compensating Errors

This is an error that occurs both on the debit side of an account and on the credit side of an account and the figures are equal which cancel each other.

E.g Sales account was undercast by Shs 20,000 and Purchase ledger was undercast with Shs 20,000. The net effect is neutral and the trial balance will still balance.

v) Error of original Entry

Where the original figure is incorrect, yet double entry is still observed using this incorrect figure. An instance of this could be where there were sales of Shs 150 goods but an error is made in calculating the sales invoice. If it were calculated as Shs 130 and Shs 130 and Shs 130 were credited as sales and debited to the personal account of the customer, the trial balance would still "balance".

vi) Error of omission

Where a transaction is completely omitted from the books, the trial balance will still agree.

vii) Transposition Errors

Where the wrong sequence of the individual characters within a number was entered e.g. 385 instead of 358 in the debit and credit entries, the trial balance would still agree.

b. Bernard Masita**i)**

Suspense a/c			
	Sh. 000		Sh. 000
Bal b/d	442 000	Purchases	150 000
Salaries	90 000	Samuel Njuguna	500 000
Discount received	59 000		
Discount allowed	59 000		
	<u>650 000</u>		<u>650 000</u>

Statement of corrected gross Profit

		Shs
Gross profit as per the books		1 985 000
Adjustments:		
Drawings in form of goods	220 000	
Purchases day book	(150 000)	
Purchases account	125 000	
Returns outwards	21 000	
Sales overturned by returns	<u>(21 000)</u>	<u>195 000</u>
		<u>2 180 000</u>

Statement of corrected net Profit		
		Shs
Net profit as per the accounts		1 229 000
Add:		
Salaries account	90 000	
Discount allowed (reversal)	59 000	
Purchases reversed	<u>59 000</u>	208 000
Less:		
Office stationery	125 000	
Sales overturned by returns	<u>22 500</u>	<u>(147 500)</u>
		<u>1 289 500</u>

TOPIC 5

FINANCIAL STATEMENTS OF A SOLE TRADER

INTRODUCTION

A sole trader - also known as a sole proprietorship is a type of business entity which is owned and run by one individual and where there' is no legal distinction between the owner and the business.

As a sole trader, your business is owned entirely by you, grown by you and ultimately succeeds or fails by you. This also means you are entitled to all profit that the business makes.

Becoming a sole trader is simple. All you have to do is register your business name and you can start trading.

There are huge incentives to becoming a sole trader but with them come terrifying or - depending on your personality - gratifying, side effects.

Financial statements of a sole trader involve the following:-

- Income statement.
- Statement of financial position.

Trial balance provides the essential input for the preparation of these accounts or statements. These accounts / statements provide necessary information to various interested groups e.g. shareholders, investors, creditors, employees, management and government agencies etc. Therefore, these financial statements are prepared to serve the information needs of these diverse groups to enable them to make appropriate decisions.

THE INCOME STATEMENT

At the end of the year, every business must ascertain its net profit (or loss). This is done in two stages:

1. Finding out the gross profit (or gross loss)
2. Finding out the net profit (or loss)

DETERMINATION OF GROSS PROFIT (OR GROSS LOSS)

Gross profit is the difference between sale proceeds of a particular period and the cost of the goods actually sold. Since gross profit means overall profit, no deduction of any sort, i.e. general, administrative or selling and distribution expenses is made. Gross Profit is said to be made when the Sale proceeds exceed the cost of goods sold. On the contrary, if the cost price of the goods is more than the selling price, then we can say-that there is a loss.

The entries / items that will appear in an income statement to ascertain the gross profit or loss will be:-

ITEMS TO BE DEBITED

I. Opening Stock:

It refers to the value of goods at hand at the end of the previous accounting year. Opening stock means the stock of an item at the beginning of a new inventory-keeping period. It becomes the opening stock for the current accounting year and contains the value of goods in which the business deals.

2. Purchases:

It refers to the value of goods (in which the concern deals) which are purchased either on cash or on credit for the purpose of resale. The balance of the purchase account, appearing in the Trial Balance, reflects the total purchases made during the accounting period. While dealing with purchases, we must bear in mind the following aspects:

- a) Purchase of capital asset should not be added with the purchases. If it is already included in purchases, it should be deducted immediately.
- b) If goods are purchased for personal consumption and Lliey acc added with tne purchases, they should be excluded. These types of purchases should be treated as drawings.
- c) If some of the goods purchased are still in transit at the year-end, it is better to debit Stock-in-transit Account and credit Cash or Supplier's Account.
- d) If the amounts of purchases include goods received on consignment, on approval or on hire purchase, these should be excluded from purchases.
- e) Cost of goods sent on consignment must be deducted from the purchases in case of a trading concern.

3. Purchases Returns/Returns Outwards:

It may come about that due to some reason; the goods are sent back to the supplier. In that case, the supplier is debited in the book of accounts and purchases returns or returns outwards are credited. It appears on the credit side in the Trial Balance. There are two ways of showing the purchases returns in the income statement. It may be shown by way of deduction from purchases in the income

statement. An alternative way is to show the purchases returns in the credit side of the income statement.

4. Direct Expenses:

These types of expenses are incurred in connection with purchase, procurement or production of goods. These expenses are directly related to the process of production. It also includes expenses that bring the goods up to the point of sale.

ITEMS TO BE CREDITED

I. Sales

It refers to the sale of goods in which the business deals and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets, which were acquired for utilization in business. However, goods sent to customers on approval basis, free samples and sales tax, if any, included in the sales figure should be excluded.

2. Sales Returns / Returns Inward

When goods are returned by the buyers for some reason, it is called Sales Return or Returns Inward. In the books of account, "Returns

Inwards Account" or "Sales Returns Account" is debited and buyer's account is credited.

It appears on the debit side of Trial Balance. We can show the sales returns in the Trading Account in two ways. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns is in the debit side of the Trading Account.

3. Abnormal Loss

It refers to the abnormal loss of stock due to fire, theft or accident. If any abnormal loss is there, it is credited fully to the Trading Account because the Trading

Account is prepared under normal conditions of the business and has no place for abnormal instances.

4. Closing Stock

It refers to the value of goods lying unsold at the end of any accounting year. This stock at the end is called closing stock and is valued at either cost or market price, whichever is lower. The trial balance generally does not include closing stock.

Therefore the following entry is made to incorporate the effect of closing stock in the income statement;

To Closing Stock A/c Dr

To income statement A/c Cr

However, if closing stock forms a part of Trial Balance, it will not be transferred to

Income statement but taken only to the statement of financial position. In case of the goods that have been dispatched to customers on approval basis, such goods should be included in the value of closing stock.

Ascertaining the gross profit or loss

After recording the above items in the respective sides of the income statement, the balance is calculated to ascertain Gross Profit or Gross Loss. If the total of, credit side is more than, that of the debit side, the excess represents Gross Profit. Conversely, if the total of debit side is more than that of the credit side, the excess represents Gross Loss.

TRADING ACCOUNT (HORIZONTAL FORMAT)

	Sh		Sh
Opening stock	XX	Sales	XX
Purchases	XX	Less: Returns Inwards	(XX)
Add: Carriage Inwards	<u>XX</u>	Net sales	XX
	XX		
Less: Returns Outwards	(XX)		
Cost of stock available for sale	XX		
Less: Closing stock	XX		
Cost of sales	XX		
Gross Profit	<u>XX</u>		
	<u>XX</u>		<u>XX</u>

INTR TRADING ACCOUNT (VERTICAL FORMAT)

	Sh	Sh	Sh
Sales			XXX
Less: Returns Inwards			<u>(XX)</u>
Net sales			XX
Opening stock	XX		
Purchases	XX		
Add: Carriage Inwards	<u>XX</u>		
	XX		
Less: Returns Outwards	XX		
Cost of stock available for sale		XX	
Less: Closing stock		<u>(XX)</u>	
Cost of sales			<u>(XX)</u>
Gross Profit			<u>XX</u>

Illustration

From the following details draw up the trading account of Mr.Karanja for the year ended 31 December 2010, which was his first year in business.

	Sh. "000"
Carriage inwards	13,400
Returns outwards	9,900
Returns inwards	17,800
Sales	774,840
Purchases	666,660
Stock of goods: 31 December 2010	149,780

Mr.Karanja
Trading Account for the year ended 31 Dec 2010

	Sh. "000"	Sh. "000"
Sales		774 840
Less: Returns Inwards		<u>17 800</u>
		757 040
Less: Cost of sales		
Purchases	666,660	
Add: Carriage Inwards	13,400	
Less: Returns Outwards	(9,900)	
Less: Closing stock	(149,780)	
Cost of sales		<u>(520,380)</u>
Gross Profit		236 660

Illustration

The following details for the year ended 31 March 2010 are available. Draw up the trading account of B. Osongo for that year.

	Sh. "000"
Stocks: 1 April 2009	16,523
Returns inwards	1,372
Returns outwards	2,896
Purchases	53,397
Carriage inwards	1,122
Sales	94,600
Stocks: 31 March 2010	14,323

Solution**B. Osongo****Trading Account for the year ended 31 March 2010**

	Sh. "000"	Sh. "000"	Sh. "000"
Sales			94,600
Less: Returns Inwards			<u>(1,372)</u>
			93,228
Less: Cost of sales			
Opening Stock		16,523	
Purchases	53,397		
Add: Carriage Inwards	<u>1 112</u>		
	54,519		
Less: Returns Outwards	<u>2, 896</u>	<u>51.623</u>	
cost of goods available for sale		68, 146	
Less: Closing stock		<u>(18,504)</u>	<u>(49,642)</u>
Gross Profit			<u>43 586</u>

DETERMINATION OF NET PROFIT (OR LOSS)

After ascertaining the gross profit, the subsequent step is to ascertain net profit or net loss during an accounting period. Here the revenues and expenses of an accounting period are summarized to reflect the alterations in various critical areas of the firm's operations. This step indicates how the revenue (money received from the sale of products and services before expenses are withdrawn) is transformed into the net income (the result after all revenues and expenses have been accounted for). It displays the revenues recognised for a specific period and the cost and expenses charged against these revenues, including write-offs (e.g. depreciation and amortization of various assets) and taxes. The objective of the income statement is to explain to the managers and investors whether the company made or lost money during the period being reported. As pointed out earlier, gross profit or gross loss ascertained in first step, which becomes the starting point of the ascertainment of net profit or loss. It takes into consideration all remaining indirect (normal and abnormal) expenses and losses related to or incidental to business. These operating and non-operating expenses are charged and shown to the debit side of the account. After transferring the Gross Profit or Gross Loss, the sources of other incomes like commission or discount received are shown on the credit side. The credit side also includes the non-trading income like interest on bank deposits or securities, dividend on shares, rent of property let out, profit generated out of the sale of fixed assets, etc. On the debit side will appear all other expenses that appear in the Trial Balance but cannot find a place in the Trading Account. The debit side will also include the losses arising out of sale of assets and any abnormal losses.

The net income is measured by matching revenues and expenses. Net income is the difference between total revenues and total expenses.

ITEMS TO BE DEBITED

- **Management Expenses:** These are the expenses incurred for carrying out the day-to-day administration of a business. Expenses under this head include office salaries, office rent and lighting, printing and stationery and telegrams, telephone charges etc.
- **Selling and Distribution Expenses:** These expenses are incurred for selling and distribution of products and services, as the name indicates. They comprise of commissions and salaries of salesmen, advertising expenses, packaging, bad debts etc.
- **Maintenance Expenses:** These expenses are incurred for maintaining the fixed assets of the administrative office in a good condition. They include expenses towards repairs and renewals.
- **Financial Expenses:** These expenses are incurred for arranging finances necessary for running the business. These include interest on loans, discount on bills, brokerage and legal expenses for raising loans etc.
- **Abnormal Losses:** Some abnormal losses may arise during the accounting period. All types of abnormal losses are treated as unusual expenses and debited to Profit & Loss Account. Examples are stock lost by fire but not covered by insurance, loss on sale of machinery, cash defalcation etc.
- **Wages and salaries** earned by the worker- whether paid or otherwise- and rent, electricity, telephone expenses are to be taken into consideration whether paid during the accounting period or later.

To ascertain the amount of expenses to be debited to the income statement, four types of events are essentially considered and then cash payment is made in connection with these events. They are as under:

1. Expenses incurred and paid out in that year: If some particular expenditure is incurred in a year and paid in the same year, the same will be debited to the income statement.
2. Expenses incurred but not paid out, partly or fully, during the current year: There are some expenses, which are incurred in the current accounting period, but not paid for, partly or fully, by the end of the period; they are called "Outstanding Expenses". These expenses become liabilities of the business at the end of the accounting year. In fact, on the date of the final accounts, outstanding expenses- in the form of both the expenses and a liability- exist without having been recorded in the books of account. For recording it, the following entry is to be passed:

Expenses A/c Dr. (will be shown in the income statement account A/c)

To Outstanding Expenses A /c (will appear in the liabilities side of statement of financial position)

3. Expenses paid for during the current year, but not incurred as yet, partly or fully: Sometimes, it may happen that some expenses are paid during the current year, but are not incurred as yet, partly or fully. Those expenses are known as "Prepaid Expenses".

Prepaid expense is an asset to the business and will be shown in the statement of financial position. The adjustment entry to be passed is;-

Prepaid Expenses A/c Dr. (to be shown as asset in the statement of financial position)

To Expenses A/c (balance of this account to be debited to income statement A/c)

4. Expenses of the current year, likely to arise in subsequent period: Sometimes, an expenses or a loss may arise in the future in connection with current years' business. In such a case, we make a provision for the anticipated loss and a charge is created against the profit for the current period. This provision is shown as either a liability or a contingent asset. i.e. it appears in the statement of financial position as a deduction from some other asset. The best example of this anticipated expense is Provision for bad debts.

ITEMS ON THE CREDIT SIDE OF THE INCOME STATEMENT

The Items that will appear in the credit side of income statement Account can be broadly classified as under:

1. **Gross Profit:** This is the balance of the Trading Account transferred to the Profit & Loss Account. If the Trading Account shows a gross loss, it will appear on the debit side.
2. **Other Incomes:** Sometimes a business might generate some profit, which is not due to the sale of its goods or services, because the business may have some other source of financial income. The examples are discount or commission received.
3. **Non-trading Income:** The business may have various transactions with the bank. At the end of the year, the business may earn some amount of interest, which will find a place in the Profit & Loss Account as non-trading income. The business may have some investment outside the business in the form of shares, debentures or units. All sorts of gains obtained from such kinds of investments are considered as non-trading income and are treated accordingly.
4. **Abnormal Gains:** [here may be capital gains arising during the course of the year, e.g. profit arising out of sale of a fixed asset. The profit is shown as a separate income on the credit side of the Profit & Loss Account. We must remember that all incomes from the abnormal gains or other income should be credited to the Profit & Loss Account if they arise or accrue during the period. Similarly, income received in advance should be deducted from the income.

ASCERTAINING THE NET PROFIT & LOSS

Once the respective accounts are transferred from trial balance to income statement, gross profit/loss ascertained and all adjustments are taken care of, the income statement will now be balanced. The totals of debit side and credit side are computed and the difference between these totals is either a net profit or net loss. If the total of debit side exceeds the total of credit side, there is a net loss, whereas when the total of credit side exceeds the total of debit side, there is a net profit. Net Profit is the last item to be recorded on debit side; else, net loss is the last item on credit side. After computing net profit/loss, the totals of two sides of income statement match.

The balance in the Profit and Loss Account represents the net profit or net loss. If the credit side is more than the debit side, it shows the net profit. Alternatively, if the debit side is more than the credit side, it shows net loss. When the Profit and Loss Account shows a net profit, we pass the following entry:

Dr Profit & Loss A/c

Cr To Net Profit A/c

If the Profit and Loss Account shows a net loss, the entry will be reversed.

FORMAT**PROFIT AND LOSS ACCOUNT**

It shows the net profit or net loss that the business has made from all the activities during a financial period.

The net profit (or loss) is determined by deducting all the expenses from all the incomes of the same financial period.

In practice, the trading account is combined together with the net profit and loss account into one report so that the format is as shown below:

Name Statement of financial position 31/Dec/2010			
	Sh. "000"	Sh. "000"	Sh. "000"
Sales			XX
Less: Returns Inwards			<u>XX</u>
			XX
Less: Cost of sales			
Opening stock		XX	
Purchases	XX		
Add: Carriage Inwards	<u>XX</u>		
	XX		
Less: Returns Outwards	<u>(XX)</u>		
Cost of goods available for sale		<u>XX</u>	
		XX	
Less: Closing stock		<u>(XX)</u>	
Cost of sales			(XX)
Gross Profit			XX
Discount received			XX
Rent received			XX
Interest received			XX
Other incomes			<u>XX</u>
Gross income			XX
Less: Expenses			
Carriage Outwards		XX	
Discounts allowed		XX	
Postage & stationary		XX	
Salaries & wages		XX	
Rent paid		XX	
Insurance & rates		XX	
Bank charges		XX	
Other expenses		<u>XX</u>	<u>XX</u>
Net profit/ (loss)			<u>XX</u>

Illustration

From the following trial balance of P Nyangweso draw up a trading , profit and loss account for the year ended 30 September 2012, and a balance sheet as at that date.

	Dr. Sh. "000"	Cr. Sh. "000"
Stock 1 October 19x8	23,680	
Carriage outwards	2,000	
Carriage inwards	3,100	
Returns inwards	2,050	
Returns outwards		3,220
Purchases	118,740	
Sales		186,000
Salaries and wages	38,620	
Rent	3,040	
Insurance	780	
Motor expenses	6,640	
Office expenses	2,160	
Lighting and heating expenses	1,660	
General expenses	3,140	
Premises	50,000	
Motor vehicles	18,000	
Fixtures and fittings	3,500	
Debtors	38,960	
Creditors		17,310
Cash at bank	4,820	
Drawings	12,000	
Capital		126,360
	<u>332 890</u>	<u>332 890</u>

Solution**P. Nyangweso****Trading, Profit and Loss Account as at 30 September 2003**

	Sh. "000"	Sh. "000"	Sh. "000"
Sales			186,000
Less: Returns Inwards			(2,050)
			183,950
Less: Cost of sales			
Opening stock		23,680	
Purchases	118,740		
Add: Carriage inwards	<u>3,100</u>		

	121,840		
Less: Returns Outwards	(3,220)	118,620	
Cost of goods available for sale		142,300.	
Less: Closing stock		(29,460)	(112,840)
Gross Profit			71,110
Less Expenses			
Salaries & wages		38,620	
Carriage outwards		2,000	
Rent		3,040	
Insurance		780	
Motor expenses		6,640	
Office expenses		2,160	
Lighting & heating		1,660	
General expenses		3,140	(58,040)
Net Profit			<u>13 070</u>

ADJUSTMENTS MADE WHEN PREPARING THE INCOME STATEMENT

1. Bad Debts

In order to display high amount of sales figures, goods are frequently sold out to known customers on credit. Some of these customers fail to pay their debts due to insolvency. These debts, which cannot be recovered, are called Bad Debts. It is a loss to the business and an adjustment is needed. The required entry will be:

Bad Debts A/c Dr
To sundry debtors A/c Cr

And then

Profit & Loss Account Dr
To Bad Debts A/c Cr

It should be noted here that no adjustment is required for any bad debt that already appears in the Trial Balance. Bad debt appearing in the Trial Balance should be debited only to Profit & Loss Account of the Period.

2. Provision for Bad Debts

Credit sales are recognised as income at the time of the sale without knowing the exact time of collection. In the course of time, loss may result from unsuccessful attempts to protect the dues from the customers. Every organisation creates a provision for this anticipated loss, from the reported income of the credit sales in the current period.

There are different methods of creating provision for bad debts. However, we will discuss only one method here. Accounting entry will depend upon the situation as to whether provision for bad debts is or is not appearing in the Trial Balance.

Situation 1: When provision for Bad Debts not appearing in the Trial Balance: The accounting entry will be:

Profit & Loss Account Dr.
 To Provision for Bad Debts Account Cr
 (To be shown in the Balance Sheet as a deduction for Debtors)

Situation 2: When provision for Bad Debts appearing in the Trial Balance:

At first, calculate the amount of provision to be created at the end of the period in the same way as above. Now compare the provision with the provision appearing in the Trial Balance. There are two resultant options:

- a. If the new provision exceeds the provision appearing in the Trial Balance, pass the following entry:
 Profit & Loss Account Dr
 To provision for Bad Debts Cr
- b. If the new provision is less than the provision appearing in the Trial Balance, pass the following entry:
 Provision for Bad Debts Dr
 To Profit & Loss Account Cr

Here, it should be noted that only new provision should be shown in the statement of financial position as a deduction from Sundry Debtors.

3. Discount allowed on Debtors

Many business organizations offer to give a cash discount to all those debtors who arrange to make their payment on or before the due date. It is clear that the real worth of debtors will be the gross figure of debtors minus the cash discount that they would be given.

The figure of debtors should be accordingly adjusted.

The difficulty, however, is that nobody knows how many debtors will entertain cash discount and what the amount will be. Therefore, all that is possible is to make a rough estimate. Usually, it is made at a percentage of outstanding debtors who actually repay their obligation. Therefore, the estimate amount of bad debt should be deducted from the total of debtors and provision for discount on debtors should be made only on the balance.

Dr. Income statement Account
 Cr To Provision for discount on Debtors Account
 (To be shown in the statement of financial position by way of deduction from Sundry debtors)

Example:

- Total Sundry Debtors as per Trial Balance shs. 40,600
- Bad Debts after Trial Balance sh. 600
- Provision for debt to be created @ 5% on Sundry Debtors
- Provision for Discount on Sundry Debtors to be created @ 2%

Calculate the amount of Provision for Discount on Sundry Debtors.

	Shs.
Debtors as per Trial Balance	40,600
Less: Bad debt written off	<u>(600)</u>
	40,000
Less: Provision for bad debt at 5%	<u>(2,000)</u>
	<u><u>38 000</u></u>

Provision for discount on Sundry Debtors will be: $2/100 \times \text{shs. } 38,000 = \text{shs. } 760$.

4. Reserve for discount on Creditors

If goods are purchased on credit and cash is paid to creditors in time, creditors allow cash discount. It is considered to be the income of the business. For this, following entries are passed:

(i) Creditors Account Dr.

To bank Account Cr
To Discount Account Cr

(ii)

Discount Received Account Dr.
To Profit & Loss Account Cr

At the end of the accounting year, we may expect certain discount out of such creditors. However, that discount will be received in the next year though it is actually related to the current period. An adjustment is requested for the expected discount from creditors that should be reflected in the accounts at the year-end as follows:

Step 1

Calculate probable amount of discount to be received from creditors. Generally, it is calculated by applying a percentage on outstanding creditors.

Step 2

Pass the following entry to record it:

Reserve for Discount on Creditors Account Dr. To income statement Account Cr

Step 3

Show this reserve for Discount on Creditors in the statement of financial position by way of deduction from creditors.

In the next year, when the actual discount is received, the following entry is to be passed:

(i) Creditors Account Dr.

To Bank/ Cash Account

To Discount Received Account Cr.

(ii) Discount Received Account Dr. To Reserve for Discount on Creditors Account Cr.

Reserve for Discount on Creditors Account is bound to leave a balance. This should be adjusted while creating similar reserve on creditors outstanding on the last date of the accounting year in question. Note: In actual practice, no organisation makes any reserve for discount on creditors due to the principle of conservatism.

5. Depreciation

According to Pickles, "Depreciation is the permanent and continuing diminution in the quality, quantity or value of an asset". It is a measure of wearing out, consumption or other loss of values Iota depreciable asset arising from use and passage of time. It is generally charged to such assets as Plant & Machinery, Building, Furniture, Equipment, etc.

Initially, the cost of the assets including installation cost is debited to the particular assets. In each accounting period, a portion of the cost expires and it needs adjustment for showing" correct profit of the period and correct value of the assets.

Adjustment entries are:

(a) When assets account is maintained at written down value:

(i) Depreciation Account Dr.

To Assets Account Cr.

(Being depreciation charged)

(ii) Income statement Account Dr.

To Depreciation Account Cr.

(Being depreciation transferred to profit & Loss Account)

(b) When assets account is maintained at cost price:

(i) Depreciation Account Dr.

To Provision for Depreciation Account Cr

(Being depreciation Charged)

- (ii) Profit & Loss Account Dr.
 To Depreciation Account Cr
 (Being depreciation transferred to profit & Loss Account)

Total accumulated depreciation is shown in the statement of financial position on the liabilities side. Alternatively, it can be shown by way of deduction from the original cost of assets side.

Here, it should be noted that no adjustment is required for depreciation that already appears in the Trial Balance. Depreciation that already appears in the Trial Balance should only be debited to income statement Account.

6. Goods Distributed as Free samples:

This is one kind of advertisement. When goods are distributed to the prospective customers as free samples, an expense is incurred (known as advertisement expense) and there is a usual reduction from the stock of goods.

The following entry is passed:

Advertisement Account Dr.

To Purchase Account (For a trader) Cr

Or

To income statement Account (For a manufacturer)

At the year-end, transferring the entry to the income statement Account closes the Advertisement Account:

Income statement Account Dr

To Advertisement Account Cr.

7. Income Tax

Income tax is not an expense to earn revenue. Therefore, when the profit is calculated, we cannot deduct income tax from the profit and treat it as an expenditure of the business. For a sole proprietor, income tax is payable by the owner and not by the business. Therefore, if income tax appears in the Trial Balance, it should be treated as drawing and should be deducted from the capital. Following are the entries to be passed:

- (a) Income Tax Account Dr. (When Paid)

To Cash/ Bank Account Cr

- (b) Drawing Account Dr.

To Income Tax Account Cr

However, for a registered partnership firm, income tax is payable by the business itself and not by the owners. It generally appears as an appropriation of the net profits. The following entry is passed:

Profit and Loss Appropriation Account Dr.

To Income Tax Account Cr

8. Drawing Made by the Proprietors

Drawing made by the proprietor(s) may be in cash or in kind. Drawing relates to the resources of the business and the capital of the owner(s).

Drawings made in Cash: In this case, following entries are passed:

- (a) Drawings Account Dr.
To Cash/Bank Account Cr
- (b) Capital Account Dr.
To Drawings Account Cr

Drawings made in kind: When some of the stocks are withdrawn from the business, the following entries are passed:

- (a) Drawings Account Dr.
To Purchases Account Cr.
- (b) Capital Account Dr.
To Drawings Account Cr.

If the drawings made by the owner are incorporated in sales, we are to pass a reverse entry to cancel the original entry. For the drawings, the above two entries are to be passed:

9. Mutual Indebtedness

Sometimes, a debtor may also be a creditor for the business. If finished goods are sold to X for shs.100 and raw material is purchased from him for shs. 500', the name of X will appear both in the debtors and creditors list. Generally, we set off these types of accounts.

We transfer the account that has a smaller balance to the account having a bigger balance and, in effect, one account is closed. The following entry is passed (the amount will be the smaller of the two figures):

Sundry Creditors Account Dr.shs .500
To Sundry Debtors Account shs . 500

10. Debtors arising out of Dishonour of Cheques or Bills

When a cheque previously received from a debtor is dishonoured, the old position of debtor and creditor is restored between the buyer and the seller respectively. In this case, the Debtor Account is debited and Bank Account is credited. In effect, the value of the sundry debtors increases and bank balance decreases.

When a bill previously received from a debtor is dishonoured, the old position of debtor and creditor is restored between the buyer and the seller respectively.

In this case, the Debtor Account is debited and Bank Account is credited. In effect, the value of the sundry debtor's increases and one of the following is credited, depending on the manner in which it has been previously dealt with:

Sundry Debtors Account Dr. (Dishonour of Bill)

To Bills Receivable Account (When the bill is retained)

To Bills for Collection Account (When the bill is sent to bank for collection)

To Bank Account (When the bill is discounted with banker)

To Endorsee Account (When the bill is endorsed)

If a provision for doubtful debts is to be created, it will be on the value of the sundry debtors after making the above Adjustments.

11. Abnormal Loss of Stock by Accident e.g., by Fire

If a portion of the stock is lost, the value of such loss is first to be ascertained.

Therefore, Abnormal Loss Account is to be debited and income statement Account is to be credited.

Transferring balance to the income statement Account closes abnormal loss account. Income statement Account is to be debited and abnormal loss account is to be credited. If the above loss is insured against risk, Insurance Claim Account (or Insurance Company Account) is to be debited and Abnormal Loss Account is to be credited. Until the money is received, Insurance Claim (or Insurance Company Account) will find a place in the asset side of the Balance Sheet. When the money is received, Bank Account is debited and the Insurance Claim

Account (Insurance Company Account) is credited. If the goods are partially insured, the portion not covered by insurance is to be charged to income statement Account.

Journal entry to be passed is as follows:

- (i) Accidental Loss Account Dr. (Actual loss of stock)
To Trading Account Cr
- (ii) (a) Insurance Claim Account Dr. (Insurance claim admitted by the insurance Co)
Or
(b) Insurance Company Account Dr. (Insurance claim admitted by the insurance Co)
- Income statement Account Dr. (Claim not admitted)
To Accidental Loss Account

12. Commission to the manager

Sometimes, the manager of a concern is given a percentage of the profit as commission. Since it is an expense like salaries, we must account for it. The entry will be:

Income statement Account Dr

To Commission Account Cr.

If the amount is not paid within the accounting period, it will be shown in the liability side of the Balance Sheet as commission payable.

A problem arises with the ascertainment of the amount payable as commission. The reason is that commission may be paid at a certain percentage before or after charging such commission. If the commission is paid before charging commission, calculation is very easy.

We simply multiply the rate with the profits.

13. Goods Sent on Approval Basis

When goods are sold to the customers on sale or return basis or on approval basis, it is not considered as sale till the time it is not approved by the customer or till the expiry of a fixed period as agreed by the parties. When goods are sold initially to a customer on approval basis, we pass the entry for the sales. At the year-end, if the goods are still lying with the customers awaiting approval, the following entries are to be passed:

- i. To cancel previous entry
Sales Account Dr.
 To Sundry Debtors Account Cr.
- ii. To add the value of the closing stock (Cost of goods lying with the customer):
Stock Account Dr.
 To income statement Cr

In the statement of financial position, it will be deducted from sundry debtors at sales price and the closing stock will be increased by the cost of such sales.

14. Interest on Loan- Not yet Paid- Fully or partly

In the Trial Balance, the amount of the loan appears in the credit column. The amount of interest paid appears on the debit column. However, if a portion of the interest is still outstanding at the year end. We pass the following entry to make the adjustment:

Interest on Loan Account Dr
 To Loan Account Cr

If nothing has been paid as interest, we are to find out the amount by applying the rate with the amount of the loan and then pass the above entry. The total amount of unpaid interest will appear in the Balance Sheet as liability.

Illustration

The following trial balance was extracted from the books of Masinzaji, a sole trader as at 31 August 2009

	Sh. 000	Sh. 000
Plant machinery at cost	11,350	-
Provision for depreciation on plant and machinery	-	4,150
Motor vehicles	13,290	-
Provision for depreciation on motor vehicles	-	2,790
Goodwill	5,000	-
Quoted investments	6,470	-
Freehold premises at cost	32,000	-
Mortgage on premises	-	10,000
Interest paid/received	1,000	460
Inventory	4,670	-
Bank and cash	2,850	-
Capital	-	60,000
Drawings	5,600	-
Purchases/sales	34,260	58,640
Return inwards and outwards.	3260	2140
Carriage inwards	730	-
Carriage outwards	420	-
Discount allowed/received	1,480	1,970
Wages	7,180	-
Rates and rent	4,300	-
Allowance for bad debts	-	530
Trade receivable/payable	8,070	4340
Electricity	2,640	-
Stationery	450	-
	145,020	145,020

Required:

Additional information

- Inventory as at 31 August was valued at sh. 3,690,000.
- Allowance for bad debts is to be adjusted at 10% of debts.
- Bad debts of sh. 370,000 had been posted to the ledger.
- Goods which had cost sh. 300,000 had erroneously been invoiced to a customer for sh. 400,000 and had been accounted for as sales.
- Electricity accrued as at 31 August 2009 was sh.130,000 and prepaid rates amounted to sh.210,000
- Stock of stationery as at 31" August 2009 was sh. 230,000.
- Depreciation is to be provided on pro rata basis as follows.
 - Assets Rate per annum
 - Motor vehicle 20% on reducing balance method
 - Plant and machinery 25% on reducing balance method
- A motor vehicle was sold on credit on 151 December 2008 for sh.458,000. The motor vehicle had

- a. Been bought on 1 June 2007 for sh. 1,000,000 the sale had not been recorded to the ledger.

9. During the year Masinzaji took good worth 350,000 from the business for his own use.

Required:

Income statement for the year ended 31' August 2009

Solution

a. Income statement

Masinzaji

Income statement for year ended 31st Aug. 2009

	Sh.000	Sh.000
Sales		58,240
Return inwards		(3,260)
Net sales		54,980
Cost of sales:		
Opening inventory	4,670	
Purchases	34,260	
Return outwards	(2,140)	
Less: Drawings	(350)	
Goods available for sale	36,440	
Carriage inwards	730	
Closing inventory	(3,690)	(3,348.0)
Gross profit		21,500
Incomes:		
Discount received		1,970
Interest Received		460
Expenses		
Stationery(w6)	220	
Electricity (w4)	2,770	
Loss on sale of vehicle (w3)	251	
Increase in all of for doubtful debt (w1)	200	
Rent and Rates (w5)	4,090	
Wages	7,180	
Discount allowed	1,480	
Carriage outwards	420	
Interest	1,000	
Depreciation		
Plant and machinery (w7)	1,800	
Motor vehicle (w7)	1,958.2	
Bad debt	370	(21,739.2)
		<u>2,190.2</u>

Workings:-**W1****Provision for bad and doubtful debts**

$$10\% \times 7,300,000 = 730,000$$

Provision for bad debts account

	Sh.000		Sh.000
	-	Balance b/d	530
Balance c/d	<u>730</u>	Income statement	<u>200</u>
	<u>730</u>		<u>730</u>

W2**Motor vehicle depreciation**

First period of 3 months	20% x 1,000,000 x 3/12)	
Second period full year	20 % (1,000,000-50,000)	190,000
Third period	20 % (1,000,000-50,000-190,000)	51 000
Cumulative depreciation		291,000

W3**Disposal of motor vehicle account**

	Sh.000		Sh.000
Motor vehicle	1 000	Provision for depreciation	291
		Bank	458
		Income statement	<u>251</u>
	<u>1, 000</u>		<u>1, 000</u>

W4**Electricity Account**

	Sh.000		Sh.000
Cash	2, 640	Income statement	2, 770
Balance c/d	<u>130</u>		
	<u>2, 770</u>		<u>2, 770</u>

W5**Rent and rates Account**

	Sh.000		Sh.000
Cash	4,300	Income statement	4,090
		Balance c/d	<u>210</u>
	<u>4,300</u>		<u>4,300</u>

W6**Sh"000"**

Stationery	450
Closing stock	<u>(230)</u>
	<u>220</u>

W7**Depreciations****i. Plant and machineries**

25% (11,35(400 — 4,150;000)2—,1,800,000

ii. Motor vehicle

20% (13,290,000 — (2,790, 000 -291,000)

=1,958,200

Illustration

The following trial balance was extracted from the books of Mr.Mugominyo, a sole trader.

	Sh.	Sh.
Capital		5,920,000
Drawings	1,200,000	
Trade debtors	1,808,400	
Trade creditors		2,168,000
Sales		8,892,600
Purchases	4,188,400	
Stock – 1 st January 2003	2,533,300	
Sales returns	144,700	
Purchases returns		218,800
Cash in hand	56,800	
Balance at bank	1,056,400	
Warehouse expenses	640,000	
Discounts allowed	90,200	
Discounts received		170,000
Office salaries	600,000	
Office lighting	188,800	
Rates	108,200	
Motor vehicle (cost)	1,280,000	
Freehold premises (cost)	2,600,000	
Fixtures and fittings	576,000	
General expenses	142,400	
Insurance	28,000	
Provision for bad debts		50,000
Motor vehicle expenses	150,400	
Bad debts written off	<u>28,800</u>	
	<u>37 420.800</u>	<u>17.420.800</u>

Additional information:

1. Stock as at 31 December 2003 was valued at Sh. 1,760,000
2. Depreciation on fixtures and fittings and the motor vehicle is to be provided at the rate of 5% and 10% per annum on cost respectively.
3. Rates prepaid as at 31 December 2003 amounted to Sh.25,600.
4. Unexpired insurance as at 31 December 2003 is to be made at 21/2 of the trade debtors,

Required:

- a) Trading and profit and loss account for the year ended 31 December 2003.
- b) Balances sheet as at 31 December 2003,

Solution**a)**

Mr.Mugominyo
Statement of financial statement
For the year ended 31 December 2003

	Shs '000'	Shs '000'	Shs '000'
Sales			8,892,600
Sales returns			(144,700)
Net sales			8,747,900
Cost of sales			
Opening stock		2,533,300	
Purchases	4,188,400		
Purchases returns	(218,800)	3,969,600	
Closing stock		(1,760,000)	(4,742,900)
Gross profit			4,005,000
Discount received			170,000
Provision for bad debts (w1)			<u>4,790</u>
			4,180,790
Expenses			
Warehouse expenses		640,000	
Discount allowed		90,200	
Office salaries		600,000	
Office lighting		188,800	
Rates: Paid	108,200		
Prepaid	(25,600)	82,600	
Depreciation (w2) Motor Vehicle		128,000	
Fixtures and Fittings		28,800	
General expenses		142,400	
Insurance: paid	28,000		
Unexpired	(4,000)	24,000	
Motor vehicle expenses		150,000	
Bad debts written off		<u>28,800</u>	(2,103, 600)
Net profit			<u>2,076,190</u>

Mugominyo**Balance Sheet as at 31 December 2003**

	Cost Sh. 000	Acc. Dep Sh.000	N.B.V Sh.000
Non-current assets			
Freehold Premises	1,280,000	128,000	1,152,000
Motor Vehicles	2,600,000	-	2,600,000
Fixtures and fittings	<u>576,000</u>	28,800	<u>547,200</u>
	<u>4,456,000</u>		<u>4,299,200</u>
Current Assets			
Stock		1,760,000	
Debtors	1,808,400		
Provision for bad debts	<u>(45,210)</u>	1,763,190	
Cash at bank		1,056,400	
Cash at hand		56,800	
Prepayments		29,600	<u>4,665,990</u>
			<u>8,965,190</u>
Liabilities			
Creditors			2,169,000
Financed by:			
Capital		5,920,000	
Drawings		(1,200,000)	
Net profit		<u>2,076,190</u>	<u>6 796,190</u>
			<u>8,965,190</u>

1. Provision for Bad debts

$$2.5\% \times 1,808,400 = 45,210$$

Provision for bad debts account

	Sh.000		Sh.000
P&L	4, 790	Balance b/d	50, 00
Balance c/d	45, 210		
	<u>50,000</u>		<u>50,000</u>

2. Depreciation

$$\text{Fixtures and fittings } 5\% \times 576,000 = \text{Sh } 28,800$$

$$\text{Motor vehicle } 10\% \times 1,280,000 = \text{Sh } 128,000$$

3. Prepayments

	Sh “000”
Rates	25 600
Unexpired insurance	<u>4 000</u>
	<u>29 600</u>

STATEMENT OF FINANCIAL POSITION

Statement of financial position is a summary of the financial balances of a sole proprietorship, a business partnership or a company. Assets, liabilities and ownership equity are listed as of a specific date, such as the end of the financial year. It is a statement of assets and liabilities, which helps us to establish the financial position of a business enterprise on a particular date, i.e. on a date when financial statements or final accounts are prepared or books of accounts are closed. In fact, this statement treats the balances of all those ledger accounts that have not yet been squared up. These accounts relate to assets owned, expenses due but not paid, incomes accrues but not received or certain receipts which are not due or accrued. In other words, it deals with all those real and personal accounts, which have not been accounted for in the Manufacturing, Trading or Profit & Loss Accounts. Besides, a statement of financial position also treats all those items given in the adjustments, which affect real or Personal Accounts. The Nominal accounts are treated in the income statement in the usual manner. A statement of financial position is often described as a "snapshot of a company's financial condition". It aims to ascertain the nature and amount of different assets and liabilities so that the financial position 'such as liquidity or solvency position could be evident to all those interested. Therefore, an important feature of a statement of financial position is to show the exact financial picture of a business concern on a particular date.

DIFFERENCE BETWEEN TRIAL BALANCE AND STATEMENT OF FINANCIAL POSITION

The following are the points of difference between Trial Balance and statement of financial position;

Trial Balance	Statement of financial position
The purpose of preparing a trial balance is to check the arithmetic accuracy of account books.	A Statement of financial position is drafted to reveal the financial position of the business.
A trial balance is prepared to document that the total amount of account balances with debit balances is equal to the total amount of account balances with credit balances.	A Statement of financial position shows that the total of the asset amounts is equal to the total of the amounts of liabilities and stockholders' equity.
It is prepared before the preparation of income statement Account.	It is prepared after the preparation of income statement Account.
It does not contain the value of the closing stock of goods.	It contains the value of the closing stock, which appears on the assets side.
Expenses due but not paid and incomes due but not received do not appear in the Trial Balance.	Expenses due but not paid appear on the liability side and income due but not received appears on the asset side of the Statement of financial position.
In case of Trial Balance, the columns are named as 'debit' and 'credit' columns.	The two sides of Statement of financial position are called 'liabilities' and 'assets' sides

	respectively.
It is a list of balance extracted from the ledger accounts.	It contains the balance of only those accounts, which represent assets and liabilities.
It contains the balance of all accounts- real, nominal and personal.	It contains the balance of only those accounts, which represent assets and liabilities

PREPARATION AND PRESENTATION OF STATEMENT OF FINANCIAL POSITION

The Process of preparation and presentation of Statement of financial position involves two steps:

- Grouping
- Marshaling

Grouping

In the first step, the different items to be shown as assets and liabilities in the Statement of financial position are grouped appropriately. For this purpose, items of similar nature are grouped under one head so that the Balance Sheet could convey an honest and true message to its users. For example, stock, debtors, bills receivables, Bank, Cash in Hand etc. are grouped under the heading Current Assets and Land and Building, Plant and Machinery, Furniture and Fixtures, Tools and Equipment's under Non-current Assets. Similarly Sundry creditors for goods must be shown separately and distinguished from money owing, other than due to credit sales of goods.

Marshaling

The second step involves marshaling of assets and liabilities. This involves a sequential arrangement of all the assets and liabilities in the Statement of financial position. There are two methods of presentation:

- The order of liquidity
- The order of permanence

Under liquidity order, assets are shown on the basis of liquidity or reliability. These are rearranged in an order of most liquid, more liquid, liquid, least liquid and not liquid (fixed) assets. Similarly, liabilities are arranged in the order in which they are to be paid or discharged.

Under the "Order of performance", the assets are arranged on the basis of their useful life. The assets predicted to be most fruitful for the business transaction for the longest duration will be shown first. In other words, this method puts the first method in the reserve gear. Similarly, in case of liabilities, after capital, the liabilities are arranged as long term, medium term, short term and current liabilities. This is the commonly used method.

For a better understanding of how various items should be placed, it is important to know the type and nature of assets and liabilities that are to be classified and arranged in either of two orderly

manner⁴ discussed earlier. For the purpose of presentation of assets in the statement of financial position, assets are classified as under:

1. Non-current assets
2. Intangible Assets
3. Current Assets
4. Fictitious Assets
5. Wasting Assets
6. Contingent Assets

Non-current assets

These are those assets, which are acquired for the purpose of producing Goods or rendering services. These are not held for resale in the normal course of business. Fixed assets are used for the purpose of earning revenue and hence these are held for a longer duration. These are also treated as 'Gross Block' and 'Net Block' (Non-current assets after depreciation). Investment in these assets is known as 'Sunk Cost'. Examples of Non-current assets are Land & Building, Plant and Machinery, Furniture and Fixtures, Tools and Equipment, Motor vehicles etc. All fixed assets are tangible by nature.

Intangible assets

Intangible assets are those capital assets, which do not have any physical existence. Although these assets cannot be seen or touched, they are long lasting and prove to be profitable to owner by virtue of the right conferred upon them by mere possession. They also help the owner to generate income. Goodwill trademarks, copyrights and patents are the examples of intangible assets.

Current assets

Current assets include cash and other assets, which are converted or realized into cash within a normal operating cycle or say, within a year. These are acquired for resale, assisting and helping the process of production, rendering service or supplying of goods. These assets constantly keep on changing their form and contribute to routine transactions and operations of business. Examples are Cash, Bank, Bills Receivables, Debtors, Stock, Prepaid expenses etc. Current assets are also known as Floating Assets or Circulating Assets.

Liquid or quick assets

Those current assets, which can be converted into cash at a very short notice or immediately, without incurring much loss or exposure to high risk, are quick assets. Quick assets can be worked out by deducting Stock (raw materials, work-in progress or finished goods) and prepaid expenses out of total current assets.

Fictitious assets

These are the non-existent worthless items which represent unwritten-off losses or costs incurred in the past, which cannot be recovered in future or realized in cash. Examples of such assets are preliminary expenses (formation expenses), Advertisement suspense, Underwriting commission, Discount on issue of shares and debentures, Loss on issue of debentures and Debit balance of income statement Account. These fictitious assets are written off or wiped out by debiting them to income statement Account.

Wasting assets

An asset that has a limited life and therefore dwindles in value over time is a wasting asset. This type of asset has a limited useful life by nature and depletes over a limited duration. These assets become worthless once their utility is over or exhausts fully. During the life of productive usage, assets of this type produce revenue, but eventually reach a state where the worth of the assets begins to diminish. Such assets are natural resources like timber and coal, oil, mineral deposits etc.

Contingent assets

Contingent assets are probable assets, which may or may not become assets, as that depends upon occurrence or non-occurrence of a specified event or performance or non-performance of a specified act. For example, a suit is pending in the court of law against ownership title of a disputed property. Subsequently, if the verdict goes in favour of the business concern, it becomes the asset of the concern. However, if the business firm does not win the lawsuit, it will not have ownership rights of the property; it will be of no use to it. Thus, it remains a contingent asset as long as the judgment is not pronounced by court. Such assets are shown by means of footnotes and hence do not form part of assets shown in the Balance Sheet. Besides this, hire-purchase contract, uncalled share capital etc. are the other examples of contingent assets.

CLASSIFICATION OF LIABILITIES**Non-current liabilities/Long-term liabilities**

These are the obligations that the business enterprise is expected to meet after a relatively long period. Such liabilities do not become due for payment in the ordinary course of business operation or within normal operating cycle.

Debentures, long-term loans from banks or financial institutions are the examples of long-term liabilities.

Current liabilities

Current liabilities are those liabilities that are payable within normal operating cycle, i.e. within a given accounting year. These may arise out of realization from current assets or by creating fresh, current liability (obligation). Trade creditors, Bills payable, Bank overdraft, outstanding expenses, short—term loan (payable within twelve months or within the accounting year) are examples of current liabilities.

Contingent liabilities

These liabilities may or may not be sustained by an entity depending on the outcome of a future event such as a court case. These liabilities are recorded in a company's accounts and displayed in the statement of financial position when both probable and reasonably estimable. It is not an actual liability but an anticipated (probable) liability, which may or may not become payable. It depends upon the occurrence of certain events or performance of certain acts. An element of uncertainty is always attached to a contingent liability; it is a potential liability that may or may not become a sure liability. Contingent liabilities are exemplified in the liability for bills discounted, liability for acting as surety, liability arising on a suit for damages pending in the court of law, liability for calls on partly paid shares etc. If a parent guarantees a daughter's first car loan, the parent has a contingent liability. If the daughter makes her car payments and pays off the loan, the parent will have no liability. If the daughter fails to make the payments, the parent will have a liability. Contingent liabilities are shown as footnotes under the statement of financial position.

In accounting, a contingent liability and related contingent loss are recorded with a journal entry only if the contingency is probable as well as estimable. If a contingent liability is only possible (not probable) or if the amount cannot be estimated, a journal entry is not required. However, a disclosure is required. When a contingent liability is remote (such as a nuisance suit), neither a journal nor a disclosure is required.

PREPARING FINANCIAL STATEMENTS UNDER INCOMPLETE INFORMATION

An incomplete record situation is whereby, the accounting system falls short of the double entry. This may be due to:

- Lack of records at all; or
- Insufficient records that will facilitate the preparation of final accounts

Reasons for incomplete records:

- a) Managers or owners may not have the skills or expertise in preparing and maintaining an accounting system (records and procedures).

- b) It may not be economical for the business to maintain accounting records due to the volume or/and nature of transactions (small scale businesses)
- c) Records are destroyed (e.g. through fire), stolen or misplaced.

There are 4 main approaches in preparing final accounts where there are insufficient records.

- a) Estimating income from the net assets.
- b) Estimating income from the use of ratios.
- c) Use of a simple cashbook and bank statement.
- d) Use of control accounts.

N/B: approach number c and d are normally used together

(a) Estimating Income from the Net Assets

Where the available records are so deficient (i.e. it is impossible to compile a reasonable complete cash summary, the only method of estimating the profits or loss for the period, is to prepare statement of affairs showing the net worth of the business at the beginning and at the end of the period.

The profit/loss is estimated by use of the following formulas:

$$\text{Profit or loss} = \text{Closing Capital} - \text{Opening Capital} + \text{Drawings} - \text{Additional Capital}$$

Or where there are no non-current liabilities then this optional formula can be used

$$\text{Profit or loss} = \text{Closing Capital} - \text{Opening Capital} + \text{Drawings} - \text{Additional Capital}$$

Illustration

A sole trader's capital position is as follows:

	2002 Sh.	2003 Sh.
Motor vehicle		
Cost	7,500	7,540
Depreciation	<u>3,000</u>	<u>4,500</u>
	4,500	3,000
Stock	2,960	3,450
Debtors	1,150	2,060
Bank	925	2,125
Cash	<u>263</u>	<u>54</u>
	9,798	10,689
Creditors	<u>2,860</u>	<u>3,340</u>
Net assets	<u>6,938</u>	<u>7,349</u>

He has estimated his drawings for 2003 at Shs.12,500. Estimate his net profit for the year.

Solution

$$\begin{aligned}
 \text{Net profit} &= \text{Closing Net Asset} - \text{Opening Net Asset} + \text{Drawings} - \text{Additional Net assets} \\
 &= 7,349 - 6,938 + 12,500 \\
 &= \text{sh.}12,911
 \end{aligned}$$

b) Use of Ratios

There are three important ratios to be looked at:

- 1) Gross profit margin
- 2) Mark up
- 3) Stock turnover

If a firm has a uniform Gross Profit for all the items sold then any information available on sales or purchases can be used to derive the total Gross Profit for the period and in case there is sufficient information on expenses, then the Net Profit can also be derived.

The above ratios are computed as follows:

$$1) \quad \text{Gross Profit Margik} = \frac{\text{Gross Profit}}{\text{Sales (selling price)}} \times 100$$

E.g. If the selling price of a unit is Shs 100 and Gross Profit made per unit is Shs 25, the Gross Profit Margin will be:

$$\begin{aligned}
 &= \frac{25}{100} \times 100 \\
 &= 25\%
 \end{aligned}$$

If a firm sells 1,000 units in a financial period, then the Gross Profit will be:

$$\begin{aligned}
 &= 25\% (\text{shs. } 100,000) \\
 &= \text{shs. } 25,000
 \end{aligned}$$

2) Mark up

$$\text{Gross Profit Margik} = \frac{\text{Gross Profit}}{\text{Cost of Sales (cost price per unit)}} \times 100$$

In the above example, the markup will be: 25×100

$$\begin{aligned}
 &= \frac{25}{75} \times 100 \\
 &= 33.3\%
 \end{aligned}$$

NB: $75 = 100 - 25$

Cost = selling price — gross profit

3) Stock Turnover

Measures the rate at which a firm uses its stocks to make sales or turnover. The formula is:

$$\text{Average stock} = \frac{\text{Cost of Sales}}{\text{Average Stocks}}$$

$$\text{Average stock} = \frac{\text{Opening Stock} + \text{Closing Stock}}{2}$$

Example: A firm has the following data for the period:

	Shs
Opening stock	20,000
Purchases	300,000
Closing stock	30,000

Required: The Stock Turnover Ratio

$$\text{Average Stock} = \frac{30,000 + 20,000}{2}$$

$$= 25,000$$

$$\text{Cost of sales} = (20,000 + 300,000) - 30,000$$

$$= 290,000$$

$$\text{Stock Turnover} = \frac{290,000}{25,000}$$

$$= 11.6 \text{ times}$$

(c) Use of Cashbook and Bank Statement (in addition) Control Accounts.

If there is sufficient information relating to cash payments and receipts, then a simple cashbook for both cash in hand and cash at bank can be prepared in confirmation of deposits and payments made from the bank statement.

The information can then be posted to the relevant accounts e.g. any income received to the relevant income accounts, expenses to relevant expense accounts and assets and liabilities to relevant accounts. Information relating to amounts owed to suppliers/creditors and amounts due from debtors can be posted in summary to the control accounts.

The preparation of the cashbook and control accounts will enable one to estimate any cash sales or credit sales and cash purchases or credit purchases.

Steps in Preparing the Final Accounts

1. Prepare a statement of affairs at the beginning of the period. (a list of all assets and liabilities) to determine the beginning capital.
2. Open and post the balances and transactions to these 3 relevant accounts (i.e. the cashbook (for both cash in hand and bank), sales ledger control account and purchases ledger control account. Any other account can be. Opened where necessary.
3. Make adjustments for any accruals or prepayments.
4. Extract a list of the balances. (Trial balance)
5. Prepare the final accounts.

Illustration

Mr. Vidija is the proprietor of a grocery and general store. He has not previously engaged, an accountant. He informs you that this year the inspector of Taxes refuses to accept the Accountant A has supplied of his trading results for the year ended March 31 2006. That account is as follows:

Details	Sh.	Details	Sh.
Payments for goods	9,495,000	Takings	10,930,000
Payments for expenses	1,130,000		
Profits	305,000		
	<u>10,931,000</u>		<u>10,930,000</u>

He instructs you to examine his records and prepare accounts.

From your examination of the records and from interviews with your clients, you ascertain the following information.

1. The takings are kept in a drawer under the counter; at the end of each day the cash is counted and recorded on a scrap of paper; at irregular intervals Mrs. Vidija transcribes the figures into a notebook; a batch of slips of papers was inadvertently destroyed before the figures had been written into the notebook, but Mr. and Mrs. Vidija carefully estimated their takings for that period, and the estimated figures included in the total of Sh. 10,390,000.
2. The following balances can be accepted:

	March 31	
	2005	2006
Cash in hand	Sh.	Sh.
Balance at bank	45,000	87,000
Good debts	156,000	219,000
Creditors for purchases of stock	458,000	491,000
Stock at cost	279,000	243,000
	<u>1,950,000</u>	<u>1,900,000</u>

3. Debts totaling Sh.356, 000 were abandoned during the year as bad; the takings included Sh.25,000 recovered in respect of old debt abandoned in a previous year.

4. Vidija rents the shop and living accommodation on a weekly tenancy for Sh. 3,000 per week including rates; the rent is included in expenses Sh.1, 130,000. The living accommodation may be regarded as one-third of the whole.
5. The expenses total also includes:
 - i. Sh. 35,000 running expenses of Vidija's private car;
 - ii. Sh. 60,000 for exterior decoration of the whole premises, the landlord having refused to have this done
 - iii. Sh. 160,000 for alterations to the premises to enlarge the storage accommodation.
6. Vidija takes Sh.10,000 per week from the business and hands it over to his wife, who pays all the household and personal expenses except those referred to below.
7. Vidija pays for his own cigarettes and beer from cash taken from the drawer; this is estimated at Sh.1,500 per week.
8. Vidija competed in a football pool for 30 weeks of the year, staking Sh1,000 each week, buying a postal order with cash taken from drawer; his winnings totaled Sh.59,000.
9. During the year Vidija bought a second hand car (not used for business) from a friend; the price agreed was Sh.350,000 but as the friend owed A Sh.67,000 for goods supplied from the business the matter was settled by a cheque for the difference.
10. An assurance policy on Vidija's life matured and realized Sh. 641,000.
11. Vidija cashed a cheque for Sh.100,000 for a friend; the cheque was dishonored and the friend is repaying the Sh.100,000 by installments. He had paid Sh.40,000 by March 31 2006;
12. Other private payments by cheque totaled Sh.96,000 plus a further sum of Sh. 110,000 for income tax.
13. You are to provide Sh.42,000 for accountancy fees.

You are required to prepare:

- a) A statement of financial position of the business as at March 31 2005
- b) A income statement account for the year ended March 31 2006; and
- c) A statement of financial position for the business as at March 31 2006

Solution

(a)

Mr.Vidija	
Statement of financial position as at 31st march 2005	
Current assets	Sh.
Stock	1,950,000
Debtors	458,000
Cash at bank	156,000
Cash in hand	45,000.
	2,609,000
Less: Creditors	(279,000)
Capital account	<u><u>2,330,000</u></u>

(b) Trading and profit and loss account.

Mr.Vidija Income statement for year ended 31" march 2006		
Sales		11,638,000
Opening stock	1,950,000	
Purchases	<u>9,459,000</u>	
	11,409,000	
Less: Closing stock	<u>(1,900 ,000)</u>	
Cost of sales		<u>(9,509,000)</u>
Repairs(3 x 60,000)		2,129,000
Gross profit		
Rent and rates(2/3 x 3,000 x 52weeks)	104,000	
Sundry expenses	719,000	
Cost of enlarging storage accommodation	160,000	
Bad debts(356,000 — 25,000)	40,000	
Accountancy fees	331,000	
Net profit for the year	<u>42,000</u>	<u>(1,396,000)</u>
		<u><u>733,000</u></u>

Note:

The cost of enlarging storage accommodation could be capitalized but it has been written off in the year in which incurred on prudent grounds.

a)

Mr.Vidija Statement of financial position as at 31 March 2006		
Current assets	Sh.	Sh.
Stock		1,900,000
Debtors		491,000
Cash at bank		219,000
Cash in hand		<u>87,000</u>
		2,697,000
Less: Current liabilities		
Trade creditors	243,000	
Accountancy fees	<u>42,000</u>	<u>(285,000)</u>
		<u><u>2,412,000</u></u>
Capital account of A		
Balance as at 1 April 2005		2,330,000
Net profit		733,000
		3,063,000
Less: Drawings		<u>(651,000)</u>
		<u><u>2,412 000</u></u>

Workings**Cash Summary Account**

	Sh.		Sh.
Balances 1/4/05	201,000	Expenses	1,130,000
(cash Sh.45,000+ bank Sh. 156,000)		Purchases	9,495,000
Bad debt recovered	25,000	Cash drawings	520,000
Football pool winnings	59,000	Personal drawings	78,000
Insurance policy	641,000	Football pools	30,000
Repaid by friend	40,000	Car(350,000-67,000)	283,000
Balance cash takings carried to total debtors account	11,182,000	Loan to friend	100,000
		Drawings by cheque	96,000
		Income tax	110,000
		Balance 31/3/06(cash Sh. 87,000 bank Sh.219,000)	306,000
	<u>12,148,000</u>		<u>12,148,000</u>

Total debtors account

	Sh.		
Debtors 1/4/05	458,000	Cash takings	11,182,000
Balance=Sales	11,638,000	Friend car	67,000
		Bad debts w/o	356,000
		Debtors 31/3/06	491,000
	<u>12,096,000</u>		<u>12,096,000</u>

Total Creditors Account

	Sh.		Sh.
Cash	9,495,000	Creditors 1/4/05	279,000
Creditors 31/3/06	243,000	Balances-Purchases	9,459,000
	<u>9,738,000</u>		<u>9,738,002</u>

Sundry Expenses Account

	Sh.		Sh.
Cash	1,130,000	Rent	156,000
		Car expenses	35,000
		Alterations	60,000
		Sundry expenses	719,000
		Balance c/d	160,000
	<u>1,130,000</u>		<u>1,130,000</u>

Drawings Account			
	Sh.		Sh.
Cash	520,000	Football pool winnings	59,000
Cheques	96,000	Life policy money	641,000
Rent(private element)	52,000	Repayment by friend	40,000
Private car expenses	35,000	Balance net drawings	651,000
Decorations(house)(one-third of Sh.60)	20,000		
Purchase of car	350,000		
Cash paid to friend	100,000		
Cigarettes etc.	78,000		
Football pools	30,000		
Income tax	110,000		
	<u>1,391,000</u>		<u>1,391,000</u>

LIMITATIONS OF FINANCIAL STATEMENTS

The income statement and the statement of financial position, if must have been gathered, are full of information about the results of operations and the financial position of the firm concerned.

In fact, it would be unthinkable to appraise the performance and standing of a firm without the aid of these two statements. A firm proclaims its efficiency, profit-ability and standing through them and it is because of this that accounting is said to be the language of business.

However, the message conveyed by the statements is not infallible and often, one should not readily accept the conclusions indicated by the financial statements. This is because by their very nature, the statements suffer from a number of limitations,

These are given below but here we shall discuss only the impact of accounting policies.

The limitations briefly are the following:-

- i. In spite of the great emphasis nowadays on accounting standards, the latest effort in respect of which is being made by the IAS and the institute of certified public accountants of Kenya (ICPAK), the management has a choice out of a number of accounting policies chiefly in regard to valuation of inventory, depreciation, provision of gratuity, treatment of research and development expenditure etc.
- ii. There are numerous parties which are interested in the financial statements. The proprietors or shareholders, the workers, the investors, the creditors etc. are some of the obvious parties which are interested in the firm and, therefore, in the financial statements concerned. Financial analysts and academicians are also interested. Unfortunately, the information which concerns these parties differs and it is difficult to draw up one set of financial statements that will be equally useful to all the parties.

As matters stand, the statements concerning companies have to be drawn up in India in accordance with Schedule VI of the Companies Act which is mostly from the point of view of the shareholders. The statements as drawn up today merely perform the custodial function,

showing statements as drawn up today merely perform the custodial function, showing whether or not the funds entrusted to the Management have been faithfully managed. The statements are quite defective from the point of view of decision making. Whether a shareholder will be wise to dispose off his holdings or to increase them will be difficult to decide on the basis of the information contained in the financial statements.

- iii. One of the important limitations from which financial statements suffer is the fact that quantitative factors, translated in terms of money, are the only factors which can be revealed in the statements.

The quantitative content of financial statements in Kenya has increased beyond recognition, for example, quantities also must be given for sales, purchases, and stocks.

Even so, such information cannot throw adequate light on the qualitative factors, namely, the attitudes of workers and consumers towards the company, research and development effort, the quality and caliber of management etc. these are vital for the continued success of the company.

- iv. Great deal of effort these days is being directed towards evaluation of human resources at the disposal of undertakings. However, these efforts have not yet been crowned with success and it is a long way before a meaningful figure about this most important asset can be entered in the financial statements.

Short of this, however, the directors' report can certainly describe fully, unless it is harmful to disclose information to competitors, the problems faced by the company, the plans of the company and the manner in which company is preparing to meet the future.

- v. Last, but not the least, financial statements have now begun to suffer from a very serious limitation which arises from the great fall in the value of money, in other words, inflation. Even if a company is five years old, the values of the assets stated in the balance sheet will be completely out of tune with the prevailing values. This means that profitability worked out on the basis of the balance sheet figures will be misleading.

Further, it is to be recognized that good deal of profit reported in the profit and loss account of a company today is due to inflation and, therefore, illusory. This is proved by the fact that a large number of mills in India today are sick because, even though they reported good profits in the past, they could not build up enough funds to replace their plant and machinery when it was worn out.

REVISION EXERCISE

QUESTION 1

The following balances were extracted from the books of Patel and Sons in respect of the year ended 31 December 2005:

	Sh.	Sh.
Sales		1,352,000
Purchases	990,000	
Debtors	177,800	
Creditors		83,400
Stock in trade (I January 2005)	80,000	
Machinery (cost)	112,500	
Furniture	17,000	
Rent for building	19,200	
Cash in hand	8,500	
Cash at bank	34,738	
Drawings	24,000	
Capital		180,000
Salaries	37,820	
Bad debts	2,400	
Suspense account	6,000	
Provision for bad debts		6,400
Printing expenses	4,600	
Postage	3,000	
Travelling expenses	15,800	
Telephone expenses	3,200	
Miscellaneous expenses	83,612	
Insurance premiums	2,080	
	<u>1,621,800</u>	<u>1,621,800</u>

Additional information:

1. Old furniture which stood in the books (as at I January 2005) at Sh.2,400,000 was disposed of at Sh.1,160,000 during the year in part exchange for new furniture costing Sh.2,080,000. A net invoice of Sh.920,000 in respect of this transaction was erroneously passed through the Purchases Day Book.
2. The suspense account represented money advanced to a sales team detailed to undertake a sales campaign in the Rift Valley Province. On returning, the sales team disclosed that Sh.2,400,000 was used for travelling, Sh.1,000,000 for legal fees and Sh.1,800,000 for miscellaneous expenses. The balance was yet to be refunded by 31 December 2005.
3. The business is conducted in a rented building and 50% of the building is used for accommodation of the business owner's family.

4. Depreciation is to be provided on the straight line basis at 10%) per annum on machinery and 5% per annum on furniture. Depreciation is to be applied for the whole year regardless of date of purchase of the asset.
5. Total bad debts for the year amounted to Sh.4,000,000. Provision for doubtful debts is to be maintained at 5% of the outstanding debtors
6. Closing stock amounted to Sh100,000,000
7. Insurance premiums cover the one year period ended 31 January 2006.

Required:

- a) Trading and profit and loss account for the year ended 31 December 2005.
- b) Balance sheet as at 31 December 2005

Solution:**Patel and Sons****Trading and Profit and Loss Account for the Year Ended 31 December 2005**

	Shs '000'	Shs '000'	Shs '000'
Sales			1,352,000
Cost of sales			
Opening stock	80,000.00		
Purchases (w1)	<u>989,080.00</u>	1,069,080.00	
Closing stock		<u>(100,000.00)</u>	<u>(969,080.00)</u>
Gross profit			382,920.00
Expenses			
Rent (w2)		9,600.00	
Salaries		37,820.00	
Bad debts		4,000.00	
Increase in provision for bad debts (w3)		2,410.00	
Printing expenses		4,600.00	
Postage		3,000.00	
Travelling expenses (w4)		18,200.00	
Telephone expenses (w5)		3,200.00	
Miscellaneous		85,412.00	
Insurance Premium (w6)		1,906.67	
Legal fees		1,000.00	
Depreciation (w7) - Furniture		834.00	
- Machinery		11,200.00	
Loss on disposal — Furniture (w8)		<u>1,240.00</u>	<u>(184,422.67)</u>
Net profit			<u>198,497.33</u>

Patel and Sons
Balance sheet as at 31Dember 2005

Non-Current Assets	Cost	Accum. Depre	Net Book Value
	Sh.'000'	Sh. '000'	Sh. '000'
Machinery	112,00.00	11,200.00	100,800.00
Furniture (w9)	<u>16,680.00</u>	<u>834.00</u>	<u>15,846.00</u>
	<u>128,680.00</u>	<u>12,034.00</u>	<u>116,646.00</u>
Current Assets			
Stock		100,000.00	
Debtors(w10)		167,390.00	
Bank		34,780.00	
Cash		8,500	
prepayment		<u>173.33</u>	<u>310,851.33</u>
			<u>427,497.33</u>
Capital and liabilities:			
Liabilities			
Creditors		83,400.00	
Sundry creditors		<u>(800.00)</u>	82,600.00
Capital			180,000.00
Net profit			198,497.33
Drawings			<u>(33,600.00)</u>
			<u>427,497.33</u>

Workings:**1. Purchases**

Shs'000'	Shs'000'
Balance b/d	Furniture
990,000.00	920.00
	Balance c/d
<u>990,000.00</u>	<u>989,080.00</u>
	<u>990,000.00</u>

2. Rent

Shs'000'	Shs'000'
Balance c/d	Drawings
19,200.00	9,600.00
	Balance c/d
<u>19,200.00</u>	<u>9,600.00</u>
	<u>19,200.00</u>

3. Provision for bad debts a/c

Shs'000'	Shs'000'
Balance c/d	Balance b/d
8,810.00	6,400.00
	P & L
<u>8,810.00</u>	<u>2,410.00</u>
	<u>8,810.00</u>

4. Travelling a/c

	Shs'000'		Shs'000'
Balance b/d	15,800.00	P & L	18,200.00
Suspense	<u>2,400.00</u>		
	<u>18,200.00</u>		<u>18,200.00</u>

5. Miscellaneous a/c

	Shs'000'		Shs'000'
Balance b/d	83,612.00	P & L	85,412.00
Suspense	<u>1,800.00</u>		
	<u>85,412.00</u>		<u>85,412.00</u>

6. Insurance premium a/c

	Shs'000'		Shs'000'
Balance b/d	2,080.00	Bank	173.33
		Balance c/d	<u>1,906.67</u>
	<u>2,080.00</u>		<u>2,080.00</u>

7. Depreciation

Machinery: $10\% \times \text{Shs } 112,000,000 = \text{Shs } 11,200,000$

Furniture: $5\% \times 16,680,000 = \text{Shs } 834,000$

8. Disposal a/c (furniture)

	Shs'000'		Shs'000'
Furniture	2,400.00	Furniture	1,160.00
		Loss on depreciation	<u>1,240.00</u>
	<u>2,400.00</u>		<u>2,400.00</u>

9. Furniture a/c

	Shs'000'		Shs'000'
Balance b/d	17,000.00	Disposal	2,400.00
T-in-A	1,160.00		
Purchases	<u>920.00</u>	Balance c/d	<u>16,680.00</u>
	<u>19,080.00</u>		<u>19,080.00</u>

10. Debtors a/c

	Shs'000'		Shs'000'
Balance b/d	177,800	Disposal	1,600
		Prov. For bad debts	8,810
		Balance c/d	<u>167,390</u>
	<u>177,800</u>		<u>177,800</u>

11. Suspense a/c

	Shs'000'		Shs'000'
Balance b/d	6,000	Travelling	2,400
		Legal fees	1,000
		Miscellaneous	1,800
	<u>6,000</u>	Sundry creditors	<u>800</u>
			<u>6,000</u>

QUESTION 2

The following trial balance was extracted from the books of Hari Singh as at 31 December 2004:

	Sh.	Sh.
Drawings	1,600,000	
Cash	676,000	
Petty cash	100,000	
Fixtures and fittings (cost)	2,000,000	
Stock (1 January 2004)	5,000,000	
Salaries and wages	5,200,000	
Debtors and creditors	5,000,000	3,500,000
Bank balance	2,100,000	
Rent	900,000	
Electricity	600,000	
Motor vehicle (written down value)	1,024,000	
Advertising	900,000	
Capital		3,400,000
Purchases	40,000,000	
Sales		60,000,000
Postage and telephone	300,000	
Discounts allowed	1,140,000	
General expenses	400,000	
Petty cash expenses	960,000	
Suspense account		1,000,000
	<u>67,900,000</u>	<u>67,900,000</u>

Additional information:

1. Closing stock as at 31 December 2004 was valued at Sh.7,500,000
2. Petty cash balance represents the month end imprest amount. As at 31 December 2004, the petty cashier had vouchers amounting to Sh.40,000 which had not been reimbursed by the main cashier.
3. Discounts allowed amounting to Sh.100,000 had been posted to the debit of the debtors account.
4. Sales had been undercast by Sh.400,000.
5. The motor vehicle, which had been purchased on 1 January 2002, was being depreciated at 20% per annum on the reducing balance basis. The original cost of the motor vehicle was

Sh.2,000,000. It has been decided that the motor vehicle be depreciated at 6% per annum on the straight line basis and to make the change effective from the date of purchase.

6. Cash withdrawn from the bank for business use amounting to Sh400,000 had not been entered in the bank column of the cash book. No entry has been made for stock valued at Sh1,000,000 taken by the proprietor for personal use.
7. Telephone bills amounting to Sh.100,000 were unpaid as at 31 December 2004.
8. Advertising expenses include the cost of a sales campaign conducted during the year of Sh.600,000. It is expected that the benefits of this campaign will be enjoyed over the next three years.
9. Fixtures and fittings are to be depreciated at 20% per annum on cost.

Required:

- a) Trading, profit and loss account for the year ended 31 December 2004.
- b) Balance sheet as at 31 December 2004.

Solution:

Hari Singh
Trading profit and loss account
For the year ended 31 December 2004

	Shs '000'	Shs '000'	Shs '000'
Sales (W1)			60,400
Cost of sales			
Opening stock	5,000		
Purchases	<u>40,000</u>	45,000	
Closing stock		<u>(7,500)</u>	<u>(37,500)</u>
Gross profit			22,900
Depreciation (W2)			616
			23,516
Expenses			
Telephone and postages (W3)		400	
Advertising		300	
Depreciation		400	
Salaries and wages		5,200	
Rent		900	
Discount allowed		1,140	
General expenses		400	
Petty cash expenses		<u>960</u>	<u>(9,700)</u>
			<u>13,816</u>

Hari Singh
Balance sheet as at 31 December 2004

Non-current Assets	Cost	Accum. Depre	Net Book Value
	Sh. '000'	Sh. '000'	Sh. '000'
Fixtures and fittings	2,000	400	1,600
Motor vehicle	<u>2,000</u>	<u>360</u>	<u>1,640</u>
	<u>4,000</u>	<u>760</u>	<u>3,240</u>
Current Assets			
Stock		7,500	
Debtors (w5)		4,900	
Bank		1,700	
Cash		676	
Prepayments (w4)		<u>600</u>	<u>15,476</u>
Total assets			<u>18,716</u>
Capital and Current Liabilities			
Current Liabilities			
Creditors		3,500	
Accruals		<u>600</u>	<u>4,100</u>
Capital			3,400
Drawings			(2,600)
Net profit			<u>13,816</u>
			<u>18,716</u>

Workings:**1. Sales**

	Shs.'000'
Sales	60,000
sales undercast	<u>400</u>
Total assets	<u>600,400</u>

2. Adjusted Depreciation

Provision for Depreciation

Reducing balance basis: Accumulated depreciation for 3 years

Cost - N. B. V

Sh 2,000,000 - shs 1,024,000=Sh 976,000

Straight line method:

 $6\% \times 2,000,000 \times 3 = \text{Sh } 360,000$

Overcharged depreciation: Accumulated depreciation for 3 years

Sh 976,000 - Sh 360,000 -Sh 616,000

3. Telephone and postage a/c

	Shs'000'		Shs'000'
Bank	300	P & L	400
Balance b/d	<u>100</u>		
	<u>400</u>		<u>400</u>

4. Advertising a/c

	Shs'000'		Shs'000'
Bank	900	P & L	300
		Balance b/d	<u>600</u>
	<u>900</u>		<u>900</u>

5. Debtors a/c

	Shs'000'		Shs'000'
Balance b/d	5,000	Discount allowed	100
		Balance c/d	<u>4,900</u>
	<u>5,000</u>		<u>5,000</u>

TOPIC 6

FINANCIAL STATEMENTS OF A PARTNERSHIP

INTRODUCTION

There are a number of ways in which a partnership may be defined, but there are four key elements.

Two or more individuals

A partnership includes at least two individuals (partners). In certain jurisdictions, there may be an upper limit to the number of partners.

Business arrangement

A partnership exists to carry on a business.

Profit motive

As it is a business, the partners seek to generate a profit.

Unincorporated business entity

A partnership is an unincorporated business entity. That means:

- The reporting entity (business entity) principle applies to a partnership, so for accounting purposes, the partnership is a separate entity from the partners
- The partners have unlimited liability, and
- If the partnership is unable to pay its liabilities, the partners may be called upon to use their personal assets to clear unpaid liabilities of the partnership.

Therefore A partnership is an unincorporated association of two or more individuals .,to carry on a business for profit.

A partnership, by the Kenya Partnership Act of 1962 Chapter, is defined as the relationship which exists between persons carrying on a business in common with a view of profit.

According to the definition there are the following essential elements:

- a) There must be a business which would include trade, occupation or profession.
- b) The business must be carried on for the purpose of making a profit
- c) The business must be carried on by all or any one of them acting on behalf of all partners.
- d) There must be an association of two or more persons
- e) Common property or part ownership does not create a partnership. Sharing returns, loans offered, or debts do not create a partnership.

Types of partnerships

There are two main types of partnerships: General partnership and Limited Partnership.

General partnerships are governed by the Partnership Act of 1962 Cap 29. These are partnerships which consist of persons whose liability for the debts and obligations are unlimited, because they take part in management of the partnership business.

Limited partnerships are governed by the Limited Partnership Act of 1962 (Cap 30). They consist of one or more general partners whose liability is unlimited and one or more limited partners whose liability is limited to the amount of capital contributed by them to the firm.

He has no right to share in management of the firm and if he does so, his liability becomes unlimited for the firm's debts.

The purpose of a limited partnership is to give limited liability to some partners who did not wish to take an active part in the business.

However, the objective can be satisfied by forming a private company under the Companies Act. Very few limited partnerships exist.

PARTNERSHIP AGREEMENT

A partnership can be formed without any legal formalities by any two or more people. The maximum number of people who can form such a partnership under our laws is 20.

When two or more people decide to form a partnership, such an agreement, whether written or verbal or even inferred from the conduct of the parties, constitutes a contract and a partnership is automatically created.

However, it is generally strongly recommended that a partnership contract or agreement should be written in order to lessen the chances of misunderstanding and future disagreement because it can be easily referred to.

It is good practice to set out the terms agreed by the partners in a partnership agreement. While this is not mandatory, it can reduce the possibility of expensive and acrimonious disputes in the future. As a formal agreement is not mandatory, there is no definitive list of what it should contain. The agreement should identify the partners; their respective business-related duties and responsibilities; how income will be shared; the criteria for additional investments and withdrawals; and the guidelines for adding partners, the withdrawal of a partner, and liquidation of the partnership. For income tax purposes, the partnership files an information return only. Each partner shares in the net income or loss of the partnership and includes this amount on his/her own tax return.

When a partnership agreement is in written form it should cover the following areas:

- a. The names of the firm and the location of the business.
- b. The nature of the business to be carried on by the firm.
- c. The amount of capital to be contributed and left in the business by each partner.
- d. The ratio in which profits are to be shared — one partner may be entitled to a greater share of the profits because he has more expenses or is doing a greater share of the work.
- e. The rate of interest to be allowed on investment capital and the rate of interest to be charged on drawings. Interest on capital may be appropriate where one or more partners are contributing a materially greater sum than others. Interest on drawings is used to discourage withdrawal.
- f. Salaries to be allowed to partners and other benefits such as commissions or bonuses. Some partners may be entitled to a salary because of the work they are performing.
- g. Any variations in the usual rights of a partner
- h. The method to be followed on admission or retirement of a partner
- i. Method to be followed in the event of dispute among partners
- j. Duration of partnership
- k. Manner in which accounts are to be prepared and inspected.

Rights of Partners

- a) Every partner has a right to take part in the conduct and management of business.
- b) Every partner has a right to be consulted and heard in all matters affecting the business of the partnership.
- c) Every partner has a right of free access to all records, books and accounts of the business, and also to examine and copy them.
- d) Every partner is entitled to share in the profits equally.
- e) A partner who has contributed more than the agreed share of capital is entitled to interest at the rate of six percent per annum. But no interest can be claimed on capital.
- f) A partner is entitled to be indemnified by the firm for all acts done by him in the course of the partnership business, for all payments made by him in respect of partnership debts or liabilities and for expenses and disbursements made in an emergency for protecting the firm from loss provided he acted as a person of ordinary prudence would have acted in similar circumstances for his own personal business.
- g) Every partner is, as a rule, joint owner of the partnership property. He is entitled to have the partnership property used exclusively for the purposes of the partnership.
- h) A partner has power to act in an emergency for protecting the firm from loss, but he must act reasonably.
- i) Every partner is entitled to prevent the introduction of a new partner into the firm without his consent
- j) Every partner has a right to retire according to the Deed or with the consent of the other partners. If the partnership is at will, he can retire by giving notice to other partners.

- k) Every partner has a right to continue in the partnership.
- l) A retiring partner or the heirs of a deceased partner are entitled to share in the profits earned with the aid of the proportion of assets belonging to such outgoing partner or interest at six per cent per annum at the option of the outgoing partner (or his representative) until the accounts are finally settled.

Duties of partners

- a) Every partner is bound to diligently carry on the business of the firm to the greatest common advantage. Unless the agreement provides, there is no salary.
- b) Every partner must be just and faithful to the other partners.
- c) A partner is bound to keep and render true, proper, and correct accounts for the partnership and must permit other partners to inspect and copy such accounts.
- d) Every partner is bound to indemnify the firm for any loss caused by his willful neglect or fraud in the conduct of the business.
- e) A partner must not carry on a competing business, nor use the property of the firm for his private purposes. In both cases he must hand over to the firm any profit or gains made by him but he must himself suffer any loss that might have occurred.
- f) Every partner is bound to share the losses equally with the others.
- g) A partner is bound to act within the scope of his authority.
- h) No partner can assign or transfer his partnership interest to any other person so as to make him a partner in the business.

Powers of Partners

The above relates to relations among the partners themselves. When it comes to dealings with outsiders or third parties, the partners are supposed to have the power to act in certain matters and not to have such power in others.

In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners, will be binding on the firm.

In the case of a trading firm, the implied powers of the partners are as follows:

- a) Buying and Selling goods
- b) Receiving payments on behalf of the firm and giving valid receipts
- c) Drawing cheques and drawing, accepting and endorsing bills of exchange and promissory notes in the name of the firm
- d) Borrowing moneys on behalf of the firm with or without pledging the stock in trade
- e) Engaging servants for the business of the firm.

In the following cases, a partner has no powers. This is to say, the third parties cannot bind the firm unless the partners have agreed to be so bound.

- a) Submitting a dispute relating to the firm to arbitration
- b) Opening a bank account on behalf of the firm in the name of a partner
- c) Compromise or relinquishment of any claim or portion of claim by the firm.
- d) Withdrawal of a suit or proceedings filed on behalf of the firm.
- e) Admission of any liability in a suit or proceedings against the firm
- f) Acquisition of immovable property belonging to the firm
- g) Transfer of immovable property belonging to the firm.
- h) Entering into partnership on behalf of the firm

The rights, duties and powers of partners can be changed by mutual consent.

Types of Partners

Besides the usual partners who contribute to the capital of the firm and take part in its business, the following special types of partners may be noted.

Sleeping or Dormant partner is one who is in reality a partner, but whose name does not appear in any way as partner, and who is not known to outsiders as partner.

He is liable to those third parties who subsequently discover that he was or is a partner. He has no duties to perform but he has the right of access to the books of account and of examining and copying them.

Nominal partner is a person whose name is used as if he was a member of the firm, but who, in reality, is not a partner. He is liable to those third parties who give credit to the firm on the strength of his being a partner.

Partner in profit only is one who gets a share of the profits and does not share losses. He is liable to outsiders. He does not take part in the management of the business.

Partner by estoppel or holding out is one, who without really being a partner, so conducts himself as to lead others to believe him to be a partner. Similarly, if one is declared to be a partner and does not disclaim the partnership, one will be treated as partner by holding out. Such persons are liable to those third parties who extend credit to the firm on the belief that such persons are partners.

Sub-partner gets a share of profits of the firm from one of the partners. A sub-partner has no rights against the firm and he is not liable for its debts.

An **incoming partner** is one who is newly admitted to the firm. He is not liable for the debts and obligations of the firm incurred before his joining the firm unless he so agrees.

A **retiring or outgoing partner** continues to be liable for obligations incurred before his retirement, and will continue to be liable even for future obligations, if he does not give public notice of his retirement.

Minor partner; A minor can be admitted to the benefits of an existing partnership with the consent of all the partners. The minor is not personally liable for the debts of the firm but his share in the partnership property and profits of the firm will be liable for the firm's debt and obligations. He can bring a suit for accounts and for his distributive share when he wants to sever his connections with the firm, but not otherwise.

But he was the right of access to the accounts of the firm including the right to examine and copy. Within six months of his attaining majority or when he comes to know that he enjoys the benefits of partnership (whichever date is later), he has to elect whether or not he wants to continue as partner. He must give public notice of his decision not to continue as partner, otherwise he will be deemed to have elected to be a full-fledged partner. On his election as a partner he will become liable for the debts of the firm since he was admitted to the benefits of the firm.

If he repudiates his partnership, all his liabilities will cease from the date of the public notice to this effect.

In the absence of any agreement to the contrary:-

1. No partner has the right to a salary
2. No interest is to be allowed on capital; if allowed, it is an appropriation of profit and a charge against it.
If the profit is less than the interest to be allowed on capitals, the interest will be limited to the profit. In case of losses, no interest will be allowed.
3. No interest is to be charged on drawings
4. Interest at the rate of six per cent is to be allowed on a partner's loan to the firm
5. Profits and losses are to be shared equally.

PARTNERSHIP ACCOUNTING

Except for the number of partners' equity accounts, accounting for a partnership is the same as accounting for a sole proprietor. Each partner has a separate capital account for investments and his/her share of net income or loss, and a separate withdrawal account. A withdrawal account is used to track the amount taken from the business for personal use. The net income or loss is added to the capital accounts in the closing process. The withdrawal account is also closed to the capital account in the closing process.

Share of residual profit

This is the amount of profit available to be shared between the partners in the profit and loss sharing ratio; after all other appropriations have been made.

Interest on drawings

Charging interest on drawings is a means of discouraging partners from withdrawing excessive amounts from the business. From this, it follows that interest on drawings is a debit entry in the partners' current accounts and a credit entry in the Appropriation Account.

In an exam situation depending on what the question is testing, it will either provide the amounts of interest on capital and drawings or give details of how to calculate the amounts.

Remember to deal with each of these appropriations before sharing the residual profit between the partners.

A final point in this context is that, if the total of the appropriations is greater than the profit for the year, the amount to be shared between the partners will be a loss. This will mean that the entries for the share of the residual profit will be a credit in the

Appropriation Account (thus resulting in a nil balance) and debits in the partners' current accounts.

Therefore, it should be noted that there is a distinction to • (income minus expenses), which is calculated in exactly the profit (the remaining profit after profit for the year has accordance with the partnership agreement). be made between the profit for the year same way as for a sole trader and residual been adjusted by the appropriations in

Appropriations of profit

Another point to remember is that the Appropriation Account is an additional accounting statement that is required for a partnership. For a sole trader, the profit for the year is simply transferred to the credit side of the proprietor's capital account (the double entry i. completed by a debit entry in the income statement, resulting in a nil balance on that statement). In the case of a partnership, the income statement will still be debited, but the profit will be credited to the appropriation account, rather than the capital account. As each appropriation is dealt with, the double entry is completed through entries in both the appropriation account and the partner's current account (if current accounts are not maintained by the partnership, the entries will be made in the capital accounts).

Partners' salaries

To some extent the term 'salaries' is a misleading description. The salaries of employees are business expenses that are written off to the income statement, thereby reducing profit for the year. However, as partners are the owners of the business, any amounts that are paid to them under the partnership agreement are part of their share of the profit. As the amount is guaranteed, it must be dealt with through a credit entry in the partner's account (usually the current account) before the residual profit is shared.

The double entry is completed by a debit entry in the Appropriation Account.

Interest on capital

Almost always, interest on capital will be paid on partners' capital balances only — although the balances on the current accounts are actually part of the total capital balance, it is normal to exclude them from the value of capital on which interest is paid.

Paying interest on capital is a means of rewarding partners for investing funds in the partnership as opposed to alternative investments. As such, it reduces the amount of profit available for sharing in the profit and loss sharing ratio. This means that a debit entry is needed in the Appropriation Account. The double entry is completed by a credit entry in the current account of the partner to whom the salary is paid.

Interest on drawings

Charging interest on drawings is a means of discouraging partners from withdrawing excessive amounts from the business. From this, it follows that interest on drawings is a debit entry in the partners' current accounts and a credit entry in the Appropriation Account.

In an exam situation depending on what the question is testing, it will either provide the amounts of interest on capital and drawings or give details of how to calculate the amounts.

Remember to deal with each of these appropriations *before* sharing the residual profit between the partners.

A final point in this context is that, if the total of the appropriations is greater than the profit for the year, the amount to be shared between the partners will be a loss. This will mean that the entries for the share of the residual profit will be a credit in the

Appropriation Account (thus resulting in a nil balance) and debits in the partners' current accounts.

DISTINCTION BETWEEN CURRENT AND FIXED CAPITAL

In one sense, there is no difference. A partner's total capital is the sum of the balances on their capital account and their current account.

In practice, however, it is convenient to separate the amount invested by the partner (the capital account) from the amount they have earned through the trading activities of the partnership (the current account). Therefore, the capital account is usually fixed, while the current account is the current total of appropriations and the share of residual profit/loss, less drawing.

Remember that a partner's drawings will be a debit entry in the partner's current account.

During the course of the year, a partner withdraws money for his private use; at the end of the year, he is credited with interest on his capital, salary due to him and his share of profits and debited with interest on drawings (all depending upon the Partnership Deed).

If entries for all these transactions are passed through his capital account, the amount of his capital at the end of the year will be different from what it was in the beginning. If, therefore, such entries are passed through the capital account, the capital will be fluctuating.

In some firms, a separate account is opened to record all such entries as drawings, interest on drawings and capital, salary, share of profit, etc.

The name given to such an account is Partners' Current Account or Drawings Account. If this is the arrangement, the capital is fixed. Balances of both the Capital Account and the Current Account are shown in statement of financial position. Strictly speaking, the amount of capital mentioned in the Partnership Deed should remain fixed.

A capital account records the partner's equity investment at any point in time. It is credited initially with the fair market value of the assets contributed by the partner at the time of formation of the partnership; subsequent changes reflect the partner's share of net income earned, additional assets invested, and assets withdrawn.

FORMAT'S

CURRENT ACCOUNT

	Shs	Shs	Shs		Shs	Shs	Shs
Balance b/d	XX	XX	XX	Balance b/d	XX	XX	XX
Interest on drawings	XX	XX	XX	Interest on capital	XX	XX	XX
Drawings	XX	XX	XX	Salaries	XX	XX	XX
Balance c/d	XX	XX	XX	Share of profits	XX	XX	XX
				Loan interest	XX	XX	XX
	-	-	-	Balance c/d	XX	XX	XX
	<u>XX</u>	<u>XX</u>	<u>XX</u>		<u>XX</u>	<u>XX</u>	<u>XX</u>
				Balance b/d	XX	XX	XX

FIXED CAPITAL ACCOUNT

	Shs A	Shs B	Shs C		Shs A	Shs B	Shs C
Loss or revaluation	XX	XX	XX	Balance b/d	XX	XX	XX
Goodwill written off	XX	XX	XX	Gains on revaluation	XX	XX	XX
				Additional capital (c/book or asset)	XX	XX	XX
				Goodwill	XX	XX	XX
	-	-	-	Balance c/d	XX	XX	XX
	<u>XX</u>	<u>XX</u>	<u>XX</u>		<u>XX</u>	<u>XX</u>	<u>XX</u>
				Balance b/d	XX	XX	XX

How does goodwill arise, and how is it treated?

Goodwill is defined as the amount by which the fair value of the net assets of the business exceeds the book value of the net assets. It arises due to factors such as the reputation, location, customer base, and expertise or market position of the business. (In simple terms, 'fair value' can be thought of as being the same as 'market value'.)

The first step is to create the asset of goodwill. This is a debit entry for the value of the goodwill in the goodwill account. The double entry is completed with credit entries in the old partners' capital accounts. The value of each entry is calculated by sharing the value of the goodwill between the partners in the old profit and loss sharing ratio.

If goodwill is to be retained in the partnership (sometimes referred to as 'carried in the books') no further entries are required.

If goodwill is not to be carried in the books, it is eliminated by a credit entry in the goodwill account.

The double entry is completed with debit entries in the partners' capital accounts. The value of each entry is calculated by sharing the value of the goodwill between the new partners in the new profit and loss sharing ratio.

If a partner is contributing (or withdrawing) capital, the relevant amount will be recorded in both the partner's capital account and the bank account. A contribution will be a credit entry in the capital account and a debit entry in the bank account, and a withdrawal will be a debit entry in the capital account and a credit entry in the bank account.

How loans from partners treated

A loan is not part of the partner's capital, and the loan is treated in the same way as a loan from a third party. The liability of the partnership will be recorded by the creation of a liability, resulting in a credit balance for the amount of the loan. The debit entry will depend on how the loan was made. If the partner deposited cash in the bank account, the debit entry will be in the bank account. If the loan was created by converting a proportion of the partner's capital into a loan, the debit entry will be in the capital account.

The interest on the loan will be a business expense and should therefore be debited to the income statement.

INCOME STATEMENT

Partnership accounts do not present much difficulty unless there is an admission, retirement, death or dissolution.

The income statement is prepared in the usual way as discussed in the chapter for financial statements of a sole trader.

A new section called the Appropriation account is included and this account shows how the partners share the Net Profit for the period. (In addition to other expenses in the profit and loss, an expense for interest on loan given by one of the partners is included and the credit entry is made on the partner's current account.)

The format for the Appropriation account is as follows:

	Shs	Shs
Net Profit for the year		XXX
Add: Interest on drawings		
A	XXX	
B	XXX	
C	<u>XXX</u>	<u>XXX</u>
Less: Interest on capital.		XXX
A	XXX	
B	XXX	
C	<u>XXX</u>	<u>XXX</u>
Less: Salaries		XXX
A	XXX	
B	XXX	
C	<u>XXX</u>	<u>XXX</u>
Balance of profit to be shared in percentage ratio		XXX
A (ratio)	XXX	
B (ratio)	XXX	
C (ratio)	<u>XXX</u>	<u>XXX</u>
		<u>Nil</u>

Illustration

Presidential Cleaning had the following profit sharing clauses in their partnership agreement.

- 5% interest on capital based on average balance . a. Clinton Shs.40,000 (opening balance)
 - Bush Shs.60,000 (opening balance)
 - Obama Shs.20,000 (opening balance)
- 5% interest on current based on opening balance (except if they are overdrawn)
 - Clinton Shs.10,000 (opening balance)
 - Bush - Shs.15,000 (opening balance)
 - Obama Shs.5,000 (opening balance)
- Interest on the advance from Clinton is paid. at 5% (treated as an expense)
 - Clinton loaned the partnership Shs.30,000 at the start of the year
- 10% interest on the average level of drawings during the year (drawings made evenly throughout the year)
 - Shs.20,000 Clinton
 - Shs.30,000 Bush
 - Shs.20,000 Obama

5. Residual profits or losses are share in the same ratio as the partners' capital contributions. Salaries for partners

- a. Shs.50,000 Clinton
- b. Shs. 60,000 Bush
- c. Shs.45,000 Obama

6. The partnership made a profit of Shs.250,000 during the year. Bush contributed a Shs.10,000 van half way through the year.

Required;

An appropriation statement

Solution

Appropriation Statement Presidential Cleaning For year ending 31st March 2014

	Shs.	Shs.
Profit		250,000
Less; interest on loan to Clinton		<u>(1,500)</u>
		248,500
Add; Interest on drawings		
Clinton	1,000	
Bush	1,500	
Obama	<u>1,000</u>	<u>3,500</u>
		252,000
Less ; Interest on capital		
Clinton	2,000	
Bush	3,250	
Obama	<u>1,000</u>	<u>(6,250)</u>
		245,750
Less ; Interest on current		
Clinton	500	
Obama	<u>250</u>	<u>(750)</u>
		245,000
Less ; salaries		
Clinton	50,000	
Bush	60,000	
Obama	<u>45,000</u>	<u>(155,000)</u>
		90,000
Less ; Share of residue		
Clinton		30,000
Bush		45,000
Obama		<u>15,000</u>
		<u>90,000</u>

Loan made by partner Debit Bank account if funds were deposited in the partnership bank account or

Credit Loan account Capital account if capital was converted into a loan

Profit for year	Debit Credit	Income statement Appropriation account
Partners' salaries	Debit Credit	Appropriation account Partners' Current Accounts
Interest on capital	Debit Credit	Appropriation account Partners' current accounts
Interest on drawings	Debit Credit	Partners' current accounts Appropriation account
Residual profit	Debit Credit if profit is greater than total of appropriations:	Appropriation account Partners' current accounts
	Debit Credit if profit is greater than total of appropriations:	Partners' current accounts Appropriation account
Interest on loan from partner	Debit Credit	Income statement Bank account if the interest has been paid to the partner or Accrued expenses if the interest remains unpaid
Loan made by partner	Debit Credit	Bank account if funds were deposited in the partnership bank account or Capital account if capital was converted into a loan Loan account

Illustration

X and Y own a grocery shop. Their first financial year ended on 31 December 2002.

The following balances were taken from the books on that date:

Capital	X- Sh.60, 000	Y— Sh.48, 000
Partnership salaries	X.— Sh.9, 000	Y — Sh. 6,000.
Drawings	X — Sh. 12,000	Y— Sh. 13,400

The firm's net profit for the year was Sh. 32,840.

Interest on capital is to be allowed at 10% per year.

Profits and losses are to be shared equally.

Required;

From the information above prepare the firm's appropriation account and the partners' current accounts.

Solution

X and Y Profit and Loss Appropriation account for the year ended 31 Dec 2002

	Shs.	Shs.
Net for profit for the year		32,840
Less ; Interest on capital		
X	6,000	
Y	<u>4,800</u>	<u>(10,800)</u>
		22,040
Less ; salaries		
X	9,000	
Y	<u>6,000</u>	<u>(15,000)</u>
Balance of profit to be shared in profit ratio		
X $\frac{1}{2}$	3,520	
Y $\frac{1}{2}$	<u>3,520</u>	<u>(7,040)</u>
		<u>Nil</u>

Current Accounts

	X Sh.	Y Sh.		X Sh.	Y Sh.
Drawings	12,860	13,400	Interest on capital	6,000	4,800
			Salaries	9,000	6,000
Bal c/d	<u>5,660</u>	<u>920</u>	Profit shared	<u>3,520</u>	<u>3,520</u>
	<u>18,520</u>	<u>14,320</u>		<u>18,520</u>	<u>14,320</u>
			Bal c/d	5,660	920

Illustration

Draw up a profit and loss appropriation account and current accounts for the year ended 31 December 2012

- Net profits Sh.30, 350
- Interest to be charged on capitals: Wachira Sh.2, 000; P Sh.1, 500; Hamisi Sh. 900
- Interest to be charged on drawings; Wachira Sh.240; P Sh.180; Hamisi Sh.130
- Salaries to be credited: Phylis Sh.2,000; Hamisi Sh.3,500.

- v. Profits to be shared: Wachira 50%; Phylis 30%; Hamisi 20%.
- vi. Current accounts: balances b/f Wachira Sh.1,860; Phylis Sh.946; Hamisi Sh.717
- vii. Capital accounts: balances b/f Wachira Sh.40,000; Phylis Sh.30,000; Hamisi Sh.18,000
- viii. Drawings: Wachirs Sh.9,200; Phylis Sh.7,100; Hamisi Sh.6,900.

Solution

	Sh.	Sh.
Net profit for the year		30,350
Add: Interest on drawings		
Wachira	240	
Phylis	180	
Hamisi	<u>130</u>	<u>550</u>
		30,900
Less: Interest on capital		
Wachira	2,000	
Phylis	1,500	
Hamisi	<u>900</u>	<u>(4,400)</u>
		26,500
Less: salaries;		
Phylis	2,000	
Hamisi	<u>3,500</u>	<u>(5,500)</u>
		21,000
Balance of profit to be shared		
Wachira 50%	10,500	
Phylis 30%	6,300	
Hamisi 20%	<u>4,200</u>	<u>(21,000)</u>
		<u>Nil</u>

	Wachira	Phylis	Hamisi		Wachira	Phylis	Hamisi
	Sh.	Sh.	Sh.		Sh.	Sh.	Sh.
Interest on drawings	240	180	130	Bal b/d	1860	946	717
Drawings	9200	7100	6900	Interest on capital	2000	1500	900
				Salaries		2000	3500
Bal c/d	4920	3466	2287	Share of profits	10000	6300	4200
	<u>14360</u>	<u>10746</u>	<u>9317</u>		<u>14360</u>	<u>10746</u>	<u>9317</u>

STATEMENT OF FINANCIAL POSITION

The statement of financial position also the same as that for a sole trader but the interest of each partner in the business should be shown separately and any loan given by a partner to the firm is also shown separately in the non-current liability section therefore, the format will be as follows.

	Sh	Sh	Sh
Total assets.			XXX
Capital:			
A			XXX
B			XXX
C			<u>XXX</u>
			XXX
Current account			
A		XXX	
B		XXX	
C (debit balance)		<u>(XXX)</u>	<u>XXX</u>
			XXX
Non-current liabilities			
10% loan B		XXX	
10% loan bank		<u>XXX</u>	<u>XXX</u>
			<u>XXX</u>

Illustration

Fatuma, Ridhaa and Mashemba are partners running a firm under the name Fatima. The trial balance for the partnership as at 31st December 2009 was as follows:

	Sh “000”	Sh “000”
Capital accounts :Fatuma		320 000
Ridhaa		320 000
Mashemba		160 000
Current account: Fatuma		25 000
Ridhaa		30 000
Mashemba	10 500	
Drawings : Fatuma	8 200	
Ridhaa	12 100	
Mashemba	3 600	
Salaries and wages	766 000	
Rent	96,000	
Loan (Ridhaa)		74,500
Motor vehicle at cost	1,100,000	
Office equipment and fittings at cost	300,000	

Purchases	1,825,600	
Opening inventory	36,940	
Sales		3,594,470
Trade receivables	84,800	
Trade payables		19,400
Cash in hand	3,450	
Balance at bank	135,770	
Motor insurance	25,000	
Electricity	9,070	
General expenses	<u>126,340</u>	
	<u>4,543,370</u>	<u>4,543,370</u>

Additional Information

I. Inventory as at 31 October 2010 was valued at sh. 3,200,000 2. Depreciation is to be provided as follows:

Asset	Rate per annum	Method
Furniture and fittings	5%	Straight-line
Motor vehicles	20%	Reducing balance

3. Prepayment and accruals as at 31 October 2010 were as follows:

	Prepayment Sh.	Accruals Sh.
Wages	100,000	-
Auditors fees	-	120 000
Director's income	-	20 000
Carriage income	-	540 000
Carriage outwards	30 000	-

4. Corporation tax for year ended 31 October was sh. 278,000

5. Allowance for doubtful debts as at 31 October 2010 was sh. 145,000

6. The board of directors has approved the following:

- Final dividend of sh. 0.50 per share
- Transfer of sh. 285,000 from the general reserve

Required:

- Income statement for the year ended 31 October 2010
- Statement of financial position as at 31 October 2010

Solution**1. Income statement and appropriation account****Fatuma, Ridliaa and Mashemba****Income statement and appropriation account for the year ended 31st December, 2009**

Details	Shs.	Shs.
Sales		3,594,470
Cost of sales		
Opening stock	36,940	
Purchases	1,825,600	
Cost of goods available for sale	1,862,540	
Less: Closing stock	(54,860)	(1,807,680)
Gross profit		1,786,790
Less: Expense		
Motor insurance (w2)	18,750	
Depreciation: Motor Vehicle (w1)	275,000	
Office equipment & fittings (w1)	60,000	
Salaries and wages	766,000	
Rent	96,000	
Electricity	9,070	
General expenses	126,340	(1,351,160)
Net profit		435,630
Share of profit:		
Fatuma	174,252	
Ridha	174,252	
Mashemba	87,126	(435,630)
		<u>nil</u>

ii. Partners current accounts**Partner's Current Accounts**

Details	Fatuma	Ridha	Mashemba	Details	Fatuma	Ridha	Mashemba
Balance b/d			10,500	Bal. b/d	25,000	30,000	
Drawings	8,200	12,100	3,600	Profit share	174,252	174,252	87,126
Balance c/d	<u>191,052</u>	<u>192,152</u>	<u>73,026</u>		<u>199,152</u>	<u>199,152</u>	<u>87,126</u>
	<u>199,152</u>	<u>199,152</u>	<u>87,126</u>	Balance b/d	<u>191,052</u>	192,152	73,026

iii. Statement of financial position.**Fatuma, Ridhaa and Mashemba****Statement of financial position as at 31 December**

Non-Current Assets	Cost	Accum. Depre	Net Book Value
	Sh.	Sh.	Sh.
Motor vehicle	1,100,000	(275,000)	825,000
Office equipment's & fittings	<u>300,000</u>	<u>(60,000)</u>	<u>240,000</u>
	<u>1,400,000</u>	<u>335,000</u>	<u>1,165,000</u>
Current Assets			

Stock		54,860	
Advance insurance		6,250	
Trade receivable		84,800	
Bank		135,770	
Cash		<u>3,450</u>	<u>285,130</u>
			1 350 130
Financed By:			
Capital accounts: Futuma		320,000	
Ridhaa		320,000	
Mashemba		<u>160,000</u>	800,000
Current accounts: Fatuma		191,052	
Ridhaa		192,152	
Mashemba		<u>73,026</u>	456,230
Loan			<u>74,500</u>
Current Liabilities			
Trade payable			<u>19,400</u>
			<u>1,350,130</u>

WI

Provision for depreciation

Motor vehicle; $25\% \times 1,100,000 = 275,000$

Office equipment and fittings $20\% \times 300,000 = 60,000$

W2

Insurance account

	Shs		Shs
Cash	25,000	Income statement	18,750
		Balance c/d	<u>6,250</u>
	<u>25,000</u>		<u>25,000</u>

Motor vehicle account

	Shs		Shs
Balance b/d	1,100,000	Depreciation	275,000
		Balance c/d	<u>825,000</u>
	<u>1,100,000</u>		<u>1,100,000</u>

Equipment and furniture account

	Shs		Shs
Balance b/d	300,000	Depreciation	60,000
		Balance c/d	<u>240,000</u>
	<u>300,000</u>		<u>300,000</u>

CHANGES IN PARTNERSHIP

ADMISSION OF A NEW PARTNER

When a new partner is admitted into the firm, this marks the end of the old partnership and the beginning of a new one.

The new partner will have to bring in the capital that is due from him as per the agreement and also pay for a share of the goodwill.

Goodwill is credited to the partner's account (only the old) and is again written off by debiting the partner's account (inclusive of the new one in the new Profit Sharing Ratio).

When a new person is admitted as partner, the two main problems to be tackled are regarding

- a) Treatment of goodwill
- b) Revaluation of assets and liabilities

Goodwill: Depending upon the share of profits to be given to the new partner, either a sum of money will be paid by him to the old partners (through the firm or privately) or the old partners will be credited with their share of the goodwill.

It is proper that it should be so. The new partner will take a share of profits which comes out of the shares of other partners. The old partners must be compensated for such a loss,

The amount to be brought in by the new partner for goodwill is in addition to the amount to be brought in as capital.

The various possibilities as regards goodwill are:

a. Premium method

- i. The new partner brings goodwill in cash which is left in the business
- ii. The new partner brings goodwill in cash but the cash is withdrawn by the old partners.
- iii. The amount of goodwill is paid by the new partner to the old partners privately.

b. Revaluation method

The new partner does not bring cash for goodwill which is raised in the books and is allowed to remain in the books.

c. Memorandum Revaluation Method

Goodwill is raised in the books and then is immediately written off.

Before considering the entries to be made in the above cases, one must decide regarding the ratio in which goodwill is to be credited to the old partners.

Traditionally, goodwill was credited to the old partners in the old profit-sharing ratio and, if the amount was to be written off, it was written off to all the partners in the new profit-sharing ratio. There would be no doubt that this should be the case when, on the admission of a new person as partner, the ratio as among the old partners does not change.

But what if on the admission of a new partner the profit-sharing of old partners as among themselves is also changed?

If one treats paying sums in respect of goodwill to old partners as compensation for their surrendering to the new partner a part of their profits, then obviously the amount to be credited to partners should be in the ratio of loss of profits.

Suppose, A and B, sharing in the ratio of 3:2, admit C as partner and it is agreed that the new profit-sharing ratio is 2:2:1. It is obvious that B does not suffer at all on C's admission.

He previously received two fifths of profits: he still receives two fifths of profits.

It is A alone who has suffered and, therefore, any amount brought in as goodwill by C should be credited to only A.

Thus, it is proper to credit goodwill brought in by a new partner to the old partners in the ratio in which they suffer on the admission of the new partner.

There would be no difficulty if the whole value of goodwill is raised in the books. This would then mean revaluation of an asset and any profit arising out of such revaluation is naturally to be credited to the old partners in the old ratio.

Hence, if goodwill is raised at its full value, it should be credited to the old partners in the old

Illustration

Amitu and Bosire have been in partnership, sharing profits and losses in the ratio 4:3.

They agreed to admit Cheche to the partnership, with profits and losses being shared between Amitu, Bosire and Cheche in the ratio 3:2:1. On the date of the change in partnership, the partners' capital and current account balances were:

	Capital	Current
Amitu	Shs 60,000 Cr	Shs 12,800 Cr
Bosire	Shs 40,000 Cr	Shs 9,500 Cr

It was agreed that, at the date of Cheche's admission, the partnership was to be valued at Shs 164,300.

Step 1- Calculate goodwill

The total book value of the partnership is equal to the combined value of the partners' capital and current accounts, or Shs 122,300 (Shs 60,000 + Shs 12,800 + Shs 40,000 + Shs 9,500)

The partnership is valued at Shs 164,300,

Therefore, the goodwill is valued at Shs 42,000 (Shs 164,300 — Shs 122,300).

Step 2 — Create goodwill asset in books

The goodwill account is created by a debit entry of Shs 42,000.

This value is credited to the old partners in the old profit and loss sharing ratio — i.e. 4/7 (or Shs 24,000) to Amitu and 3/7 (or Shs 18,000) to Bosire.

Thus, the new capital balances are:

Amitu Shs 84,000 Cr (Sits 60,000 Cr and Shs 24,000 Cr)

Bosire Shs 58,000 Cr (Shs 40,000 Cr and Shs 18,000 Cr)

If goodwill is to be carried in the books, no further entries are needed, as the only change is that a new asset of goodwill has been created, and the capital balances of the old partners have increased by the same value.

Step 3 — Eliminate goodwill (if required by question)

If goodwill is not to be carried in the books, it is eliminated by a credit entry in the goodwill account, and debit entries in the partners' capital accounts, based in the new profit and loss sharing ratio:

Amitu Shs 21,000 (Shs 42,000 x 3/6)

Bosire Shs 14,000 (Shs 42,000 x 2/6)

Cheche Shs 7,000 (Shs 42,000x1/6)

As a result, the new capital balances are:

Amitu Shs 63,000 Cr (Shs 84,000 Cr and Shs 21,000 Dr)

Bosire Shs 44,000 Cr (Shs 58,000 Cr and 14,000 Dr)

Cheche Shs 7,000 Dr (share of goodwill eliminated)

Step 4 Contribution of capital by new partner (if required by question)

If the question requires a contribution by any of the partners (or a repayment of capital) we simply need to follow the normal principles of double-entry bookkeeping.

For example, the question may require the new partner to contribute cash so that the opening capital balance is nil.

In this case, a credit of Shs 7,000 is needed in Cheche's capital account, so this is the amount of cash that must be contributed.

The entries will therefore be:

Debit Bank Shs 7,000
Credit Capital — Cheche Shs 7,000

Illustration:

John and Joel were partners in a business sharing profits and losses in the ratio of 2:1. Interest on fixed capital was allowed at the rate of 10% per annum. No interest was charged on current accounts. On 30 September 2011 Joy was admitted as a partner and from that date profits and losses were to be shared in the ratio of 2:2:1 for John, Joel and Joy respectively. Goodwill was not to be retained in the books with adjusting entries being made in the current accounts.

The following trial balance was extracted from the partnership's books of account as at 31 March 2012:

	Sh “000”	Sh “000”
Leasehold premises	15,000	
Motor vehicles (at cost)	16,400	
Furniture and fittings (at cost)	5,800	
Accumulated depreciation as at 1 April 2011:		
Motor vehicles		3,780
Furniture and fittings		970
Capital accounts: John		6,500
Joel		5,600
Cash introduced by Joy		9,000
Purchases	43,200	
Sales		80,000
Bank balance	2,460	
Receivable	6,440	
Rent and rates	840	
Inventory (1 April 2011)	9,600	
Salaries	14,960	
Selling and distribution costs	5,240	
Current accounts: John		3,440
Joel		2,200
Payables		8,450
	<u>119,940</u>	<u>119,940</u>

Additional information:

1. No entries have been made to record the admission of Joy. Goodwill was agreed at Sh.10.5 million. Sh.6 million of the cash introduced by Joy was the fixed capital.
2. Salaries include the following partners' drawings:

Sh “000”

John	2,580
Joel	2,040
Joy	680

3. Depreciation is to be provided as follows:

Asset	Rate per annum
Motor vehicles	20% on cost
Furniture and fittings	10% on cost

4. The sales during the six month period from 1 October 2011 to 31 March 2012 were 50% more than the sales during the six month period from 1 April 2011 to 30 September 2011. The selling and distribution expenses varied with the sales.
All other expenses accrued evenly.
5. Inventory as at 31 March 2012 was valued at Sh.11 million.
6. Allowance for doubtful debts was Sh.229,000 as at 30 September 2011 and Sh.309,000 as at 31 March 2012.
7. The leasehold premises is to be amortised over 30 years from 31 March 2011

Required:

- a) Income statement for the year ended 31 March 2012.
- b) Statement of financial position as at 31 March 2012.
- c) Partners' current accounts.

Solution:**a) Income statement****Partners****Income statement for the year ended 31st march, 2012**

	30th September 2011		31st March 2012		Total	
	Sh. ‘000’		Sh. ‘000’		Sh. ‘000’	
Sales		32,000		48,000		80,000
Less cost of sales						
Inventory	9,600		14,480		9,600	
Purchases	<u>21,600</u>		<u>21,600</u>		<u>43,200</u>	
Goods available for sale	31,200		36,080		52,800	
Less closing inventory	(14,480)	(16,720)	(11,000)	(25,080)	(11,000)	(41,800)
Gross profit		15,280		22,920		38,200
Less expenses						
Rent	420		420		840	
Salaries	4,830		4,830		9,660	
Selling & distribution	2,096		3,144		5,240	
Depreciation on:						
Motor vehicles	1,640		1,640		3,280	
Furniture and fittings	290		290		580	
Prov. for doubtful debts	<u>229</u>	(9,505)	<u>309</u>	(10,633)	<u>538</u>	(20,138)

Net profit		5,775		12,287		18,062
Interest on capital:						
John	325		325		650	
Joel	280		280		560	
Joy	=	(605)	300	(905)	300	(1,510)
Profit to be shared		5,170		11,382		16,552
Share of profit						
John	3,447		4,553		8,000	
Joel	1,723		4,553		6,276	
Joy	=	(5,170)	2,276	(11,382)	2,276	(16,552)
		NIL		NIL		NIL

W1

Apportionment of sales	$3/5 \times 80,000,000 = 48,000,000$
To 30 th September 2011	100: 150 = 2 : 3
To 31 st March 2012	$2/5 \times 80,000,000 = 32,000,000$

W2**Interest on capital**

To 30 th September 2011	John: $10\% \times 6,500,000 \times \frac{1}{2}$	= 325,000
	Joel: $10\% \times 5,600,000 \times \frac{1}{2}$	= 280,000
	Joy:	= -
To 31 st March 2012	John: $10\% \times 6,500,000 \times \frac{1}{2}$	= 325,000
	Joel: $10\% \times 5,600,000 \times \frac{1}{2}$	= 280,000
	Joy: $10\% \times 6,000,000 \times \frac{1}{2}$	= 300,000

W3**Goodwill Account**

	Shs '000'		Shs '000'
Current Account:		Current account:	
John: $2/3 \times 10500$	7000	John: $2/5 \times 10500$	4200
Joel: $1/3 \times 10500$	3500	Joel: $2/5 \times 10500$	4200
		Joy $1/5 \times 10500$	2100
	<u>10,500</u>		<u>10,500</u>

W4

Salaries expense for the business $14,960,000 - 5,300,000 = 9,660,000$

b) Statement of financial position

John, Joel and Joy Statement of financial position as at 31st march 2012			
Non –current assets	Cost Sh. ‘000’	Depreciation Sh. ‘000’	NBV Sh. ‘000’
Non –current assets			
Leasehold premises	15,000		15,000
Motor vehicle	16,400	7,060	9,340
Furniture and fittings	<u>5,800</u>	<u>1,550</u>	<u>4,250</u>
	<u>37,200</u>	<u>8,610</u>	<u>28,590</u>
Current assets			
Inventory		11,000	
Trade receivables	6,440		
Provision for doubtful debts	<u>(538)</u>	<u>5,902</u>	
Bank balance		<u>2,460</u>	<u>19,362</u>
Total assets			<u>47,952</u>
Equity and liabilities			
Capital Account			
John			6,500
Joel			5,600
Joy			6,000
Current Account			
John			12,310
Joel			6,296
Joy			<u>2,796</u>
Owner’s Equity			39,502
Current liabilities			
Trade payables			<u>8,450</u>
Total Equity and Liabilities			<u>47,952</u>

c) Partners' current accounts.

Partners’ current accounts For the year ended 31st march 2012							
	John Shs‘000’	Joel Shs‘000’	Joy Shs‘000’		John Shs‘000’	Joel Shs‘000’	Joy Shs‘000’
Drawings	2,580	2,040	680	Balance b/d	3,440	2,200	3,000
Goodwill	4,200	4,200	2,100	Cash	-	-	-
Bal. c/d	12,310	6,296	2,796	Goodwill	7,000	3,500	300
				Int. on capital	650	560	2,796
				Share of profit	<u>8,000</u>	<u>6,196</u>	<u>5,576</u>
	<u>19,090</u>	<u>12,536</u>	<u>5,576</u>		<u>19,090</u>	<u>12,536</u>	<u>2,796</u>
				Balance b/d	12,810	6296	

RETIREMENT OR WITHDRAWAL OF A PARTNER

If an existing partner wishes to retire or withdraw from the partnership, the partner may be bought out by an existing partner or may receive assets from the partnership. If an existing partner purchases the interest of the retiring partner, the partnership records an entry to close out the capital account balance of the retiring partner and adds the amount to the capital account balance of the

partner who purchased the interest. If the partnership gives assets to the retiring partner in the amount of the partner's capital account balance, an entry is made to reduce the assets and zero out the retiring partner's capital account balance. If the retiring partner receives more assets or fewer assets than the partner's capital account balance, the difference is taken from or added to the capital accounts of the remaining partners according to how they share in gains or losses. -

Illustration:

Kanini, Lucy and Ndwiga are in partnership sharing profits and losses in the ratio 3:2:1 respectively. Ndwiga decided to retire on 31 December 2012 and Gitonga was admitted as a partner on that date.

The following is the partnership trial balance as at 31 December 2012

	Sh.	Sh.
Premises	1,800,000	
Plant	740,000	
Vehicles	300,000	
Equipment	40,000	
Inventory as at 31 December 2012	1,247,580	
Accounts receivable	699,600	
Cash	15,200	
Accounts payable		380,720
Bank overdraft		84,000
Loan Ndwiga		560,000
Capital: Kanini		1,700,000
Lucy		1,300,000
Ndwiga		700,000
Current accounts :Kanini		74,280
Lucy	50,180	
Ndwiga		93,560
	<u>4,892,560</u>	<u>4,892,560</u>

Additional information

1. Revaluation premises Sh. 2,400,000 plant Sh. 700,000 and inventory Sh. 1,083,580
2. Allowance for doubtful debts amounting to sh. 60,000 is to be provided
3. Goodwill amounting to sh. 840,000 is to be recorded in the books on the day Ndwiga retires. The partners in the new partnership do not wish to maintain goodwill.
4. Kanini and Lucy are to share profits in the same ratio as before. Gitonga will have the same share of profits as Lucy.
5. Ndwiga is to take his car at book value of sh. 78,000 in part payment and the balance of all he is owned by the firm in cash except sh. 400,000 which he is willing to leave as a loan account.
6. The partners in the new firm are to start on equal footing so far as capital and current accounts are concerned. Gitonga is to contribute cash to bring his capital and current accounts to the same amount as the original partner from the old firm who has the lower investment in the business
7. The original partner in the old firm who has the higher investment will draw cash so that capital and current account balances equal those of his new partners

Required;-

- Partners capital account
- Partners current account
- Statement of financial position for the partnership of Kanini, Lucy and Gitonga as at 31 December 2012

Solution:

Kanini Lucy Ndwiga and Gitonga Capital accounts for the year ended 31 December 2012									
	Kanini Shs	Lucy Shs	Ndwiga Shs	Gitonga Shs		Kanini Shs	Lucy Shs	Ndwiga Shs	Gitonga Shs
Goodwill	360,000	240,000	-	240,000	Bal b/d	1,700,000	1,300,000	700,000	1,712,000
Car loan	-	-	78,000	-	Cash	-	-	66,000	-
cash	-	-	400,000	-	Revaluation	198,000	132,000	140,000	-
Drawings	486,000	-	521,560	-	Goodwill	420,000	280,000	93,560	-
Bal c/d	<u>1,472,000</u>	<u>1,472,000</u>		<u>1,472,000</u>	Current a/c	-	-		
	<u>2,318,000</u>	<u>1,712,000</u>	<u>99,560</u>	<u>50,180</u>		<u>2,318,000</u>	<u>1,712,000</u>	<u>99,560</u>	<u>1,712,000</u>

Kanini Lucy Ndwiga and Gitonga Current accounts for the year ended 31 December 2012									
	Kanini Shs	Lucy Shs	Ndwiga Shs	Gitonga Shs		Kanini Shs	Lucy Shs	Ndwiga Shs	Gitonga Shs
Bal b/d	-	50,180	-	-	Bal b/d	74,280	-	93,560	50,180
Capital a/c	-	-	93,560	-	Cash	-	-	-	-
Drawings	24,100	-	-	-	Bal c/d	-	50,180	-	-
Bal c/d	<u>50,180</u>	-	-	<u>50,180</u>					
	<u>74,280</u>	<u>50,180</u>	<u>93,560</u>	<u>50,180</u>		<u>74,280</u>	<u>50,180</u>	<u>93,560</u>	<u>50,180</u>

c) Statement of financial position

Kanini Lucy and Gitonga Statement of financial position as at 31 December 2012			
Non Current assets	Cost Shs	Acc. Dep Shs	NBV Shs
Premises	2,400,000		2,400,000
Plant	700,000		700,000
Vehicle	222,000		222,000
Equipment	<u>40,000</u>		<u>40,000</u>
			3,362,000
Current Assets			
Inventory (W5)	1,083,580		
Account receivables	639,600		
Bank (W6)	646,520		
Cash	<u>15,200</u>		<u>2,444,900</u>
			<u>5,806,900</u>

Equity and liabilities			
Capital A/c			
Kanini			1,472,000
Lucy			1,472,000
Gitonga			1,472,000
Current a/c			
Kanini			50,180
Lucy			(50,180)
Gitonga			<u>50,180</u>
			4,466,180
Long term Liabilities			
Loan from Ndwiga			960,000
Current Liabilities			
Account payables			<u>380,720</u>
			<u>5,806,900</u>

W1**Goodwill a/c**

	Sh.		Sh.
Capital a/c		Capital account	
Kanini $\frac{3}{6} \times 840,000$	420,000	Kanini $\frac{3}{7} \times 840,000$	360,000
Lucy $\frac{2}{6} \times 840,000$	280,000	Lucy $\frac{2}{7} \times 840,000$	240,000
Ndwiga $\frac{1}{6} \times 840,000$	<u>140,000</u>	Gitonga $\frac{2}{7} \times 840,000$	<u>240,000</u>
	<u>840,000</u>		<u>840,000</u>

W2**Revaluation a/c**

	Sh.		Sh.
Plant	40,000	Premises	600,000
Inventory	164,000		
Capital A/c			
Kanini $\frac{3}{6} \times 396,000$	198,000		
Lucy: $\frac{2}{6} \times 396,000$	132,000		
Ndwiga $\frac{1}{6} \times 396,000$	<u>66,000</u>		
	<u>600,000</u>		<u>600,000</u>

W3**Premises A/c**

	Sh.		Sh.
Balance b/d	1,800,000	Balance c/d	2,400,000
Revaluation	<u>600,000</u>		
	<u>2,400,000</u>		<u>2,400,000</u>

W4

Plant A/c

	Sh.		Sh.
Balance b/d	740,000	Revaluation	40,000
		Balance c/d	<u>700,000</u>
	<u>740,000</u>		<u>740,000</u>

W5

Inventory A/c

	Sh.		Sh.
Balance b/d	1,247,580	Revaluation	164,000
		Balance c/d	<u>1,083,580</u>
	<u>1,247,580</u>		<u>1,247,580</u>

W6

Bank a/c

	Sh.		Sh.
Capital	1,712,000	Balances	84,000
Current	50,180	Drawings	
		Capital	486,000
		Current	24,100
		Capital	521,560
		Balance c/d	<u>646,520</u>
	<u>1,762,180</u>		<u>1,762,180</u>

REVISION EXERCISE

QUESTION 1

Aisha, Birdi and Wafula are partners. They share profits and losses in the ratio of 3:2:1. In the first year of trading, ending 31 December 2004, the partnership earned a net profit of Shs.15,800,000. They have agreed interest should be allowed on fixed capital balances at 10% per annum. Also, it has been agreed that Birdi should receive a partnership salary of sh.4,500,000 per annum. Capital - account balances are as follows: Aisha Shs.8,000,000, Birdi Shs.6000,000 and Wafula Shs.6,000,000

You are required to draw up the appropriation account of the partnership for the year ended 31 December 2004.

Solution:

Aisha, Birdi & Wafula			
Appropriation Account for year ended 31 December 2004			
	Shs.000	Shs.000	Shs.000
Net profit			15,800
Less: interest on capital			
Hirst	800		
Bright	600		
Warhust	<u>600</u>	2,000	
		<u>4,500</u>	<u>6,500</u>
Salary: Bright			<u>9,300</u>
Balance of profits shared:			
Hirst	4,650		
Bright	3,100		
Warhust	<u>1,550</u>		
			<u><u>9,300</u></u>

QUESTION 2

Stewart and Armstrong are in partnership sharing profits and losses equally. The following balances have been extracted from the books as at 31 December 2006.

Capital a/c: Sh.000	Current a/c: Sh.000	Salaries: Sh.000	Drawings: Sh.000
Stewart, Shs.15,000	Stewart, Shs.3,200	Stewart, Shs. 6,000	Stewart, Shs. 8,000
Armstrong; Shs.20,000	Armstrong, Shs.800	Armstrong, Shs.4,000	Armstrong, Shs.5,000

The firm's net profit for the year to 31 December 2006 was Shs.26,750,000.

Interest is to be allowed on capital at 10% per year.

Interest is to be charged on drawings based on 5% of total drawings for the year, irrespective of when the drawings were taken.

Required:-

- An appropriation account for the year ended 31 December 2006
- The current accounts for both partners

Solution:

Steward and Armstrong
Appropriation Account for year ended 31 December 2004

	Shs.000	Shs.000	Shs.000
Net profit			26,750
Less: interest on drawings			
Steward		400	
Armstrong		<u>250</u>	<u>650</u>
			27,400
Less: interest on capital			
Steward	1,500		
Armstrong	<u>2,000</u>	<u>3,500</u>	
Salary: Steward	6,000		
Armstrong	<u>4,000</u>	<u>10,000</u>	
			<u>13,250</u>
Balance of profits shared:			
Steward		6,625	
Armstrong		<u>6,625</u>	<u>13,250</u>

Current Accounts

Details	Steward	Armstrong	Details	Steward	Armstrong
Balance b/d		800	Bal. b/d	3,200	
Interest on drawings	400	250	Interest on capital	1,500	2,000
Drawing	8,000	5,000	Salaries	6,000	4,000
Balance c/d	<u>8,925</u>	<u>6,575</u>	Profit share	<u>6,625</u>	<u>6,625</u>
	<u>17,325</u>	<u>12,625</u>		<u>17,325</u>	<u>12,625</u>

QUESTION 3

Peter, Mark and Brian are partners. They share profits and losses equally. In the first year of trading, ending 31 December 2007, the partnership earned a net profit of Shs 32,800,000. They have agreed interest should be allowed on fixed capital balances at 10u/0 per annum. Also, it has been agreed

that Mark should receive a partnership salary of Shs.7, 200,000 per annum. Capital account balances are as follows; Peter Shs. 1 8, 000,000, Mark Shs.12, 000,000 and Brian Shs.9, 000,000.

You are required to draw up the appropriation account of the partnership for the year ended 31 December 2007.

Solution:

Peter, Mark and Brian			
Appropriation Account for year ended 31 December 2004			
	Shs.000	Shs.000	Shs.000
Net profit			32,800
Less: interest on capital			
Peter	1,800		
Mark	1,200		
Brian	<u>900</u>	3,900	
		<u>7,200</u>	<u>11,100</u>
Salary: Mark			<u>21,700</u>
Balance of profits shared:			
Peter	7,234		
Mark	7,233		
Brian	<u>7,233</u>		
			<u>21,700</u>

QUESTION 4

Smith and Jones are in partnership. According to their partnership agreement, they share profits and losses equally (1:1). Smith is entitled to a salary of shs. 1,000,000 p.a. and Jones is given a commission of shs. 500,000. Smith and Jones contributed shs.4, 500,000 each as capital with an interest on capital of 10% p.a.

During the year ending 31st December 2002 Smith and Jones mad drawings of Shs.2,000,000 each. The rate of interest charged on such drawings being of 10% p.a.

The balances on the partners' current account on 1 January were: Smith Shs.550,000 (Cr) and Jones Shs. 700,000 (Dr). The Net Profit registered for the year was Shs. 5,000,000.

You are required to prepare:

- The Profit and Loss Appropriation Account;
- The Partners' Current Account;
- Statement of financial position (extract) showing the current account balances only.

Solution:

**Profit and Loss Appropriation Account for the year ending
31 December 2002**

	Shs.000	Shs.000	Sh.000
Net Profit			5,000
Add Interest on Drawings:			
Smith (10% x2,000)		200	
Jones (10% x2,000)		<u>200</u>	<u>400</u>
			5,400
Less Interest on Capital:			
Smith (10% x 4,500)	450		
Jones (10% x 4,500)	<u>450</u>	900	
Less Salary:			
Smith		1000	
Less Commission:			
Jones		<u>500</u>	<u>2,400</u>
			<u>3,000</u>
Share of Profits:			
Smith (1/2 x3,000)		1,500	
Jones (1/2 x 3,000)		<u>1,500</u>	<u>3,000</u>

(b)

Partners' Current Accounts

Details	Shs.000	Shs.000	Details	Shs.000	Shs.000
Balance b/d	-	700	Interest on capital	450	450
Drawing	2,000	2,000	Salaries	1,000	-
Interest on drawings	200	200	Commissions	-	500
Balance c/d	1,000	-	Share of Profit	1,500	1,500
	-	-	Balance c/d	<u>-</u>	<u>450</u>
	<u>3,500</u>	<u>2,900</u>		<u>3,500</u>	<u>2,900</u>

The Balance in the Current Account may be either a credit or a debit balance.

A Credit Balance is that part of profit for the year, which the partner has not yet taken. Therefore the partner is a creditor because the business owes money to the partner.

A Debit Balance represents an excess of money taken by the partner over profits earned. This leaves the partner to be a debtor for the sum because the partner owes money to the business.

(c)

Statement of financial position (Extract) as at 31 December 2002

	Shs.000	Shs.000
Financed by:		
Capital Account Balances:		
Smith	4,500	
Jones	<u>4,500</u>	9,000
Current Account Balances		
Smith	1,300	
Jones	<u>(450)</u>	850
		<u>9,850</u>

QUESTION 5

Jimmy and Billy are in partnership and according to their partnership agreement they share profits and losses equally; interest is allowed on capital at 5% p.a.

Jimmy is entitled to a salary of Sh.500,000. The following Trial Balance is extracted from their books on 31 December 2001.

Trial Balance as at 31 December 2001

	Dr. Shs.000	Cr. Shs.000
Premises	6,000	
Carriage	100	
Bad Debts	50	
Purchases and Sales	16,000	28,000
Returns	80	60
Salaries	1,400	
Rates and Taxes	400	
Insurance	140	
Cash in hand	700	
Stock 1 January 2001	3,500	
Fixtures and Fittings	4,500	
Wages	2,600	
Capital: Jimmy	-	6,000
Billy	-	6,000
Current: Jimmy	100	-
Billy		150
Drawings: Jimmy	800	
Billy	900	
Debtors and Creditors	8,000	5,000
Provision for Bad Debts	-	250
Discounts	100	20
Office Expenses	<u>110</u>	-
	<u>45,480</u>	<u>45,480</u>

Additional information;-

1. Stock on 31 December 2001 was Shs 2,800,000.
2. Shs 60,000 of the carriage is for carriage in.
3. Depreciate Fixtures and Fittings by 10%.p.a.
4. Wages accrued Shs 400,000.
5. Provision for Bad Debts to equal 10% of Debtors.

You are required to prepare in vertical format:

- a) A Trading, Profit and Loss and Appropriation Account for the year ending 31 December 2001;
- b) A Current Account
- c) Statement of financial position as at 31 December 2001.

Solution:

Jimmy and Billy
Trading and Profit and Loss Account for the Year Ended 31 December 2001

	Shs '000'	Shs '000'	Shs '000'
Sales			28,000
Return Inwards			(80)
Net sales			27,920
Cost of sales			
Opening stock 1 Jan 2001		3,500	
Purchases	16,000		
Return outwards	(60)	15,940	
Net purchases		60	
Carriage inwards		19,500	
		<u>2,800</u>	<u>(16,700)</u>
Closing stock 31 December 2001			11,220
Gross profit			<u>20</u>
Add Discount received			11,240
Expenses:			
Discount allowed	100		
Office expenses	110		
Carriage outwards	40		
Bad debts	50		
Salaries	1,400		
Rates	400		
Wages	3,000		
Insurance	140		
Bad debts provision	550		
Depreciation	450		<u>(6,240)</u>
Net profit			5,000
Interest on capital:			
Jimmy	300		
Billy	<u>300</u>	<u>600</u>	
Salary:			

Jimmy		<u>500</u>	<u>(1,100)</u>
			<u>3,900</u>
Share of profit			
Jimmy (1/2x3900)		<u>1,950</u>	
Billy (1/2x3900)		<u>1,950</u>	<u>3,900</u>

Current Accounts

Details	Jimmy Shs.000	Billy Shs.000	Details	Jimmy Shs.000	Billy Shs.000
Balance b/d	100	-	Balance b/d	-	150
Drawing	800	900	Interest on capital	300	300
Balance c/d	1,850	1,500	Salaries	500	-
	-	-	Share of Profit	<u>1,950</u>	<u>1,950</u>
	<u>2,750</u>	<u>2,400</u>		<u>2,750</u>	<u>2,400</u>
			Balance c/d	1,850	1,500

Jimmy and Billy**Statement of financial position as at 31 December 2001**

Fixed Assets	Cost Sh.000	Accum. Depre Sh.000	Net Book Value Sh.000
Premises	6,000	-	6,000
Fixtures and fittings	<u>4,500</u>	<u>450</u>	<u>4,050</u>
	<u>10,500</u>	<u>450</u>	<u>10,050</u>
Current Assets			
Stock 31 Dec 2001			
Debtors		2,800	
Less Bad debt provision	8,000		
Cash in hand	(800)	7,200	
		<u>700</u>	<u>10,700</u>
Financed By:			<u>20,750</u>
Capital Balances			
Jimmy			
Billy		6,000	
		<u>6,000</u>	12,000
Current Balances			
Jimmy		1,850	
Billy		1,500	15,350
Current Liabilities			
Creditors		5,000	
Wages Accrued		<u>400</u>	<u>5,400</u>
			<u>20,750</u>

QUESTION 6

Jack and Richard are in partnership as retail grocers. Their partnership agreement allows interest on capital at 1 January 2001 at the rate of 8% p.a. Jack is allowed an annual salary of Sps.5,000,000 and

Richard, who works part-time a salary of sh.3,000,000. Profits or Losses are shared equally. The following Trial Balance was extracted from their books on 31 December 2001.

Trial Balance as at 31 December 2001

	Dr. Shs.000	Cr. Shs.000
Capital 1 January 2001: Jack		90,000
Richard		45,000
Current Account 1 January 2001 Jack	150	
Richard	70	
Sales		120,000
Stock- 1 January 2001	2,500	
Purchases	104,780	
Premises	100,000	
Delivery Van	15,000	
Rates	1,500	
Van Expenses	950	
Insurance	360	
Cash at Bank	3,500	
Cash in Hand	60	
Creditors	1,170	
Repairs to Premises	12,300	
Drawings: John	10,000	
Richard	5,000	
	<u>256,170</u>	<u>256,170</u>

Taking into consideration the following:

1. Stock 31 December 2001 Shs.4, 600,000.
2. Insurance prepaid Shs 90,000.
3. Depreciation of delivery van 10% of book value.
4. An extension costing Shs 10,000,000 had been posted as repairs to premises.

You are required to prepare:

- a) Trading and Profit and Loss Accounts, including the Appropriation section for the year ending 31 December 2001.
- b) Partners' Current Account for the year ending 31 December 2001.
- c) Statement of financial position as at 31 May 2001.

Solution:**Trading and Profit and Loss Account for the Year Ended 31 December 2001**

	Shs '000'	Shs '000'	Shs '000'
Sales			120,000
Cost of sales			
Opening stock 1 Jan 2001		2,500	
Purchases		<u>104,780</u>	
		107,280	
Closing stock 31 December 2001		<u>(4,600)</u>	
Gross profit			
Expenses:			
Rates		1,500	
van expenses		950	
Insurance		270	
Repairs to premises		1,500	
Depreciation (10% $\times$ 15,000)		<u>1,500</u>	
Net profit			<u>10,800</u>
Less: Interest on capital:			
Jack (8% $\times$ 90,000)	7,200		
Richard (8% $\times$ 45,000)	<u>3,600</u>	10,800	
Less Salary:			
Jack	5,000		
Richard	<u>3,000</u>	<u>8000</u>	
			<u>(18,800)</u>
			<u>(8,000)</u>
Share of profit			
Jack (1/2 $\times$ 8,000)		4,000	
Richard (1/2 $\times$ 8,000)		<u>4,000</u>	<u>(8,000)</u>

Current Accounts

Details	Jack Shs.000	Richard Shs.000	Details	Jack Shs.000	Richard Shs.000
Balance b/d	150	70	Interest on capital	7,200	3,600
Drawing	10,000	5,000	Salaries	5,000	3,000
Balance c/d	4,000	4,000	Share of Profit	<u>1,950</u>	<u>2,470</u>
	<u>14,150</u>	<u>9,070</u>		<u>14,150</u>	<u>9,070</u>

Statement of financial position as at 31 December 2001

Fixed Assets	Cost	Accum. Depre	Net Book Value
	Sh.000	Sh.000	Sh.000
Premises (+10,000)	110,000	-	110,000
Delivery van	<u>15,000</u>	<u>1,500</u>	<u>13,500</u>
	<u>125,000</u>	<u>1,500</u>	<u>123,500</u>
Current Assets			
Stock 31 Dec 2001		4,600	
Cash at bank		3,500	
Cash in hand		60	
Insurance prepaid		<u>90</u>	
			<u>10,700</u>
Financed By:			<u>20,750</u>
Capital			
Jack		90,000	
Richard		<u>45,000</u>	135,000
Current			
Jack		(1,950)	
Richard		<u>2,470</u>	(4,420)
Current Liabilities			
Creditors			<u>1,170</u>
			<u>131,750</u>

TOPIC 7

FINANCIAL STATEMENTS OF A COMPANY

INTRODUCTION

Limited companies come into existence because of the growth in size of business and the need to have many investors in the business.

Partnerships were not suitable for such businesses because the membership is limited to 20 persons.

Types of companies

There are 2 principle types of companies:

Private companies

These have the words limited at the end of the name. Being private, they cannot invite the members of the public to invest in their ownership.

Public companies

They are much larger in size as compared to private companies. They have the words public limited company at the end of their name.

They can invite the members of the public to invest in their ownership and the companies may be quoted on the stock exchange.

CAPITAL STRUCTURE OF A COMPANY INCLUDING INITIAL ISSUES OF SHARES AT FULL PRICE, RIGHTS ISSUES AND BONUS

The term capital structure refers to the percentage of capital (money) at work in a business by type. Broadly speaking, there are two forms of capital: equity capital and debt capital. Each has its own benefits and drawbacks and a substantial part of wise corporate stewardship and management is attempting to find the perfect capital structure in terms of risk / reward payoff for shareholders. This is true for companies and for small business owners trying to determine how much of their startup money should come from a bank loan without endangering the business.

Equity Capital

This refers to money put up and owned by the shareholders (owners). Typically, equity capital consists of two types:

1. Contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and
2. Retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the fund growth, acquisitions, or expansion.

Many consider equity capital to be the most expensive type of capital a company can utilize because its "cost" is the return the firm must earn to attract investment. A speculative mining company that is looking for silver in a remote region of Africa may require a much higher return on equity to get investors to purchase the stock than a firm such as Procter & Gamble, which sells everything from toothpaste and shampoo to detergent and beauty products.

Debt Capital

This type of capital is infused into a business with the understanding that it must be paid back at a predetermined future date. In the meantime, the owner of the capital (typically a bank, bondholders, or a wealthy individual), agree to accept interest in exchange for you using their money. Think of interest expense as the cost of "renting" the capital to expand your business; it is often known as the cost of capital. For many young businesses, debt can be the easiest way to expand because it is relatively easy to access and is understood by the average American worker thanks to widespread home ownership and the community-based nature of banks. The profits for the owners is the difference between the return on capital and the cost of capital; for example, if you borrow Shs.100,000 and pay 10% interest yet earn 15% after taxes, the profit of 5%, or Shs 5,000, would not have existed without the debt capital infused into the business.

TYPES OF SHARE CAPITAL

ORDINARY SHARES

The terms "voting share" or "Common stock" are also used in other parts of the world; common stock being primarily used in the United States.

It is called "common" to distinguish it from preferred stock. If both types of stock exist, ordinary shareholders cannot be paid dividends until all preferred stock dividends (including payments in arrears) are paid in full.

In the event of bankruptcy, ordinary share investors receive any remaining funds after bondholders, creditors (including employees), and preferred stock holders are paid. As such, ordinary share investors often receive nothing after a bankruptcy.

On the other hand, ordinary share on average perform better than preferred shares or bonds over time. Ordinary share usually carries with it the right to vote on certain matters, such as electing the board of directors. However, a company can have both a "voting" and "non-voting" class of ordinary share.

Holders of ordinary share are able to influence the corporation through votes on establishing corporate objectives and policy, stock splits, and electing the company's board of directors. Some holders of ordinary share also receive preemptive rights, which enable them to retain their proportional ownership in a company should it issue another stock offering. There is no fixed dividend paid out to ordinary shareholders and so their returns are uncertain, contingent on earnings, company reinvestment, and efficiency of the market to value and sell stock.

Additional benefits from ordinary shares include earning dividends and capital appreciation.

PREFERENCE SHARES

Preferred stock (also called preferred shares, preference shares or simply preferreds) is an equity security which may have any combination of features not possessed by ordinary share including properties of both equity and a debt instruments, and is generally considered a hybrid instrument. Preferred stock are senior (i.e. higher ranking) to common stock, but subordinate to bonds in terms of claim (or rights to their share of the assets of the company).

Preferred stock usually carries no voting rights, but may carry a dividend and may have, priority over ordinary share in the payment of dividends and upon liquidation. Terms of the preferred stock are stated in a "Certificate of Designation".

Similar to bonds, preferred stocks are rated by the major credit-rating companies. The rating for preferred stock is generally lower, since preferred dividends do not carry the same guarantees as interest payments from bonds and they are junior to all creditors.

ISSUE OF SHARES

Shares can be issued being payable for:

- a) Immediately on application
- b) By installments

Issue of shares take place on the following terms:
(Connected with the price of shares)

1) Shares issued at par value

In this case shares are issued at a price equal to the nominal value

2) Shares issued at a premium

Shares are issued at a price higher than the nominal value

3) Shares issued at a discount

Shares are issued at a price lower than the nominal value —In Kenya it is illegal for a company to issue shares at a discount

Accounting entries

To recognize the amount expected on issue:

DR- share application account at par value
CR- share capital at par value

Being the nominal value expected on application.

On receipt of amount

DR- bank account
CR- share application

Being the amount received on application

Issue at a premium

DR- share application
CR- share capital
CR- share premium

Being the amount expected on issue On receipt

DR- bank
CR-share application
Being the amount received on application

Issue at discount

DR- share application
CR- share application

Being the amount expected on application

DR- bank
DR- discount on share issue
CR- share application

Being the amount received on application and discount

Over and under subscription

Often, when a company invites investors to apply or subscribe for its shares, the number of applications will not equal the number of shares issued.

When more shares are applied for more than are actually available for issue, then the issue is said to be oversubscribed.

When fewer shares are applied for than are available for issue, then the issue is said to be undersubscribed.

When the issue is under subscribed, there is no problem since accounting entries will only be in respect of the applied shares as the unapplied portion does not represent a transaction (there is no transaction for the unapplied portion)

If however the shares are oversubscribed, the company must come up with a policy on how the shares are to be allocated.

Any excess application money will be refunded by the company.

Rights Issue

A right issue is an option on the part of the shareholder given by the company to existing shareholders at a price lower than the market price.

It involves selling ordinary shares to existing shareholders of the company on a prorata basis. When the rights are issued the shareholders have 2 options available.

Buy the new shares and exercise their rights

Sell the rights in the market,

Ignore the rights.

A rights issue therefore gives the shareholder the right (but not an obligation) to buy the new shares issued by the company.

Example

A Ltd has a share capital of Shs.200,000 trade up of 100,000 shares of Shs.2 each. The balance on the share premium is Shs.60,000. Additional capital is raised by way of a right issue. The terms are For every 5 shares held in the company, a shareholder can buy 2 shares at a price of Shs.2.5 per share.

Required;

The journal entries to reflect the above transaction assuming that all the shareholders exercise their rights and the relevant balance sheet extract.

Shares to be issued

$$\frac{100\,000}{5} \times 2 = 40,000 \text{ shares}$$

Dr Cash book (40,000 x shs.2.5) shs 100,000

Cr Ordinary share capital (40,000 x shs.2) shs 80,000

Cr Share Premium [40,000 x shs.0.5] shs 20,000

Balance sheet (extract)

140,000 Ordinary shares	2 280,000
Reserves	
Share premium	80,000

Bonus Shares

Shares issued to existing shareholders free of charge. They are paid out from either the share premium, balance of retained profits of the General Reserves.

A scrip issue is similar to bonus issue only that a scrip issue gives the shareholder the choice of receiving cash or stock dividends. In a bonus issue the shareholder has no choice but to take up the shares.

Example

A Ltd has 100,000 shares at shs.1 each to form an ordinary share capital of shs.100,000 and a balance on the share premium A/c of shs.50,000. It issues some bonus shares to existing shareholders at a rate of 1 share for every 5 shares held. This amount is to be financed by the share premium. The entries will be as follows:

Shares to be issued:

$$\frac{100\,000}{5} \times 1 = 20,000$$

Dr Share premium A/c [20,000 x shs.1] 20,000

Cr ordinary share capital 20,000

A bonus issue of 20,000 shares

Balance sheet (extract)

Ordinary shares	1,120,000
Reserves	
Share premium	30,000

TYPES OF RESERVES

Share Premium

Share premium is the amount received by a company over and above the face value of its shares.

Face value of a share is its value that is printed on the share certificate. For example, face value of a Shs.1 share is one shilling. But just because the value of share is printed shs.1 does not necessarily mean that the share is worth only one shilling. If a company has a history of good financial performance, it can sell its shares at a price higher than the face value of the shares. This difference between the selling price and the face value of a share is known as share premium.

It is important to note that share premium arises only when the "company" sells the shares. It arises only when a company issues new equity shares. It does not arise when the "investor" sells shares at a price greater than face value. If a company sells a share whose face value is shs.1 at a price of shs.2, the company earns a share premium of shs.1. But subsequently if the investor sells the same share to someone else at a price of shs.4, no share premium will be gained by the company. The investor will benefit from this gain.

Share premium is a non-distributable reserve. The company can use it only for the purposes that are defined in the bylaws of that company. It cannot be used for purposes not defined in the company's laws.

Usually the companies are not allowed to use the share premium for payment of dividends to the shareholders and to set on the operating losses. Share premium can usually be used for paying equity related expenses such as underwriter's fees. It can also be used to issue bonus shares to the shareholders. The costs and expenses relating to issuance of new shares can also be paid from the share premium.

The amount of share premium is presented in the balance sheet as part of the equity capital. It is presented below the amount of issued share capital.

Example:

A Ltd wishes to raise capital by issuing 100,000 ordinary shares at sh.1 each (per value) and the issue price (selling price) is sh.1.5 each.

The following are the entries to be made in the A/C.

Dr Cashbook (100,000 x shs 1.5) 150,000

Cr Ordinary shares capital (100,000 x shs 1) 100,000

Cr Share Premium A/c (100,000 x shs 0.5) 50,000

Issue of shares at a premium of shs 0.5

Revaluation Reserves

Any gain made on revaluation of non-current Assets especially for Land and buildings. When company sells its property to realize the gain, the amount is transferred to the Profit and Loss Account.

Capital redemption reserve

A reserve created after redemption or purchase of Preference shares without issuing new shares. The transfer is made from either the share premium or the profit and loss account

Debenture Loans

The term debenture is used when a limited company receives money on loan, and certificates called debenture certificates are issued to the lender:

They are also called loan stock or loan capital. Debenture interest has to be paid whether profits are made or not. A debenture may either be redeemable or irredeemable. Redeemable is repayable at or by a particular date and irredeemable is payable when the company is officially terminated.

Retained Profits

In accounting, retained earnings refer to the portion of net income which is retained by the company rather than distributed to its owners as dividends. Similarly, if the corporation takes a loss, then that loss is retained and called variously retained losses, accumulated losses or accumulated deficit. Retained earnings and losses are cumulative from year to year with losses offsetting earnings.

Retained earnings are reported in the shareholders' equity section of the balance sheet. Companies with net accumulated losses may refer to negative shareholders' equity as a shareholders' deficit. A complete report of the retained earnings or retained losses is presented in the Statement of Retained Earnings or Statement of Retained Losses.

INCOME TAX (ACCOUNTING TREATMENT, AND PRESENTATION)

In accounting for income tax the principle issue is how to account for the current tax liability and as well as the future tax consequences (deferred tax)

Current and deferred tax

Deferred taxes is a tax that is payable in future.

Current tax

This is the corporation tax payable by companies based on trading results for given period. Tax is mainly from profits but a company may have a taxable business which means a company doesn't have a tax liability in the current period, but carries the taxable loss to the subsequent period to be

offset against future profits. Once the corporation tax has been estimated, IAS 12 requires the following accounting treatment and presentation.

- 1) The total corporation tax liability for the period is shown as a separate item in the income statement to be referred to as income tax expense.
- 2) If part of the total liability is unpaid by the end of the financial period then the unpaid amount is to be presented as part of the current liabilities in the statement of financial position (SOFP) and referred to as current tax.
- 3) Companies often use estimates to compute corporations before tax for a given financial period. In the subsequent financial period, the tax initially estimated may either be more or less than what is actually paid. This is referred to as under provision of the previous year's tax. If actual tax paid is more than what was provided then this is called overprovision.

Actual > Estimate – underprovision

Actual < Estimate – overprovision

IAS 12 recommends that an under provision of previous year's tax should be added to the current year tax expense while an overprovision should be deducted.

Deferred tax

This is the tax that is payable or that would be saved in future. If it is payable then it is called a deferred tax liability and if it will be saved then it is called deferred tax asset. Deferred tax arises because of the differences in the way transactions are treated in accounting and the way they are treated after tax. Deferred tax is the basis of allocating tax charges to particular accounting periods. The key to deferred taxation lies in two quite different concepts of;

1) Accounting profit (reported profit)

- This is the figure of profit before tax reported to the shareholders in the published accounts.

2) Taxable profits

- This is the figure of profit on which the taxation authorities base their calculation

The difference between accounting profit and taxable profit is caused by permanent differences and temporary differences

Permanent differences

- i. One difference between accounting profit and taxable profit is caused by certain items not being taxable/allowable
- ii. Differences which only impact on tax computation of one period
- iii. Differences which do not have deferred tax consequences whatsoever

Temporary differences

These are sometimes called timing differences. These are differences between the carrying amount of an asset and for tax purposes

Examples:

- i. Certain types of incomes and expenditures that are taxed on cash rather than on accrual basis e.g. provisions which can be used by a company but which tax authorities don't recognize.
- ii. The difference between depreciation charged on a non current asset that qualifies for tax allowances and the actual allowance tax depreciation) given.

A temporary difference arises when an expense is allowed for both tax and accounting purposes but the timing of the allowance differs e.g. if relief for capital expenditure is given at a faster rate for tax purposes than depreciation in the financial estimates, the tax charged will be lower in the first years than it could have been if based on accounting profit but in the subsequent years the tax charge will be higher.

Deferred tax liability

IAS 12 requires deferred tax liability to be recognized for all temporary differences with minor expectations. A taxable temporary difference arises where the carrying value of an asset is greater than its tax base.

Deferred tax asset

IAS 12 requires that;

- i. Deferred tax asset should be recognized for all temporary differences
- ii. A deductible temporary difference arises where the tax base of an asset exceeds its carrying value.
- iii. To the extent that it is probably taxable profit will be available against which deductible temporary differences can be utilized than deferred tax asset can be recognized especially in regard to tax losses carried forward.
- iv. No discounting is allowed.

Application scenario

a) Revaluation of non-current assets

- Deferred tax should be recognized on revaluation gain even when there is no intention to sell the asset or roll over relief available on the gain.
- The revaluation of noncurrent assets results in taxable temporary differences and so its liability. This is charged as a component of other comprehensive income (alongside the revaluation gain reserve). It is therefore disclosed either in the statement of cash inflow (SOCI) or in a statement showing other comprehensive incomes.

b) Tax losses-

- When used tax losses are carried forward a deferred tax asset can be recognized to the extent taxable profit will be available in the future to offset the losses against.
- If an entity doesn't expect to have taxable profits in future, it cannot recognize an asset in its own account. If however the entity is part of a group and many surrender the tax losses to other groups and companies, a deferred tax asset may be recognized in the consolidated accounts.
- The asset is equal to the losses expected to be utilized multiplied by the tax rate.

Changes in tax rates

The corporation tax may change from one period to the next e.g. the tax rate for 2010 may be 33% and 2011 35%. The question is which tax rate should be used in computing deferred tax for the current year (assuming the current year is 2010) if a company uses the current year's tax rate then it is called the deferral method.

If a company uses the subsequent years tax rate i.e. 35%, in this case unless the subsequent tax rate is not known in which case the firm can use the deferral method.

Further points on deferral tax

IAS 12 explains that there are two main types of temporary differences notably

- Taxable temporary difference (TTD)
- Deductible temporary difference (DDT)

Taxable temporary difference- These are differences that lead to a future payment of tax i.e. deferred tax liability. They arise when the carrying amount of an asset is greater than the tax base.

Deductible temporary difference – These are temporary differences that lead to a future tax saving, i.e. deferred tax asset. They arise when the carrying amount is less than the tax base. A

deferred tax asset may also arise where the company has future taxable losses (tax losses carried forward) or if the company has a tax refund or credit.

Disclosure requirements

The tax expense (income) should be presented on the face of income statement. The major components of tax expense (income) should be disclosed separately in a note.

Current and deferred charged/credited directly to equity (taxes out of main event e.g. revaluation) should be disclosed separately in a note.

Current and deferred tax charged/credited directly to equity should be disclosed. An explanation of the relationship between tax expense (income) and accounts profit in either or both of the following forms.

1. Reconciliation between tax expense and product of account profit multiplied by the applicable rate, disclosing also the basis on which the applicable rates are computed
2. A numerical reconciliation between average effective tax rate and applicable tax rate, disclosing also the basis on which applicable tax rate is computed.
3. Amount of deferred tax asset/liability and nature of evidence supporting its recognition.

FINANCIAL STATEMENTS

INCOME STATEMENTS AND STATEMENTS OF FINANCIAL POSITION

The income statement of a company is the same as that of a sole trader, but there are additional expenses that are unique to the company and therefore, they should be included in the income statement. (e.g.)

- Director's fees salaries and other expenses
- Audit fees
- Amortization e.g. goodwill
- Debenture interest

In addition to the income statement, just like a partnership has an appropriation account which shows the allocation of the net profit for the period is to be shown. Therefore, the format will be as shown:

XYZ company income statement
For the year ended 31 December 2013

	Shs	Shs	Shs
Sales			xxx
Less Returns inwards			<u>xxx</u>
			xxx
Less Cost of Sales			
Opening Stock		xx	
Purchases		xx	
Add Carriage inwards		xx	
Less purchase returns		xx	
Less Closing stock		<u>xx</u>	<u>xx</u>
Gross Profit			xx
Add incomes			
Discount received			xx
Profit on disposal (sale of Assets)			xx
Income from investment (can also be shown below)			xx
Other incomes e.g. interest received from bank			xx
Less Expenses			
Directors salaries/fees/		xx	
Audit fees		xx	
Debenture Interest		xx	
Amortization of good will		xx	
Operating profit for the period		<u>xx</u>	<u>xx</u>
Add investment income			xx
Profit before tax			
Taxation: Corporation tax			
Transfer to deferred tax		xx	
Under or over provision		xx	
Profit after tax		<u>xx</u>	<u>xx</u>
Less transfer to the general reserve			xx
Less: Dividends			xx (xx)
Preference dividend:			
Interim paid		xx	
Final proposed		xx	
Ordinary dividend			
Interim paid		xx	
Final proposed		<u>xx</u>	<u>(xx)</u>
Retained profit for the year			xx
Retained profit b/d			<u>xx</u>
Retained profit c/d			<u>Xx</u> <u>xx</u>

Director's salaries

Salaries, fees and other expenses in relation to the directors are expenses as far as company accounts are concerned.

This is different from that of Partnerships & Sole traders which are shown as appropriations — expenses.

Audit fees

All companies are required to prepare the accounts which should be audited and therefore any fees paid in relation to audit and accountancy is an expense.

Debenture interest

Loans taken up by companies are called debentures. The interest paid on these loans is charged as an expenses and unpaid amount are shown as current liabilities in the business.

The debenture is classified under non-current liability.

Corporation tax

Companies pay corporation tax on the profits they earn. This is shown in the accounts because a company is a separate legal entity unlike for sole traders and partnerships whose tax is shown as drawings.

The tax is listed under those items as shown in the appropriation (under/over provision for previous period, transfer to deferred tax corporation tax for the year).

The under provision and corporation tax relate to direct liability to the government and therefore is a deduction from the net profit for the period.

Transfer to deferred tax is to cater for future possible tax liability.

XYZ Company
Statement of financial position format

	Shs	Shs	Shs
Non-current assets			
Land & Building			xx
Plant and Machinery			xx
Fixtures, Furniture & Fittings			xx
Motor vehicle			<u>xx</u>
			xx
Intangible Assets			
Goodwill			xx
Copyrights, patents			xx
(Long-term) Investments (mkt value)			xx
Current Assets			
Stock		xx	
Debtors	xx		
Less provision for bad debts	<u>xx</u>	xx	
Prepayments		xx	
(Short term) Investments		xx	
Cash at bank		xx	
Cash in hand		<u>xx</u>	<u>xx</u>
			<u>xx</u>
Financed by			
Authorized share capital			
100,000 ordinary shares of shs 1 each		xx	
100,000 preference shares of shs 1 each		xx	
Issued and Fully paid			
80,000 ordinary shares of shs 1 each		xx	
50,000 10% preference shares of shs 1 each		xx	
Capital Reserves		xx	
Share premium		xx	
Revaluation Reserve		xx	
Capital Redemption Reserve		xx	
Revenue Reserves		xx	
General Reserve		xx	
Profit and loss A/C		xx	
Deferred tax A/C		xx	
Non-Current Liabilities		xx	
10% debenture		xx	
Current liabilities			
Bank overdraft		xx	
Creditors		xx	
Accruals		xx	
Interest payable(debenture interest)		xx	
Tax payable		xx	

Dividends payable

xx xx
xx

Illustration

The following balances were extracted from the books of Kasaya Limited as at 30 September 2010:

	Sh. '000'
Land and buildings (net book value)	5,000
Plant and machinery (net book value)	8,600
Motor vehicles (net book value)	2,000
Inventory	6,000
Ordinary share capital (Sh.50 par value)	10,000
10% preference share capital (Sh.100 par value)	9,000
10% debentures	8,000
Corporation tax	500
Interim ordinary dividend paid	2,000
Other operating expenses	1,550
Distribution costs	6,000
Administrative expenses	13,000
Accounts payable	19,000
Other operating income	4,000
Gross profit	25,000
Debenture interest paid	400
Preference dividend paid	450
Accounts receivable	20,000
Cash at bank	4,100
Capital redemption reserve	6,000
Share premium	4,000
Revenue reserves (1 October 2009)	3,000

Additional Information:

1. The balance on the corporation tax account represents an over provision of tax for the previous year. Tax expense for the current year is estimated at Sh.3 million.
2. On 15 September 2010, the directors of the company proposed to pay the dividend due to the preference shareholders and to also pay a final dividend of Sh.2 million to the ordinary shareholders.
3. A building whose net book value is Sh.5 million is to be revalued to Sh.9 million.

Required:

- a) Income statement for the year ended 30 September 2010.
- b) Statement of financial position as at 30 September 2010.

Solution**a. Income statement****Kasaya Ltd****Statement of Comprehensive Income for the year ended 30 September 2010**

	Sh.000	Sh.000
Gross profit		25,000
Other operating income		<u>4,000</u>
		29,000
Expenses		
Administrative expenses	13,000	
Distribution costs	6,000	
Other operating expenses	1,550	
Debenture interest	<u>800</u>	<u>(21,350)</u>
Net profit before tax		7,650
Corporate tax (wl)		(2, 500)
Net profit after tax		5,150
Preference Dividends: Interim	450	
Proposed	450	(900)
Earnings attributable to equity holders		4,250
Ordinary interim paid		(2,000)
Ordinary dividend proposed		<u>(2,000)</u>
Retained profits for the year		250
Revenue reserves b/d		<u>3,000</u>
Revenue Reserves c/d		<u><u>3,250</u></u>

Kasaya Ltd**Statement of financial position for the year ended 30 September 2010**

	sh.000	Sh.000
Non-Current Assets		
Land and buildings		29,000
Plant and machinery		8,000
Motor vehicles		<u>2,000</u>
		39,000
Current Assets		
Inventory	6,000	
Accounts receivable	20,000	
Cash at bank	4,100	<u>30,100</u>
		<u>69,100</u>
Capital and Liabilities		
Ordinary share capital		10,000
10% Preference share capital		9,000
Share premium		4,000
Revenue Reserves		3,250
Revaluation Reserve		4,000
Capital redemption Reserve		6,000
		36,250
Current liabilities		
Accounts payable	19,000	
Debenture interest	400	
Corporate tax	3,000	
Proposed Dividends	<u>2,450</u>	24,850
Long term Liabilities		
10% Debentures		<u>8,000</u>
		<u>69,100</u>

Corporation tax a/c

	Shs		Shs
Balance c/d	3,000	Balance b/d	500
		Income statement	<u>2,500</u>
	<u>3,000</u>		<u>3,000</u>

W2

Proposed: Preference Dividends: Sh. 4.50,000
 Ordinary Dividends : Sh. 2,000,000

Illustration

The following balances remained in the books of Elishama Ltd. as at 30 April 2003 after the preparation of the trading account:

Share capital. authorized and issued:	Sh.
2,400,000 Sh. 20 ordinary shares	48,000,000
800,000 8% Sh. 20 preference shares	16,000,000
Stock - 30 April 2003	33,540,000
Accounts receivable and prepayments	10,880,000
Accounts payable and accruals	5,488,800
Balance at bank	3,118,400
10% debentures	6,400,000
General reserve	11,200,000
Bad debts	136,000
Gross profit for the year	32,603,200
Salaries and wages	11,280,000
Rates and insurance.	564,000
Postage and telephone	248,000
Water and electricity	486,400
Debenture interest	320,000
Directors' fees	1,000,090
General expenses	1,243,200
Motor vehicles (Cost Sh. 11,640,000)	2,720,000
Office fittings and equipment (Cost Sh. 17,856,000)	10,976,000
Land and buildings at cost	52,880,000
Profit and loss account - 1 May 2002	9,700,800

Additional information:

1. A bill for Sh. 219,200 in respect of electricity for the period up to 30 April 2003 has not been accrued.
2. The amount for insurance includes a premium of Sh. 120,000 paid in January 2003 to cover the company for six months, February to July, 2003.
3. Office fittings and equipment are to be depreciated at 15% per annum on cost and motor vehicles at 20% per annum on cost.
4. Provision is to be made for:
 - Directors' fees - Sh. 2,000,000
 - Audit fee - Sh. 480,000

The outstanding debenture interest

5. The directors have recommended that:

- A sum of Sh. 4,800,000 be transferred to general reserve.
- The preference dividend be paid.
- A 10% ordinary dividend be paid.

Required:

- Profit and loss and appropriation accounts for the year ended 30 April 2003.
- Balance sheet as at 30 April 2003.

Solution

a)

Elishama Ltd Profit and loss and appropriation a/c
For the year ended 30th April 2003

	Sh '000'	Sh '000'	Sh '000'
Gross profit			32,603.2
Expenses			
Debenture interest: Paid	320		
Due	320	640	
Bad debts		136	
Water and Electricity: Paid	486.4		
Due	<u>219.2</u>	705.6	
Rates and Insurance: Paid	564		
Advance	<u>(60)</u>	504	
Depreciation: Office fittings and equipment		2,678.4	
Motor vehicles		2,328	
Salaries and wages		11,280	
Postage and telephone		248	
Directors fees: Paid	1,000		
Provision	<u>2,000</u>	3,000	
Audit fees		480	
General expenses		1,243.2	(23,243.2)
Net profit			9,360
Add retained profit b/d			<u>9,700.8</u>
			19,060.8
Less dividend: Preference	4,800		
Ordinary	1,280	6,080	
Transfer general reserve		<u>4,800</u>	<u>(10,880)</u>
			<u>8,180.8</u>

b)

Elishama Ltd
Balance Sheet as at 30th April 2003

Non-Current Assets	Cost	Accum. Depre	Net Book Value
	Sh. '000'	Sh. '000'	Sh. '000'
Land and buildings	52,880	-	52,880
Office fittings & equipment's	17,856	9,558.4	8,297.6
Motor vehicle	<u>11,640</u>	<u>11,248</u>	<u>392</u>
	<u>82,376</u>	<u>20,806.4</u>	<u>61,569.6</u>
Current Assets			
Stock		33,540.8	
Accounts receivable and prepayment (w1)		10,940	
Bank		<u>3,118.4</u>	<u>47,599.2</u>
			<u>109,168.8</u>
Current Liabilities			
Account payment and accruals (w1)		8,508	
Proposed dividends		<u>6,080</u>	14,588
Financed By:			
2,400,000 Sh 20 Ordinary shares			48,000
800,000 8% sh 20 preference shares			16,000
10% debentures			6,400
Reserves			
General reserves			16,000
Profit and loss			8,180.8
			<u>109,168.8</u>

W1

Accounts payable and accruals a/c

	Shs'000'		Shs '000'
		Balance b/d	5,488.8
		Electricity accrued	219.2
		Directors fee	2,320
Balance c/d	8,508	Auditors fee	<u>480</u>
	<u>8,508</u>		<u>8,508</u>

W2

General reserve a/c

	Shs'000'		Shs '000'
		Balance b/d	11,200
Balance c/d	16,000	P&L	<u>4,8000</u>
	<u>16,000</u>		<u>16,000</u>

REVISION QUESTIONS

QUESTION 1

From the following trial balance of M Fry, you are asked to draw up an income statement for the year ended 31 December 2007 and a statement of financial position as at that date

	Shs.000	Shs.000
Profit and loss account 31 December 2006		23,000
Sales		52,000
Purchases	33,000	
Stock in trade 31 December 2006	9,660	
Premises	135,000	
Equipment	25,000	
Vehicles	16,000	
Bank	9,600	
Wages	14,500	
Insurance	2,340	
Preference share capital (shs 1 shares) 6%		50,000
Ordinary share capital (shs 1)		120,000
Provision for bad debts.		450
General reserve		7,800
Debtors	12,400	
Creditors		7,000
Rent	3,250	
	260,750	260,750

Additional Information:

- Stock in trade at 31 December 2007 was shs 10,660,000
- Prepaid wages shs 320,000 ,
- Insurance owing shs 45,000
- The provision for debtors is to be maintained at 5%
- Corporation tax is to be provided for at shs 1,600,000
- The preference dividend is to be provided for and an ordinary dividend of 5% is also to be provided for.

Solution:

M Fry
Trading, profit & loss Appropriation Account
For year ended 31 December 2006

	Shs.000	Shs.000
Sales		52,000
Less cost of goods sold		
Opening stock	9,660	
Purchases	<u>33,000</u>	
	42,660	
Less Closing stock	<u>10,660</u>	
		<u>32,000</u>
Gross profit		20,000
Less expenses		
Wages	14,180	
Insurance	2,385	
Rent	3,250	
Vehicle depreciation	1,600	
Equipment depreciation	5,000	
Provision for doubtful debts	<u>170</u>	
		<u>26,585</u>
Profit for the year before tax		(6,585)
Less corporation tax		1,600
Profit for the year after tax		(8,185)
Add retained profit b/f		<u>23,000</u>
Less Appropriations:		<u>14,815</u>
Ordinary dividends	6,000	
Preference dividends	3,000	
Transfer to general reserves	<u>4000</u>	
		<u>13,000</u>
Retained profit c/f		<u>1,815</u>

M Fry
Statement of financial position as at 31 December 2007

	Cost Shs.000	Dep. Shs.000	NBV Shs.000
Fixed Assets			
Premises	135,000		135,000
Equipment	25,000	5,000	20,000
Vehicles	<u>16,000</u>	<u>1,600</u>	<u>14,400</u>
	176,000	6,600	169,400
Current Assets			
Stock		10,660	
Debtors	12,400		
Less provision	<u>620</u>	11,780	
Prepayments		320	

Bank		<u>9,600</u>	
		32,360	
Current liabilities			
Creditors	7,500		
Accruals	45		
Tax owing	1,600		
Ordinary dividends owing	6,000		
Preference dividends owing	<u>3,000</u>		
		<u>18,145</u>	
Net current assets			<u>14,215</u>
Total assets less current liabilities			<u>183,615</u>
Ordinary share capital			120,000
Preference share capital			50,000
General reserve			11,800
Profit and loss account			<u>1,815</u>
			<u>183,615</u>

QUESTION 2

Johnston Ltd started trading on 1 January 2001. Its issued share capital was 450,000 ordinary shares of shs.1 each and 6% preference shares of shs 1 each. The following information is available:

- Its net profits for the first three years of business were 2001 shs 56,784; 2002 shs 67,921 and 2003 shs 37, 609..
- Preference dividends were paid for each of these years, whilst ordinary dividends were proposed as 2001 3%; 2002, 10% and 2003 5%.
- Corporation tax based on the-profits of each year was: 2001 shs 12,546; 2002 shs 16,711 and 2003 shs 9,878.
- Transfers to general reserve took place: 2002 shs 7,000 and 2003 shs 2,000.

Required;-

- a) Draw up profit and loss appropriation accounts for each of the first three years of trading.
- b) Produce statement of financial position extracts for each end of year date based on your answer to question (a).

Solution:**Johnston Ltd****Appropriation Account for year ended 31 December 2001**

	Shs.000	Shs.000
Profit for the year before tax		56,784
Less corporation tax		<u>12,546</u>
Profit for the year after tax		44,238
Less: Proposed dividends		
Preference dividends	3,000	
Ordinary dividends	<u>13,500</u>	
		<u>16,500</u>
Retained profit carried forward to next year		<u>27,738</u>

Johnston Ltd**Appropriation Account for year ended 31 December 2002**

	Shs.000	Shs.000
Profit for the year before tax		67,921
Less corporation tax		<u>16,711</u>
Profit for the year after tax		51,210
Add retained profit from last year		<u>27,738</u>
		78,948
Less: Proposed dividends		
Preference dividends	3,000	
Ordinary dividends	45,000	
Transfer to general reserves	<u>7,000</u>	
		<u>55,000</u>
Retained profit carried forward to next year		<u>23,948</u>

Johnston Ltd**Appropriation Account for year ended 31 December 2003**

	Shs.000	Shs.000
Profit for the year before tax		37,609
Less corporation tax		<u>9,878</u>
Profit for the year after tax		27,731
Add retained profit from last year		<u>23,948</u>
		51,679
Less: Proposed dividends		
Preference dividends	3,000	
Ordinary dividends	22,500	
Transfer to general reserves	<u>2,000</u>	
		<u>27,500</u>
Retained profit carried forward to next year		<u>24,179</u>

b)

Johnston Ltd**Statement of financial position extract as at 31 December 2001**

Capital & Reserves	Shs.000
Ordinary share capital shs. 1	450,000
7% preference share capital shs. 1	50,000
Profit and loss account	27,738
	<u>527,738</u>

Johnston Ltd**Statement of financial position extract as at 31 December 2002**

Capital & Reserves	Shs.000
Ordinary share capital shs. 1	450,000
Preference share capital shs. 1 7%	50,000
General reserve	7,000
Profit and loss account	23,948
	<u>530,948</u>

Johnston Ltd**Statement of financial position extract as at 31 December 2002**

Capital & Reserves	Shs.000
Ordinary share capital shs. 1	450,000
Preference share capital shs. 1 7%	50,000
General reserve	9,000
Profit and loss account	24,179
	<u>533,179</u>

QUESTION 3

Mashariki Enterprises provided the following details of assets and liabilities as at 1 June 2010. The cost details were obtained from the invoices file while others were obtained verbally from the managing director who was the proprietor.

Assets	Cost/valuation Sh. "000"	Date of acquisition	Depreciation
Equipment and furniture	2,300	1 September 2008	10% per annum
Building	26,000	1 January 2005	5% per annum
Land	3,400	1 January 2005	Nil
Motor vehicles	1,600	1 May 2010	20% per annum
Bank Balance	1000		
Trade receivables	1,380		
Opening inventory	1,800		
Prepaid insurance	450		
Cash	120		

Trade payables	1,100		
Bank loan	2,400		
Accrued sundry expenses	2,600		

The policy of the firm is to provide full depreciation in the year of purchase and none in the year of disposal, using the straight line method.

The following is a summary of receipts and payments for the year ended 31 May 2011.

	Bank Sh. "000"	Cash Sh. "000"		Bank Sh. "000"	Cash Sh. "000"
Sale of equipment		200	Rent	2,000	
Receipts from debtors		4,150	Donations		250
Sales	13,000		Suppliers of goods	5,000	
			Furniture	900	
			Salary and wages	1,400	
			Stationery		300
			Motor vehicle	400	
			Bank loan	600	
			Drawings		200
			Sales comm.	150	
			Insurance	1200	
			Bank charges	120	
			Sundry expenses		2,800
			Interest on loan		240

Additional information:

I. The following balances were available as at 31 May 2011:

- Prepaid insurance Sh.250, 000
- Accrued salary Sh.150, 000

2. Equipment with a cost of Sh.300, 000 was disposed of during the year.

3. Closing inventory was valued at Sh. 1,200,000.

4. Trade receivables as at 31 May 2011 were Sh.1, 150,000 while trade payables were Sh.1, 250,000.

Required:

- Income statement for the year ended 31 May 2011.
- Statement of financial position as at 31 May 2011.

Solution:**a) Income statement for the year**

Mashariki Enterprises		
Statement of Comprehensive Income for year ended 31 May 2011		
	Shs.000	Shs.000
Sales (w1)		16,920
cost of sales		
Opening stock	1,800	
Purchases (w2)	5,150	
Closing stock	(1,200)	(5,750)
Gross profit		11,170
Expenses:		
Insurance(w3)	1,400	
Salaries and wages (w4)	1,550	
Sundry expenses (w5)	200	
Loss of disposal (w7)	40	
Rent	2,000	
Depreciation:		
Equipment & Furniture(w6)	290	
Motor (w6)	400	
Donation	250	
Stationery	300	
Sales commission	150	
Bank charges	120	
Loan interest	240	
Depreciation building (w6)	1,300	(8,240)
Net profit		<u>2,930</u>

b) Statement of financial position

Mashariki Enterprises			
Statement of financial position as at 31 May 2011			
Non-current Assets	Cost Shs.000	Acc. Dep. Shs.000	NBV Shs.000
Land	3,400		3,400
Building	26,000	9,100	16,900
Furniture and equipment	2,900	690	2,210
Motor vehicle	<u>2,000</u>	<u>720</u>	<u>1,280</u>
	34,300	10,510	23,790
Current Assets			
Inventory		1,200	
Accounts receivable		1,150	
Prepaid insurance		250	
Bank (w8)		1,990	

Cash (w8)		<u>920</u>	<u>5,510</u>
Total assets			<u>29,300</u>
Financed by:			
Capital (w8)			23,370
Net profit			2,930
Drawings			<u>(200)</u>
			26,100
Non-Current liabilities			
Bank loan			1,800
Current liabilities		1,250	
Accounts payable		<u>150</u>	<u>1,400</u>
Accrued salary			<u>29,300</u>

Workings

W1

Trade payable a/c

	Shs.000		Shs.000
Balance b/d	1,380	Bank	13,000
Credit sales	<u>12,770</u>	Balance c/d	<u>1,150</u>
	<u>14,150</u>		<u>14,150</u>

Total sales=cash sales=credit sales=1,150,000+12,770,000=16,920,000

W2

Trade receivables a/c

	Shs.000		Shs.000
Bank	5,000	Balance b/d	1,100
Balance c/d	<u>1,250</u>	Credit purchases	<u>5,150</u>
	<u>6,250</u>		<u>6,250</u>

Total Purchases=cash Purchases =credit Purchases =0+5,150,000=5,150,000

W3

Insurance expenses a/c

	Shs.000		Shs.000
Balance b/d	450	Income statement	1,400
Bank	<u>1,200</u>	Balance c/d	<u>250</u>
	<u>1,650</u>		<u>1,650</u>

W4

Salaries and wages a/c

	Shs.000		Shs.000
Bank	1,400		
Balance c/d	<u>150</u>	Income statement	<u>1,550</u>
	<u>1,550</u>		<u>1,550</u>

W5

Sundry expenses a/c

	Shs.000		Shs.000
Cash	2,800	Balance b/d	2,600
	<u>2,800</u>	Income statement	<u>200</u>
			<u>2,800</u>

W6

Depreciation

Equip & Furniture

$$10\% \times (2,300,000 - 300,000 + 900,000) = 290,000$$

Motor Vehicle

$$(20\% \times 1,600,000 + 20\% \times 400,000) = 400,000$$

$$\text{Building} = 5\% \times 26,000,000 = 1,300,000$$

W7

Loss on disposal of equipment**Disposal: Equipment a/c**

	Shs.000		Shs.000
Equipment	300	Cash proceeds	200
		Accumulated depreciation	60
	<u>2,800</u>	Profit and loss(balancing figure)	<u>40</u>
			<u>2,800</u>

Bank and cash balances

Cash Accounts

Details	Bank Shs.000	Cash Shs.000	Details	Bank Shs.000	Cash Shs.000
Balance b/d	100	120	Rent	2,000	
Sale of equipment		200	Donations		250
Receipts from debtors	13,000		Suppliers of goods	5,000	
Sales		4,150	Furniture	900	
			Salaries and wages	1,400	
			Stationery		300
			Motor vehicle	400	
			Bank loan	600	
			Drawings Sales		200
			Commission	150	
			Insurance	1,200	
			Bank charges	120	
			Sundry Expenses		2,800
			Interest on loan	240	
			Bal e/d	<u>1,990</u>	<u>920</u>
	<u>14,000</u>	<u>4,470</u>		<u>14,000</u>	<u>4,470</u>

W9

	Shs.000
Assets	
Equipment and furniture (2,300 - 460)	1,840
Building (26,000 - 7,800)	18,200
Land	3,400
Motor vehicle (1,600 - 320)	1,280
Bank balance	1,000
Trade receivables	1,380
Inventory	1,800
Prepaid insurance	450
Cash	120
Total Assets	29,470
Less Liabilities	
Trade payables	(1,100)
Bank loan	(2,400)
Accrued expenses	<u>(2,600)</u>
Capital	<u>23,310</u>

TOPIC 8

FINANCIAL STATEMENTS OF A MANUFACTURING ENTITY

FEATURES OF A MANUFACTURING ENTITY

it will be realized that the ordinary Trading Account is not capable of showing up the cost of manufacturing goods, because:

1. It deals with stocks (both opening and closing) of finished goods
2. Some of the expenses connected with production, such as, depreciation and repairs of machinery, are usually debited to the Profit and Loss Account.

Thus, for manufacturing organizations, manufacturing accounts will be needed in addition to a trading and profit and loss accounts. This will be for internal purposes/ use in the company.

In place of purchases we will instead have the cost of manufacturing the goods. A separate 'Manufacturing Account' to which will be debited all expenses incurred in the factory on the production of goods. This means that depreciation of and repairs to plant and machinery are also debited to the Manufacturing Account and not to the Trading Account.

The total of such expenses adjusted for value of stocks of raw materials and of semi-finished goods will show the total cost of the output during the financial period.

This figure is transferred to the debit of the Trading Account which will show the gross profit made in the usual manner.

In a manufacturing concern, at any time there will be some unfinished or semi-finished work. This is called work in process or work UN certified. It is an asset like stock of materials or finished goods. The Value of work in progress in the beginning is debited to the Manufacturing Account as opening stock. The value of work in process-is credited to this account, as closing stock, and then shown in the Balance Sheet. -

CLASSIFICATION OF COSTS

Classification and apportioning costs between manufacturing and selling and administration

For a manufacturing the manufacturing costs are divided into the following types:

i) Direct material costs

Direct material costs are those materials used directly in the manufacture of products i.e. materials that can be identified in the final products. E.g. in the manufacture of tables, direct materials consist of timber, nails, glue etc.

ii) Direct labour costs

These are wages paid to those who are directly involved in the manufacture of a product e.g. in the manufacture of tables; direct labour consists of wage paid to those workers who saw, shape or join the piece of timber into table.

iii) Direct expenses

These are expenses that must be incurred in the manufacturing of a product. That is, they can be directly allocated to a particular unit of a product e.g. live changes for special equipment used in the process of manufacture, royalties

NB: The sum of all the direct costs is known as **Prime costs**

iv) Indirect manufacturing costs / fact

These are any other expenses (apart from the direct costs) for items being manufactured: e.g. cleaners wages, factory rents, depreciation of plant and equipment, factory power and lighting

NB: $\text{prime cost} + \text{indirect manufacturing costs} = \text{Production cost}$

v) Administrative Expenses

These are expenses that are administrative in nature, that is, expenses incurred in the process of planning, controlling and directing the organization. E.g. office rents, office electricity, depreciation of office machinery, secretarial salaries

vi) Selling and distribution expenses

These are expenses incurred in the process of selling, promoting and distributing the goods manufactured, E.g. advertising expenses, carriage outwards, depreciation of motor van, salesmen salaries etc.

vii) Finance Costs

These are expenses such as bank charges, discount allowed.

FINANCIAL STATEMENTS

Manufacturing account, income statement and statement of financial position

Manufacturing account part

Manufacturing account is an account prepared by manufacturing concerns to ascertain cost of goods manufactured during the period. All the expenses relating to manufacturing activity are debited.

The total represents cost of manufactures, which is transferred to trading account.

This is debited with the production cost of goods completed during the accounting period:

It consists of

- Direct materials
- Direct labour
- Direct expenses
- Indirect manufacturing costs.

It also includes adjustments for work in progress (goods that are partly completed at the end of a period)

STEPS

1. Add opening stock of raw materials to purchases and subtract the stock of raw materials. This is to get the cost of materials used during the period.
2. Add in all the direct costs to get the prime costs
3. Add all the indirect manufacturing costs.
4. Add the opening stock of WIP and subtract the closing stock WIP to get the production cost of all goods completed in the period. This is because WIP cannot be sold and therefore should not be included in the trading account.
5. The manufacturing account when completed shows the total that is available for sale during the period
This will be used in trading account in place for purchases.

Final accounts of a manufacturer

1. Manufacturing accounts — used to determine the cost of production.
2. Income statement - Used to determine the gross profit on trading.
3. Statement of financial position

Treatments of loose materials

The cost of loose tools consumed during the year is considered as a factory overhead in the manufacturing account and is determined as follows:

	shs
Opening stock of loose tools	Xx
Add purchases of loose tools	<u>Xx</u>
	Xx
Less closing stock of loose tools	<u>Xx</u>
Cost of loose tools consumed	<u><u>Xx</u></u>

Manufacturing Accounts Format

XYZ Ltd manufacturing account for the year ended 20XX		
	Sh.	
Opening stock raw materials	xxx	
Add: purchased raw materials	xxx	
Carriage inwards (raw materials)	xxx	
Less: return outwards (raw materials)	(xxx)	
<i>Cost of materials available for production</i>		(xxx)
Less closing stock (R.M)		<u>x xx</u>
<i>Cost of raw materials used</i>		xxx
Add Direct labor		xxx
Direct expenses		<u>xxx</u>
Prime costs		xxx
Indirect Manufacturing cost		
Indirect labor	xxx	
Indirect expenses	xxx	
Heating expenses	xxx	
Lighting expenses	xxx	
Depreciation of factory equipment	xxx	
Depreciation of factory van	xxx	
Factory salaries/wages	xxx	
Factory rent	<u>xxx</u>	
Total indirect expense		Xxx
Add opening work in progress		Xxx
Less closing work in progress		(xxx)
Total Cost of production for goods completed		xxx
Manufacturing gross profit added		<u>xxx</u>
Finished goods at transferred price		<u><u>xxx</u></u>

The statement of comprehensive income will be similar to that of a sole proprietorship except for the following:

- The purchases will be replaced by finished goods at transfer price. This is because finished from manufacturing are now the ones being put up for sales.
- The opening stock to be used in the statement of comprehensive income is the opening stock of finished goods
- After obtaining gross profit we add the element of factory profit if we had marked up the goods before transferring them from the factory. If there was no transfer then this need not be done. This arises because once we marked them up; the costs of goods available for sale as well as cost of sales were increased by the element of profit and consequently reducing our gross profit.

XYZ Income statement for the year ended 31 December XX

	Sh.	Sh.
Sales		xxx
Less cost of goods sold		
Opening stock of finished goods	xxx	
Add production cost of goods completed b/f	<u>xxx</u>	
	xxx	
Less closing stock of finished goods	<u>xxx</u>	
Cost of Sales		<u>xxx</u>
Gross Profit		xxx
Less Expenses		
Office Rent	xxx	
Office Electricity	xxx	
Depreciation of office machinery	xxx	
Selling & distribution expenses	xxx	
Advertising	xxx	
Delivery Van expenses	xxx	
Carriage outwards	xxx	
Carriage Outwards	xxx	
Salesmen salaries	<u>xxx</u>	<u>xxx</u>
Net Profit /loss		<u>xxx</u>

Note:

Expenses should be appointed as follows:

Indirect manufacturing costs - charged in manufacturing account

Administrative expenses - Charged in the profit & loss account

Selling and distribution expenses - Charged in the profit & loss account

Financial charges - Charged in the profit & loss account

Treatment of manufacturing Profit

Manufacturing profit occurs where goods manufactured are transferred from factory to the warehouse at a higher value more than the cost of production i.e. the market value.

The difference between the market value and the cost of production is the manufacturing profit.

Manufacturing profit should be added to the cost of production in the manufacturing account so as to arrive at the market value of goods manufactured.

The market value of goods manufactured should take the place of purchases in the trading account.

The double entry for the manufacturing profit is:

DR Manufacturing Account

CR Profit and loss account.

Treatment of unrealized Profit

Unrealized Profit occurs where it is the policy of the firm to value stocks of finished goods at market value rather than at cost.

The difference between the market value and the cost of the finished goods is the unrealized profit.

The difference between the unrealized profit on the opening stock of finished goods and the unrealized profit on the closing stock of finished goods should be charged to the profit and account.

The provision for unrealized profit on the closing stock by the end of year should be subtracted from the market value of the finished goods in the balance sheet. (i.e. closing stock is stated at production cost on the statement of financial position)

Illustration:

Carol and Mary are in partnership sharing profits and losses equally. They make handbags under the brand name 'CARY'.

The partnership trial balance as at 31 December 2013 was as follows:

	Sh. "000"	Sh. "000"
Capital: Carol		24,000
Mary		24,000
Drawings: Carol	5,000	
Mary	4,800	
Land	15,200	
Factory building at cost	20,400	
Accumulated depreciation on factory building		15,370
Delivery vans at cost	8,100	
Accumulated depreciation on delivery vans		1,912
Inventory (1 January 2013):		
Raw materials	2,300	
Work in progress	2,210	

Finished goods (10,250 handbags at Sh.2,000 each)	20,500	
Sales		63,200
Returns inward	112	
Purchase of raw materials	14,590	
Tax		3,960
Factory wages	7,630	
Office salaries	2,500	
General expenses: Factory	7,730	
Office	9,470	
Plant at cost	17,220	
Accumulated depreciation on plant		5,870
Provision for unrealised profit (I January 2013)		2,050
Allowance for doubtful debts		770
Trade receivables and payables	10,680	2,640
Bank overdraft		4,670
	<u>148,442</u>	<u>148,442</u>

Additional information:

- During the year ended 31 December 2013. 16,727 handbags were transferred to the warehouse at a price of sh.2, 400 each.
- As at 31 December 2013, inventory was valued as follows:
 - Raw materials - Sh.1, 900,000
 - Work in progress - Sh.2, 880,000
 - Finished goods - Sh.17, 428,800
- All handbags are sold at Sh.3, 200 each.
- The allowance for doubtful debts is to be maintained at 5% of the trade receivables.
- Accrued general expenses as at 31 December 2013 were as follows:
 - Factory - Sh.1,748,000
 - Office - Sh.764, 000
- As at 31 December 2013, rent and rates were prepaid as follows:
 - Factory - Sh.104, 000
 - Office - Sh.80, 000
- Depreciation is to be provided on cost as follows:

Asset	Rate per annum
Factory building	2%
Plant	10%
Delivery vans	20%
- Carol is entitled to 25% of the manufacturing profit based on the transfer price to the warehouse, while Mary is entitled to 10% of the trading gross profit.
- No interest is credited or charged on capital accounts or drawings.

Required:

- (a) Manufacturing account for the year ended 31 December 2013.
- (b) Income statement of the year ended 31 December 2013
- (c) Statement of financial position as at 31 December 2013

Solution**a) Manufacturing account**

Carol and Mary Manufacturing Account for year ended 31st December 2013		
	Sh. "000"	Sh. "000"
Direct materials		
Opening inventory	2,300	
Purchases of raw materials	14,590	
Direct raw material for use	16,890	
Less: Closing inventory	(1,900)	
Direct raw material used		14,990
Indirect factory costs		
General expenses	9,478	
Factory wages	7,630	
Depreciation:		
Factory building	408	
Plant	1,722	
		<u>19,238</u>
Gross cost of production		34,228
Add: Work in progress at start		2,210
Less: Work in progress at end		(2,880)
Cost of production		33,558
Add: Manufacturing profit		<u>6,586.8</u>
Cost of goods transferred to warehouse (16,727 × 2,400)		<u><u>40,144.8</u></u>

b) Income Statement for the year ended 31 December 2013

Carol and Mary Income statement for the year ended 31st December 2013.		
	Sh. "000"	Sh. "000"
Sales		63,200.00
Less: Return inwards		<u>112.00</u>
		63,088.00
Less: Cost of sales		
Opening inventory	20,500.00	
Cost of finished goods	40,144.80	
Goods available for sale	60,644.80	
Less: Closing inventory	(17,428.80)	
		<u><u>43,216.00</u></u>

Gross profit		19,872.00
Other incomes		
Decrease in provision for doubtful debt		<u>236.00</u>
		20,108.00
Manufacturing profit		6,586.80
Less: Expenses		
General expense	10,234.00	
Depreciation: Delivery vans	1,620.00	
Office salaries	<u>2,500.00</u>	<u>(14,354.00)</u>
		12,340.80
Salary		
Carol 25% x 6,586.80	1,646.70	
Mary 10% x 19,872.00	<u>1,987.20</u>	<u>(3,633.90)</u>
		8,706.90
Share of profit		
Carol $\frac{1}{2}$ x 8,706.90	4,353.45	
Mary $\frac{1}{2}$ x 8,706.90	<u>4,353.45</u>	<u>8,706.90</u>
		<u>Nil</u>

c) Statement of Financial Position as at 31st December 2013

Carol and Mary Statement of Financial Position as at 31st December 2013			
Non-Current Asset	Cost Sh. '000'	Acc. Dep. Sh. '000'	N.B.V Sh. '000'
Fixed Assets			
Land	15,200	-	15,200
Factory building	20,400	15,778.00	4,622
Delivery van	8,100	3,532.00	4,568
Plant	17,220	7,592.00	<u>9,628</u>
			34,018
Current assets			
Inventory			
Raw materials		1,900.00	
Work in progress		2,880.00	
Finished goods	17,428.80		
Less: Provision for unrealised profits	<u>2,050.00</u>	15,378.80	
Trade receivables	10680.00		
Less: Provision for doubtful debt	<u>(534.00)</u>	10,146.00	<u>30,304.80</u>
Total assets			<u>64,322.80</u>
Capital and liabilities			
Capital: Carol	25,000.15		
Mary	<u>25,540.65</u>		50,540.80
Current Liabilities			
Trade payables	2,640.00		
Accruals	2,512.00		
Tax	3,960.00		
Bank Overdraft	<u>4,670.00</u>		<u>13,782.00</u>
			<u>64,322.80</u>

Workings**W1****Allowance for bad debts Account**

	Shs '000'		Shs '000'
Income statement	236	Balance b/d	770
Balance c/d (5% x 15680)	<u>534</u>		
	<u>770</u>		<u>770</u>

W2**General expenses Account (factory)**

	Shs '000'		Shs '000'
Bank	7,730	Income statement	9,478
Balance c/d	<u>1,748</u>		
	<u>9,478</u>		<u>9,478</u>

W3**General expenses Account (office)**

	Shs '000'		Shs '000'
Bank	9,470	Income statement	10,234
Balance c/d	<u>764</u>		
	<u>10,234</u>		<u>10,234</u>

W4**Sh '000'**

1. Factory building 2% x 20,400 = 408
2. Plant 10% x 17,220 = 1,722
3. Delivery Vans 20% x 8,100 = 1,620

W4**Partners Capital Accounts**

Details	Carol Shs '000'	Mary Shs '000'	Details	Carol Shs '000'	Mary Shs '000'
Drawings	5,000	4,800	Balance b/d	24,000	24,000
			Salary	1,646	1,987
Balance c/d	<u>25,000</u>	<u>25,540</u>	Share of profit	<u>4,353</u>	<u>4,353</u>
	<u>30,000</u>	<u>30,340</u>		<u>30,000</u>	<u>30,340</u>

REVISION EXERCISE**QUESTION 1**

Mboyamak limited manufacturer's firm implements. The following list of balances was extracted from the books of account of the company as at 31 December 2012

	Shs
Inventory as at 1 January 2012	
Raw materials	1,270,000
Work in progress	1,555,000
Finished goods	1,163,000
Purchase of raw materials	4,576,750
Carriage of raw materials	98,000
Direct labour	4,210,400
office salaries	1,670,950
Rent	260,000
Electricity (office)	221,000
Depreciation expense Machinery	510,000
Equipment (office)	115,000
Sales	15,931,100
Electricity (factory)	406,000

Additional information;-

1. Inventory as at 31 December 2012 was given as follows:-

	Shs
Raw materials	1,445,000
Work in progress	1,230,000
Finished goods	1,442,000

- Rent is to be apportioned between the factory and office in the ratio of 3:1
- Finished goods are transferred from factory to sales at mark up of 20%
- The values of opening and closing inventory are given at the transfer price

Required;-

- Manufacturing account for the year ended 31 December 2012
- Income statement for the year ended 31 December 2012

Solution:**a) Manufacturing account**

Mboyamak limited		
Manufacturing account for the period / year ended 31 December 2012		
Direct raw materials	Sh.	Sh.
Opening inventory	1,270,000	
Purchase of raw materials	4,576,750	
Carriage inwards	98,000	
Raw materials available for use	5,944,750	
Less: Closing inventory	<u>(1,445,000)</u>	
Direct raw materials used		4,499,750
Direct labour		4,210,400
Prime Cost		8,710,150
Indirect factory expenses		
Depreciation on machinery	510,000	
Electricity	406,000	
Rent ($\frac{3}{4} \times 260,000$)	<u>195,000</u>	<u>1,111,000</u>
Gross cost of production		9,821,150
Add work in progress at start		1,555,000
Less work in progress at end		<u>(1,230,000)</u>
Cost of finished goods		10,146,150
Add profit mark up 20%		<u>2,029,230</u>
Cost of finished goods transferred to trading		<u>12,175,380</u>

b) Income statement

Mboyamak Limited		
Income statement for the year ended 31 December 2012		
	Shs	Shs
Sales		15,931,100
Less Cost of sales		
Opening inventory	1,163,000	
Cost of finished goods transferred	12,175,380	
Cost of goods available for sale	13,338,380	
Less: Closing inventory	<u>(1,442,000)</u>	<u>(11,896,380)</u>
Gross profit		4,034,720
Less expenses		
Rent($\frac{1}{4} \times 260,000$)	65,000	
Depreciation on office equipment	115,000	
Office salaries	1,670,950	
Office Electricity	<u>221,000</u>	<u>(2,070,950)</u>
Net profit		<u>2,962,770</u>

QUESTION 2

Kate and Robert are in partnership as manufacturers of plastic bottles. Kate is responsible for the factory operations and Robert is responsible for sales.

The following trial balance was extracted from their books as at 30 September 2012:

	Shs	Shs
Capital accounts:		
Kate		4,000,000
Robert		5,000,000
Drawings:		
Kate	950,000	
Robert	800,000	
Land at cost	3,000,000	
Factory building at cost	4,000,000	
Plant at cost	3,000,000	
Motor vehicles at cost	800,000	
Provision for depreciation (1 October 2011):		
Factory building		1,500,000
Plant		800,000
Motor vehicles		160,000
Inventory(1 October 2011):		
Raw materials	400,000	
Work-in-progress	420,000	
Finished goods	5,000,000	
Sales		12,000,000
Returns inward	140,000	
Purchase of raw materials	2,900,000	
Factory wages	1,650,000	
Office salaries	480,000	
General expenses:		
Factory	1,250,000	
Administrative	1,400,000	
Allowance for doubtful debts		190,000
Trade receivables and payables	2,170,000	550,000
Bank balance	500,000	
Interest free loan		4,660,000
	28,860,000	28,860,000

Additional information:

1. Inventory as at 30 September 2012 was valued as follows:

	Shs
Raw materials	340,000
Work-in-progress	530,000
Finished goods	4,600,000

2. 370,000 plastic bottles were transferred at Sh.20 each from the factory to the warehouse during the year.
3. Allowance for doubtful debts is to be adjusted to 10% of trade receivables as at 30 September 2012.
4. Accrued general expenses as at 30 September 2012 were as follows:
5. Pre-paid rates as at 30 September 2012 were as follows:

	Sh.
Factory	20,000
Administrative	12,000

6. Depreciation for the year is to be provided on cost as follows:

Asset	Rate per annum
Factory building	2%
Plant	10%
Motor vehicles	15%

7. Kate is credited with one-third of the manufacturing profit while Robert is credited with 10% of the trading gross profit.
8. The net profit or loss is shared by Kate and Robert in the ratio 3:2 respectively.
9. No interest is credited or charged on capital accounts or drawings.

Required;

- a) Manufacturing account for the year ended 30 September 2012.
- b) Income statement for the year ended 30 September 2012.
- c) Statement of financial position as at 30 September 2012.

Solution:

a) Manufacturing account

Kate and Robert Manufacturing Account For the year ended 30th September 2012

Prime Costs	Shs	Shs	Shs
Cost of raw materials used			
Opening stock of raw materials		400,000	
Add: Purchases		2,900,000	
Cost of raw materials available		3,300,000	
Less: Closing stock of raw materials		<u>(340,000)</u>	
Cost of materials used			2,960,000
Direct Labour			
Factory wages			1,650,000
Total Prime cost			4,610,000
Factory Overheads			
General expenses	1,250,000		

Add: Accrued	300,000		
Less: Prepaid	<u>(20,000)</u>	1,530,000	
Depreciation factory building		80,000	
Depreciation Plant		<u>300,000</u>	
Total factory overheads			<u>1,910,000</u>
Total production cost			6,520,000
Add: Work in progress (opening)			420,000
Less: Work in progress (closing)			<u>(530,000)</u>
Cost of goods manufactured			6,410,000
Add: Factory profit			<u>990,000</u>
Transfer value of Goods manufactured			<u>7,400,000</u>

b) Income statement

Kate and Robert Income statement
For the year ended 30th September 2012

	Shs	Shs	Shs
Sales			12,000,000
Less: Return inwards			140,000
Net sales			11,860,000
Less: cost of goods sold			
Opening stock of finished goods		5,000,000	
Add: Cost of goods manufactured goods		7,400,000	
Less: Closing stock of finished goods		<u>(4,600,000)</u>	
Cost of goods			<u>(7,800,000)</u>
Gross profit			4,060,000
Add: Other incomes			
Factory profit			990,000
Increase in provision for bad debts(w1)			<u>(27,000)</u>
Total Income			5,023,000
Less: Administration expenses			
General administrative expenses	1,400,000		
Add: Accrued	320,000		
Less; Prepaid	<u>(12,000)</u>	1,708,000	
Office salaries		480,000	
Depreciation on motor vehicles		<u>120,000</u>	<u>(2,308,000)</u>
Net profit for the year			2,715,000
Entitlements: Kate ($\frac{1}{3} \times 990,000$)		330,000	
Robert ($10\% \times 4,060,000$)		<u>406,000</u>	<u>(736,000)</u>
Profit			<u>1,979,000</u>
Share of profit: Kate $\frac{3}{5} \times 1,979,000$			1,187,400
Robert $\frac{2}{5} \times 1,979,000$			<u>791,600</u>
			<u>1,979,000</u>

c) Statement of financial position

Kate and Robert Balance Sheet
As at 31st September 2012

Non-current Assets	Sh. '000' Cost	Sh. '000' Acc. Dep	Sh. '000' NBV
Land	3,000	-	3,000
Factory & buildings	4,000	1,580	2,420
Plant	3,000	1,100	1,900
Motor Vehicles	<u>800</u>	<u>280</u>	<u>520</u>
	<u>10,800</u>	<u>2,960</u>	<u>7,840</u>
Current Assets			
Stock:			
Raw materials		340	
Work in progress		530	
Finished goods		4,600	
Accounts receivable (w2)		1,953	
Prepaid expenses		32	
Bank		<u>500</u>	<u>7,955</u>
			<u>15,795</u>
Financed by:-			
Capital: (w3)			
Kate		4,567.4	
Robert		<u>5,397.6</u>	9,965
Non-current liabilities			
Interest free loan			4,660
Current Liabilities		550	
Creditors		620	
Accrued expenses			<u>1,170</u>
			<u>15,795</u>

Workings**W1**

Provision for bad debts account $10\% \times 2,170,000 = \text{shs. } 217,000$

Allowance for doubtful debts Account

	Shs		Shs
	-	Balance b/d	190,000
Balance c/d	<u>217,000</u>	Income statement	<u>27,000</u>
	<u>217,000</u>		<u>217,000</u>

W2

Accounts receivable Account

	Shs		Shs
Balance c/d	2,170,000	Allowance for doubtful debts	217,000
		Income statement	<u>1,953,000</u>
	<u>2,170,000</u>		<u>2,170,000</u>

W3

Partners Capital Accounts

Details	Kate Shs '000'	Robert Shs '000'	Details	Kate Shs '000'	Robert Shs '000'
Drawings	950.00	800.00	Balance b/d	4,000.00	5,000.00
			Salary	330.00	406.00
Balance c/d	<u>4,567.40</u>	<u>5,397.60</u>	Share of profit	<u>1,187.40</u>	<u>791.60</u>
	<u>5,517.40</u>	<u>6,197.60</u>		<u>5,517.40</u>	<u>6,197.60</u>

W4

Depreciation

Factory building = $2\% \times 4,000,000 = \text{shs } 80,000$

Plant $10\% \times 3,000,000 = \text{shs } 300,000$

Motor vehicles $15\% \times 800,000 = \text{shs. } 120,000$

TOPIC 9

FINANCIAL STATEMENTS OF A NOT FOR PROFIT MAKING ORGANIZATION

INTRODUCTION

Non for profit organization or non-trading organization are those organizations which are established not for earning profits but for promoting art, culture, sports, education etc. Medical institution, Charitable trusts, welfare societies, educational institutions etc. are examples of non-trading organizations

The final accounts of non-trading organizations include the following:

1. Receipts and payment account
2. Income and expenditure account
3. Statement of financial position

Their main not for profit organizations prepare financial statements is to know:

- i. Whether their current incomes are sufficient to meet current expenses
- ii. What their financial position is at the end of each period.

Therefore, they prepare an account each. year called Income and Expenditure Account, setting out all incomes (or revenue receipts) on the credit side (Cr.) and all revenue expenses on the debit side (Dr.).

TYPES OF FUNDS AND THEIR ACCOUNTING TREATMENT

1) Subscription

It is a recurring income for nonprofit organizations. This is one of the main sources of revenue. This is shown on the credit side of income and expenditure account. Adjustment should be made to show the correct income for the period.

Subscription received for certain specific purpose like subscription for tournament fund, subscription for construction of pavilion etc. should be capitalized (that is shown on the liability side of the balance sheet)

2) Donations

The amount received from a person, firm or company by way of gift is called a donation. Donations may be specific donation or general donations.

a) Specific donations

If the donations are for a specific purpose, example donation for building, donation for library, donation for furniture etc. it must be treated as capital receipts and should be shown on the liability side of the balance sheet. The expenditure incurred on this account should be deducted and the balance should be shown until it is completely used up.

b) General donations

When the donations are given for a general purpose, it is the amount which will determine whether it is a capital or revenue receipts. Donation of a comparatively small amount must be treated as income, But if the amount of such donation is big, it must be treated as capital receipts and it should be shown on the liability side of the balance sheet.

3) Grants

Grant received from central, state or local bodies for routine expenses are treated as income. Grant for specific purpose such as constructions of buildings, purchase of x-ray equipment's Etc. is capitalized

4) Legacy

It is the amount received by the nonprofit organizations as per the will of a deceased person. It is a capital receipt and is shown on the liability side of the balance sheet, but if the amount is small it may be treated as income and may be shown on the credit side income and expenditure account.

In the absence of any specific information legacy must be preferably be capitalized.

5) Endowment fund

The fund meant for permanent means of support is known as endowment fund. It is a capital receipt

6) Entrance fees

This is the amount of fee collected on the admission or members. Accountants differ on the treatment of entrance fees. Many feel that since the amount is collected only once and as it is a non-recurring in nature it should be capitalized and taken to the liability side of the balance sheet but others argue that though it is paid by each member only once, the clerk or institution receives fairly regularly every year because of regular entrance of members. So it should be shown as an income in the credit side of income and expenditure account. In the absence of specific instruction in the question, students may treat it any way but they must append a note justifying the choice made.

7) Sale of old assets

The amount realized from the sale of old assets should be treated as capital receipts and should be credited to asset account. But loss or profit on its sales should be treated as revenue and is taken to income and expenditure account:

8) Sale Of newspapers and periodicals etc.

The amount received on selling newspapers, periodicals, etc. should be treated as income and is credited to income and expenditure account

9) Expenditure stock items

Items like stationery sports, materials like bats balls etc. are called expenditure stock items the value of that type Of items which remains Unused should be deducted from the total amount spent so that only the amount 'actually used up is debited to income and expenditure account vrrroat.ment is as follows:

Stock of Stationery (opening)	<u>xxx</u>
Add purchase during the year	<u>xxx</u>
	xxx (balance sheet (asset Side)
Less stock of stationery (closing)	<u>xxx</u>
Stationery item used during the year	<u>xxx</u> (debited in the I and E account)

10) Sale of scraps, grass etc.

These are treated as revenue receipts and shown on the income side

11) Life membership fee

.life membership may, sometime, be granted to members on their making a lump sum payment in lieu of annual subscription. As the service has to be rendered for a long time without further payment; it must he treated as capital receipts and should be capitalized.

12) Payment of honorarium

Amount paid to a person for the specific service rendered by him is called honorarium. For example payment made to singers, dancers etc. is shown on the expenditure side

13) Special purpose fund

If there is any special purpose fund example tournament fund, charity fund, prize fund, endowment fund etc. and there are certain items of-expenses and incomes relating to that fund. Then income and expenses should not be shown in the income and expenditure account but income should be added to Ike fund and expenses deducted from such fund on the liability side of the balance sheet

RECEIPT AND PAYMENT ACCOUNT:

"A **receipt and payment account** is a summarized cash book (cash and bank) for a given period".

or

"This is simply a summary of the cash transactions as in the cash book, analyzed and classified under suitable headings, including the opening and closing balances".

Non-profit organizations (also called non-trading concerns) prepare a receipt and payment account at the end of year. With the help of this account and some additional information, an income and expenditure account is prepared to disclose the true results of non-profit organizations. Receipt and payment account cannot disclose the true result of non-trading concern.

All the information necessary for the preparation of this account is available from cash book. Various cash receipts and cash payments during the whole year find place in this account in a classified manner. Its closing balance indicates cash in hand and cash at bank at the year end.

Characteristics of Receipt and Payment Account:

Following are the features of receipt and payment account:

1. It is abridged addition of cash book - it is, in effect, a summary of cash book.
2. All cash receipts during the whole year are recorded on its left hand (i.e., debit) side. While all the cash payments during the whole year written on its right hand (i.e., credit) side, arranged in a classified form.
3. Cash receipts and cash payments of both capital and revenue nature are recorded here.
4. Only cash transactions are recorded in this account.
5. It generally shows a debit balance. In case of bank overdraft balance, however, its net balance may be credit. Again, it may also show nil balance but such occasion is rare.
6. Its closing balance indicates closing cash in hand and closing cash at bank.
7. It is not an account within the double entry system - it is a statement only.
8. It is prepared on the last day of the accounting year.

Advantages:

The following are the advantages of receipt and payment account:

1. Total receipts and total payments under various heads are available at a glance.
2. The amount of cash in hand at the year end can be ascertained.
3. The correctness of cash book can be verified through it. The total of debit side of cash book will agree with the total of receipt side of this account. On the other hand, the total of credit side of cash book will agree with that of payment of this account.

Method of Preparation:

Receipts and payment account is prepared with all the cash receipts and cash payments of the whole year. The net result of cash receipts and cash payments of a fixed time is determined through this account. So its heading will be:

Receipt and Payment Account For the Year Ended 31.12.2005

Its left hand side is called "Receipts" and right hand side "payments". On the left hand side all cash receipts are recorded, while on the right hand side all cash payments are recorded arranged in a classified form. It starts with last year's closing cash in hand and cash at bank and closes with current year's closing cash in hand and cash at bank. In other words, its opening balance indicates last year's closing cash in hand and cash at bank, while its closing balance means current year's closing cash in hand and cash at bank.

Example:

From the following cash book prepare receipts and payments account for the year ended 31 December 2005.

Cash Book

Date	References	Amount	Date	References	Amount
2005			2005		
Jan. 1	Balance b/d	250	Jan. 5	Rent	200
Feb. 2	Subscription	600	Jan. 16	Traveling expenses	15
Mar. 10	Admission fee	25	Fed. 12	Salaries	250
Apr. 5	Subscription	950	Mar. 17	Entertainment expenses	50
May 20	Sale of old newspapers	10	Apr. 20	Electric charges	20
June 3	Subscription	880	May 5	Furniture	300
July 15	Admission fee	30	May 10	Postage	18
Aug. 20	Sale of old newspaper	15	June 3	Stationary	120
Sep. 5	Donation	100	July 12	Electric charges	30
Oct. 1	Sale of old furniture	150	Aug. 3	Newspaper	25
Nov. 15	Donation	50	Sep. 15	Salaries	320
Dec. 28	Subscription	250	Sep. 20	Newspaper	65
			Oct. 3	Traveling expenses	25

			Oct. 12	Postage	12
			Nov. 5	Rent	300
			Nov. 16	Entertainment expenses	80
			Dec. 5	Books	450
			Dec. 12	Salaries	350
			Dec. 25	Rent	130
			Dec. 31	Balance c/d	550
		_____			_____
		3,310			3,310
		_____			_____
2006					
Jan. 1		550			

Solution:

ABC Club
Receipt and Payment Account
For the year ended 31st December, 2005

Receipts	\$	Payments	\$
Balance b/d	250	Rent [200+300+130]	630
Subscription [600+950+880+250]	2,680	Traveling expenses [15+25]	40
Admission fee [25+30]	55	Salaries [250+320+350]	920
Sale of old newspaper [10+15]	25	Entertainment expenses [50+80]	130
Donation [100+50]	150	Electric charges [20+30]	50
Sale of old furniture	150	Furniture [200+300+130]	300
		Postage [18+12]	30
		Stationary	120
		Newspaper [25+65]	90
		Books	450
		Balance c/d	550
	_____		_____
	3,310		3,310
	_____		_____
Balance b/d	550		

INCOME AND EXPENDITURE ACCOUNT

It is a revenue account prepared by a nonprofit organization to ascertain surplus or deficit for a particular period. It is a nominal account. In this account only revenue receipts and revenue expenses are recorded. All revenue expenses of the current year are recorded on the debit side and revenue incomes of the current year are recorded on the credit side, the difference between incomes and expenditure represents surplus or deficit.

The comparison of the two sides shows whether or not current expenses are being met out of current income. The principles for preparing this account are exactly the same as for Trading and Profit and Loss Account.

That means that the matching principle is followed, meaning thereby that:

- No item of capital nature is included in this account but all revenue items are entered.
- Expenses and income should relate only to the year concerned (that is, items relating to the past or, future will be excluded)
- The whole of the incomes or expenses, even if some amounts are outstanding, should be included.

STATEMENT OF FINANCIAL POSITION

Statement of financial position contains assets and liabilities. Assets or capital expenditure, outstanding incomes prepaid expenses etc. are shown on the asset side. Capital receipts or liabilities. capital fund, outstanding expenses, incomes received in advance are shown on the liability side of the balance sheet; generally surplus is shown-by adding it to the capital fund.

Illustration:

The following is the summary of the cashbook of Mbedodo Football Club for the year ended 30 June 2011:

Receipts	Sh. '000'	Payments	Sh. '000'
Bank balance (1 July 2010)	2,340	Casual wages	7,200
Members subscription	49,850	Bar supplies	42,300
Entrance fees	32,060	Rates	1,200
Bar sales	60,840	Rent	24,600
Competition receipts	25,820	Secretary's basic salary	18,000
		Lighting and water	5,040
		Competition prizes	14,400
		Stationery and postage	3,840
		Repairs to gymnasium	3,300
		Ground upkeep	4,500
		Bar manager's salary	5,400
		Deposit with SACCO	35,000
		Bank balance	<u>6,130</u>
	<u>170,910</u>		<u>170,910</u>

Additional information:

1. The assets of the club on 1 July 2010 were as follows:

	Sh. '000'
Land	650,00
Gymnasium and equipment	250,00
Bar inventory	10,800
Prizes in hand	4,800

2. Bar supplies owing amounted to Sh. 4,200,000 on 1 July 2010
3. On 30 June 2011 the bar inventory was Sh. 9,600,000, prizes in hand - Sh. 2,400,00 and Sh. 5,640,000 was owing for bar supplies.
4. The secretary is to receive a leave allowance of 5% of his basic salary. It was also agreed that the bar manager should receive a Sh. 500,000 bonus for increased sales during the year.
5. From the register of members, it appeared that unpaid subscriptions as at 30 June 2011 totaled Sh. 5,100,000. Subscriptions received during the year included Sh. 2,550,000 in respect of the previous year and Sh. 1,700,000 in respect of the year starting 1 July 2011.
6. Interest earned on the deposit with the SACCO for the year ended 30 June 2011 amounted to Sh. 1,750,000
7. The rent paid was for fifteen months up to 30th September 2011
8. The gymnasium and equipment are to be depreciated at the rate of 10% per annum on straight line basis

Required:-

- a) Income and expenditure account for the year ended 30 June 2011
- b) Statement of financial position as at 30 June 2011

Solution:

- a) Income and expenditure account

Mbedodo		
Income and expenditure account for the year ended 30 June 2011		
Incomes	Sh '000'	Sh. '000
Profit from trading/ bar profit(w2)		10,000
Subscriptions(w3)		50,700
Interests earned		1,750
Entrance fees		32,060
Competition receipts		<u>25,820</u>
		120,330
Expenses		
Prizes given	2,400	
Leave allowance	900	
Basic salary	18,000	
Competition prizes	14,400	

Rent (W4)	19,680	
Depreciation gym equipment	25,000	
Casual wages	7,200	
Rates	1,200	
Lighting & water	5,040	
Stationery & postage	3,840	
Repairs to gym	3,300	
Ground upkeep	<u>4,500</u>	<u>(105,460)</u>
Surplus		<u>14,870</u>

b) Statement of financial position

Mbedodo Statement of financial position as at 30 June 2011	
Non-current assets	Sh. '000'
Land	650,000
Gym & equipment (w7)	<u>225,000</u>
	875,000
Current assets	
Subscriptions Accrued	5,100
Bar inventory	9,600
Prices in land	2,400
SACCO	35,000
Bank	6,130
Prepaid rent	4,920
Interest receivable	<u>1,750</u>
Total assets	<u>939,900</u>
Financed by:	
Accumulated fund (w6)	916,290
Surplus	14,870
Current liabilities	
Leave allowance	900
Bar manager bonus	500
Bar surplus	5,640
Prepaid subscriptions	<u>1,700</u>
Total capital liabilities	<u>939,900</u>

Workings

W1 Depreciation gym equipment = $(10\% \times 250,000) = \text{Shs. } 25,000$

W2

Bar Trading Profit & Loss a/c		
	Shs. '000'	Shs. '000'
Bar sales		60,840
Cost of sales		
Opening inventory	10,800	
Bar purchases	43,740	
Closing bar inventory	<u>(9,600)</u>	<u>(44,940)</u>
Gross profit		15,900
Bonus to manager	500	
Bar manager's salary	<u>5,400</u>	<u>5,900</u>
		<u>10,000</u>

W3

Subscription Account

	Shs '000'		Shs '000'
Balance b/d	2,550	Cash	49,850
Income and expenditure	50,700	Accrued	5,100
Prepaid c/d	<u>1,700</u>		
	<u>54,950</u>		<u>54,950</u>

W4

Prizes in land Account

	Shs'000'		Shs'000'
Cashbook	24,600	Income statement	19,680
		Prepaid c/d	<u>4,920</u>
	<u>24,600</u>		<u>24,600</u>

W5

Rent Account

	Shs'000'		Shs'000'
Balance b/d	4,800	Income statement	2,400
		Prepaid c/d	<u>2,400</u>
	<u>4,800</u>		<u>4,800</u>

W6

Statement of affairs

	Dr. Shs. '000'	Cr. Shs. '000'
Land	650,000	
Property & equipment	250,000	
Bar inv.	10,800	
Prices in land	4,800	
Subscriptions	2,550	
Bank balance	2,340	
Bar supplies accrued	-	4,200
Accumulated fund	-	<u>916,290</u>
	<u>920,490</u>	<u>920,490</u>

W7

Gym Equipment Account

	Shs '000'		Shs '000'
Balance b/d	250,000	Depreciation	25,000
		Balance c/d	225,000
	<u>250,000</u>		<u>250,000</u>

REVISION EXERCISE**QUESTION 1**

The following are the balances of assets and liabilities extracted from the books of Jenga Afya Sports Club as at 30 June 2012 and 30 June 2013:

	2012 Shs'000'	2013 Shs'000'
Sports pavilion at cost	10,000	10,000
Gym equipment at cost	6,000	?
Furniture and fittings at cost	4,000	?
Accumulated depreciation:		
Gym equipment	1,400	?
Furniture and fittings	1,200	?
Subscriptions received in advance	600	1,800
Subscriptions in arrears	1,200	1,500
Coach's fees outstanding	400	500
Restaurant payables	500	600
Pre-paid electricity	125	150
Restaurant inventory	1,100	1,900

The club's receipts and payments for the year ended 30 June 2013 were as follows:

	Sh. '000'
Receipts	
Cash balance:	
Cash in hand	2,400
Bank balance	1,650
Subscriptions	12,000
Restaurant sales	6,250
Gym services income	6,200
Sale of gym equipment	400
Payments	
Restaurant purchases	4,250
Electricity bills	400
Restaurant wages	1,360
Coach's fees	3,100
Honoraria to secretary	4,600

Club maintenance expenses	200
Travelling expenses	420
Purchase of gym equipment	3,000
Purchase of furniture and fittings	1,100
Gym expenses	1,500
Salaries and wages	1,470
Purchase of office computers	1,000
Cash balance - Cash in hand	1,500
Bank balance	5,000

Additional information:

1. Goods worth Sh.75, 000 from the restaurant were consumed by members of staff during the year ended 30 June 2013, but were not paid for.
2. Depreciation is to be provided on cost of existing assets as follows:

Asset	Rate per annum
Gym equipment	15%
Furniture and fittings	10%
Sports pavilion	5%
Office computers	20%

3. Depreciation on furniture and fittings is to be apportioned between restaurant and office at 40% and 60% respectively.
4. 10% of the subscriptions in arrears at the beginning of the year were not received by the end of the financial year. The management decided to write them off.
5. Gym equipment sold during the year had a cost of Sh. 1,000,000 and had been used for 3 years.

Required:

- a) The restaurant income statement for the year ended 30 June 2013,
- b) The income and expenditure account for the year ended 30 June 2013.
- c) Statement of financial position as at 30 June 2013.

Solution**a) Restaurant income statement****Restaurant trading account**

	Sh. '000'	Sh. '000'
Restaurant takings		6,250
Cost of sales		
Opening stock	1,100	
Purchases	4,275	
Goods available for sale	5,375	
Less closing stock	<u>1,900</u>	<u>(3,475)</u>
		2,775
Less expenses		
Restaurant wages	1,360	
Depreciation on Furniture and fittings	204	<u>(1,564)</u>
Net profit		<u><u>1,211</u></u>

b) Income and expenditure account

Jenga afya spors club
Income and expenditure account
For the year ended June 2013

	Sh '000'		Sh '000'
Loss on sale of equipment	150	Profit from restaurant	1,211
Depreciation		Subscriptions	11,220
Gym equipment	1,200	Gym service income	6,200
Furniture and fittings	306		
Sports pavilion	500		
Office computer	200		
Bad debt written off	120		
Electricity	375		
Coach fees	3,200		
Honoraria to secretary	4,600		
Club maintenance expense	20		
Gym expense	1,500		
Travelling expenses	420		
Salary and wages	1,470		
Surplus	<u>4,390</u>		
	<u><u>18,631</u></u>		<u><u>18,631</u></u>

c) Statement of financial position

Jenga afya spors club
Income and expenditure account
For the year ended June 2013

	Cost Sh '000'	Acc. Dep. Sh '000'	NBV Sh '000'
Non-current assets			
Sports pavilion	10,000	500	9,500
Gym equipment	8,000	2,150	5,850
Furniture and fittings	5,100	1,710	3,390
Computers	<u>1,000</u>	<u>200</u>	<u>800</u>
	<u>24,100</u>	<u>4,560</u>	<u>19,540</u>
Current assets			
Inventory	1,900		
Subscription in arrears	1,500		
Prepaid electricity	150		
Cash in hand	1,500		
Cash at bank	<u>5,000</u>		<u>10,050</u>
			<u>29,590</u>
Capital and liabilities			
Accumulated fund			22,375
Surplus			4,390
Less drawings			<u>(75)</u>
			26,690
Current liabilities			
Payables	600		
Subscription in advance	1,800		
Accrued coach fee	<u>500</u>		<u>2,900</u>
			<u>29,590</u>

Workings**W1****Accounts payable control Account**

	Shs'000'		Shs '000'
Restaurant payables	4,250	Balance b/d	500
Balance c/d	<u>600</u>	Credit purchases	<u>4,350</u>
	<u>4,850</u>		<u>4,850</u>

W2**Subscription Account**

	Shs'000'		Shs '000'
Balance b/d	1,200	Balance b/d	500
Income and expenditure	11,220	Bank/Cash	12,000
Balance c/d	<u>1,800</u>	Bad debts w/off	120
	<u>14,220</u>	Balance c/d	<u>4,350</u>
			<u>14,220</u>

W3

Gym Equipment Account

	Shs'000'		Shs '000'
Balance c/d	6,000	Disposal	1,000
Bank	<u>3,000</u>	Balance c/d	<u>8,000</u>
	<u>9,000</u>		<u>9,000</u>

W4

Gym Equipment Disposal Account

	Shs'000'		Shs '000'
Gym equipment	6,000	Cash	400
		Depreciation	450
		Loss	<u>150</u>
	<u>1,000</u>		<u>1,000</u>

W5

Trial Balance as at 1 July 2012

	Dr. Shs'000'	Cr. Shs'000'
Sports pavilion	10,000	-
Gym equipment	6,000	-
Furniture and fittings	4,000	-
Accumulated depreciation	-	1,400
Gym equipment	-	1,200
Furniture and fittings	-	600
Subscriptions received in advance	-	-
Subscriptions in arrears	1,200	400
Coaches fees outstanding	-	500
Restaurant payables	-	125
Prepaid electricity	125	-
Restaurant inventory	1,100	-
Cash in hand	2,400	-
Cash at bank	1,650	-
Accumulated fund	-	<u>22,375</u>
	<u>26,475</u>	<u>26,475</u>

W6

Electricity Account

	Shs'000'		Shs '000'
Balance b/d	125	Income statement	375
Cash	<u>400</u>	Balance c/d	<u>150</u>
	<u>525</u>		<u>525</u>

W7

Coach's fee Account

	Shs'000'		Shs '000'
Cash	3,100	Balance b/d	400
Balance b/d	<u>500</u>	Income statement	<u>3,200</u>
	<u>3,600</u>		<u>3,600</u>

QUESTION 2

The following is the income and expenditure account for Uzima Charitable Hospital for the year ended 31 July 2012:

Expenditure	Sh.	Income	Sh.
Medicine used	5,996,000	Subscriptions	11,200,000
Honoraria to doctors	2,400,000	Donations	1,900,000
Salaries	5,500,000	Income from annual walk	2,200,000
Electricity and water	95,000	Income from film show	2,290,000
Rent	1,200,000		
Depreciation:			
- Furniture and fixtures	420,000		
- Equipment	650,000		
Film show expenses	56,000		
Annual walk expenses	100,000		
Printing expenses	220,000		
Surplus	<u>953,000</u>		
	<u>17,590,000</u>		<u>17,590,000</u>

Additional information:

	1 August 2011	31 July 2012
Subscriptions due	14,000	32,000
Subscription received in advance	12,800	20,000
Electricity and water bills	18,400	23,000
Furniture and fixtures at net book value	4,200,000	3,780,000
Equipment at net book value	2,320,000	2,780,000
Land	-	2,000,000
Cash balance	68,000	32,000
Bank balance	1,800,000	?
Stock of medicine	1,564,000	1,950,000

Required:

- Subscriptions account for the year ended 31 July 2012.
- Receipts and payments account for the year ended 31 July 2012.
- Statement of financial position as at 31 July 2012.

Solution:**a) Subscriptions account for the year ended 31 July 2012****Subscription Account**

	Shs		Shs
Balance b/d	24,000	Balance b/d	12,800
Subscription income	11,200,800	Cash received	11,200,000
Balance c/d	<u>20,000</u>	Balance c/d	<u>32,000</u>
	<u>11,244,800</u>		<u>11,244,800</u>

b) Receipts and payments account

Receipts and payment Account For the year ended 31 July 2012			
	Sh.		Sh.
Bank b/d	1,800,000	Medicine purchased	6,382,000
Cash b/d	68,000	Honoraria to doctor	2,400,000
Subscription received	11,199,200	Salaries	5,500,000
Donation	1,900,000	Electricity and water (w3)	90,400
Annual walk	2,200,000	Rent	1,200,000
Film show	2,290,000	Film show expenses	56,000
		Annual walk expenses	100,000
		Printing expenses	220,000
		Land	2,000,000
		Equipment(w2)	1,110,000
		Cash c/d	32,000
		Bank	<u>366,800</u>
	<u>19,457,200</u>		<u>19,457,200</u>

c) Statement of financial position as at 31 July 2012

Statement of financial position As at 31 July 2012		
Non-Current assets	shs	shs
Land		2,000,000
Equipment		2,780,000
Fixtures and fittings		<u>3,780,000</u>
		8,560,000
Current Assets		
Stock of medicine	1,950,000	
Acc. Subscription	32,000	
Bank	366,800	
Cash	<u>32,000</u>	
		<u>2,380,800</u>
		<u>10,940,800</u>
Financed by:-		
Accumulated Fund b/d (w4)	9,944,800	
Surplus	<u>953,000</u>	10,897,800

Current Liabilities		
Accrued Electricity	23,000	
Subsidiary in adv.	<u>20,000</u>	<u>43,000</u>
		<u>10,940,800</u>

Workings**W1****Medicine Account**

	Shs		Shs
Balance b/d	1,564,000	Used medicine	5,996,000
Cash	<u>6,382,000</u>	Balance c/d	<u>1,950,000</u>
	<u>7,946,000</u>		<u>7,946,000</u>

W2**Equipment Account**

	Shs		Shs
Balance b/d	2,320,000	Depreciation	650,000
Cash	<u>1,110,000</u>	Balance c/d	<u>2,780,000</u>
	<u>3,430,000</u>		<u>3,430,000</u>

W3**Electricity and water Account**

	Shs		Shs
Receipts and payments	90,400	Balance b/d	18,400
Balance	<u>23,000</u>	Income and expenditure	<u>95,000</u>
	<u>113,400</u>		<u>113,400</u>

W3**Accumulated fund working**

	Shs
Assets	
Fixtures and fittings	4,200,000
Equipment	2,320,000
Cash	68,000
Bank	1,800,000
Stock	1,564,000
Accrued Subscriptions	<u>24,000</u>
	<u>9,976,000</u>
Liabilities	
Subscriptions in advance	12,800
Accrued Electricity	18,400
Accumulated fund	<u>9,944,800</u>
	<u>9,976,000</u>

TOPIC 10**ANALYZING FINANCIAL STATEMENTS****STATEMENT OF CASH FLOW****Definition**

"A statement of changes in the financial position of a firm on cash basis is called a cash flow statement."

The statement of cash flow describes the inflow (sources) & outflow (uses) of cash. It summarizes the causes of changes in cash position of a business enterprise between two balance sheets.

CATEGORIES OF CASH

1. Cash flows from operating activities
2. Cash flows from investing activities
3. Cash flows from financing activities

Cash flows from Operating Activities

Operating activities are the basic revenue producing activities of the enterprise. The amount of cash flows arising from operating activities is an indicator of a firm's operating capability to generate sufficient funds to meet its operating needs, pay dividends, repay loans, etc. without depending on external sources of finance.

Examples of cash flow from operating activities

1. Cash receipts from sale of goods & rendering of services
2. Cash receipts from royalties, fees, commissions, etc
3. Cash payment to suppliers of goods & services
4. Cash payment to & on behalf of employees
5. Cash receipts & payments of an insurance company for premiums, claims, annuities and other policy benefits
6. Cash payments or refunds of income tax relating to operating activities
7. Cash receipts and payments from contracts held for dealing or trading purposes.

Cash flows from Investing Activities

Investing activities are the acquisition & disposal of long term assets & investments. A separate disclosure of cash flows arising from investing activities is important because cash flows represent the extent to which expenditure have been made for resources to generate future incomes.

Examples of cash flow from investing activities

1. Cash payments to acquire fixed assets (including intangibles).
2. Cash receipts from disposal of fixed assets (including intangibles)
3. Cash receipts from disposal of shares, warrants, debt instruments, etc
4. Cash advances & loans made to third parties.
5. Cash receipts from the repayment of advances & loans made to third parties.

Cash flows from financing Activities

Financing activities are activities that result in changes in the size & composition of the owners' capital (including preference share capital in the case of a company) & borrowings of the enterprise.

Examples of cash flows from financing activities

- 1) Cash proceeds from issuing shares or other similar instruments
- 2) Cash proceeds from issuing debentures, loans, bonds & other short or long term borrowings
- 3) Cash repayments of amounts borrowed such as redemption of debentures, bonds, preference shares.

METHODS OF PREPARING STATEMENTS OF CASH FLOW

An enterprise should report cash flow from operating activities using either:

- The direct method, whereby major classes of gross cash payments are disclosed ;or
- The indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

DIRECT METHOD

Enterprises are encouraged to report cash flows from operating activities using the direct method. Under the direct method information about major classes of gross cash receipts and gross cash payments may be obtained either:

- a. From the accounting records of the enterprise; or
- b. By adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the income statement for:
 - i. Changes during the period in inventories and operating receivables and payables
 - ii. Other non-cash items and
 - iii. Other items for which the cash effects are investing or financing cash flows.

INDIRECT METHOD

Under the indirect method, the net cash flow from operating activities is determined by adjusting a net profit or loss for the effects of:

- a. Changes during the period in inventories and operating activities receivables and payables
- b. Non-cash items such as depreciation, provisions, deferred taxes, unrealized minority interest
- c. All other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenue and expenses disclosed in the income statement and the changes during the period in inventories and operating receivables and payable.

REPORTING CASH FLOWS FROM INVESTING AND FINANCIAL ACTIVITIES

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described below are reported on a net basis.

REPORTING CASH FLOWS ON NET BASIS

Cash flow arising from the following operating, investing or financing activities may be reported on a net basis:

- a. Cash receipts and payments on behalf of customers when the cash flow reflect the activities of the customer rather than those of the enterprise; and
- b. Cash receipts and payments for items, in which the turnover is quick, the amounts are large, and the maturities are short.

Examples of cash receipts and payments referred to in (a) above are:

1. The acceptance and repayment of demand deposits of a bank
2. Funds held for customers by an investment enterprise
3. Rents collected on behalf of and paid over to the owners of properties. Examples of cash receipts and payments referred to in (b) above are advances made for, and repayment of:
4. Principal amount relating to credit card customers
5. The purchase and sale of investments
6. Other short-term borrowing for example, those which have a maturity period of three months or less

Cash flows arising each of the following activities of a financial institution may be reported on a net basis:

- a) Cash receipts and payments for the acceptance and repayment of deposits with fixed maturity date.
- b) The placement of deposits with and withdrawal of deposits from other financial institutions
- c) Cash advances and loans made to customers and repayment of those advances and loans

INTEREST AND DIVIDENDS

Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period either as operating, investing or financing activities

The total amount of interest paid during a period is disclosed in the cash flow statement whether it has been recognized as an expense in the income statement or capitalized

Interest paid and interest and dividend received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other enterprises. Interest paid and interest and dividends received may constitute operating cash flow because they enter into the determination of net profit or loss alternatively, interest paid and interest dividends received may be classified as financing cash flow and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investment.

Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, dividends paid may be classified as a component of cash flow from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows.

TAXES ON INCOME

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flow from operating activities unless they can be specifically identified with financing and investing activities

Taxes on income arises on transactions that give rise to cash flow that are classified as operating ,investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities the relating tax cash flow are often impracticable to identify and may arise in a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as cash flow from operating activities. However, when it is practicable to identify the tax cash flows with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is then classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

NON-CASH TRANSACTIONS

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded. From a cash flow statement, such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of a company. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are :

- i. The acquisition of asset or assets either by assuming directly related liabilities or by means of a finance lease:
- ii. The acquisition of a company by means of an equity issue; and
- iii. The conversion of debt to equity.

COMPONENTS OF CASH AND CASH EQUIVALENTS

An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

OTHER DISCLOSURES

A company should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the company.

Additional information may be relevant to users in understanding the financial position and liquidation of a company. Disclosure of this information, together with a commentary by management, is encouraged and may include:

- a. The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.
- b. The aggregate amounts of cash flows that represent increase in operating capacity separately from those cash flows that are require maintaining operating capacity.

The separate disclosure of cash flows that represent increases in operating capacity and cash flows are required to maintain operating capacity is useful in enabling the user to determine whether the company is investing adequately in the maintenance of its operating capacity. A company that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the use of current liquidity and distribution to owners.

FORMAT OF CASH FLOW STATEMENT FOR NON-FINANCIAL INSTITUTION ENTERPRISE

Direct method:

	Sh	sh
Cash flows from operating activities		
Cash receipts from customers	XX	
Cash paid to suppliers (of goods and services)	XX	
Cash paid to and on behalf of employees	XX	
Cash generated from operations	XX	
Interest paid	XX	
Income tax paid	XX	
Cash flow before extraordinary item	XX	
Extraordinary item	<u>XX</u>	
<i>Net cash from operating</i>		XX
Cash flow from investing activities		
Purchase of property, plant and equipment	XX	
Proceeds from sale of equipment	XX	
Interest received	XX	
Dividends received	<u>XX</u>	
<i>Net cash from or used in investing activities</i>		XX
Cash flow from financing activities		
Proceeds from issuance of share capital	XX	
Proceeds from long term borrowing	XX	
Payment of finance lease liability	XX	
Dividends paid	<u>XX</u>	
<i>Net cash from or used in financing activities</i>		XX
Net increase in cash and cash equivalent		XX
Cash and cash equivalents at beginning of period	<u>XX</u>	
<i>Cash and cash equivalent at end of period</i>	<u>XX</u>	

Indirect method:

	sh	Sh
Cash flows from operating activities		
Net profit before taxation and extraordinary item	XX	
Adjustments for:		
Depreciation	XX	
Amortization	XX	
Foreign exchange loss/gain	XX	
Investment income/loss	XX	
Interest expense	<u>XX</u>	
<i>Operating profit before working capital</i>	<u>XX</u>	
Increase/decrease in debtors	XX	
Increase/decrease inventories	XX	
Increase/decrease in trade creditors	<u>XX</u>	
<i>Cash generated from operations</i>	<u>XX</u>	
Interest paid	XX	
Income tax paid	XX	
Cash flow before extraordinary item	XX	
Extraordinary item (specify)	XX	
<i>Net cash from operating activities</i>		XX
Cash flows from investing activities		
Purchase of property, plant and equipment	XX	
Proceeds from sale of equipment	<u>XX</u>	
Interest received	XX	
Dividends received	<u>XX</u>	
<i>Net cash from or used in investing activities</i>		XX
Cash flow from financing activities		
Proceeds from issuance of share capital	XX	
Proceeds from long-term borrowing	XX	
Payment of finance lease liability	XX	
Dividends paid	<u>XX</u>	
<i>Net cash from or used in financing activities</i>		<u>XX</u>
Net increase in cash and cash equivalents at the beginning of period		XX
cash and cash equivalents at the beginning of period		<u>XX</u>
<i>Cash and cash equivalent at end of period</i>		<u>XX</u>

FORMAT OF CASH FLOW STATEMENT FOR A FINANCIAL INSTITUTION ENTERPRISE

	sh	Sh
Cash flows from operating activities		
interest and commission receipts		XX
interest payments		XX
Recoveries on loans previously written off		XX
Cash payments of employees and supplies		<u>XX</u>
<i>Operating profit before charges in operating assets</i>		<u>XX</u>
Increase or decrease in operating assets;		
Short term funds		XX
Extraordinary item		XX
Deposits held for regulatory or monetary control purposes	XX	
Funds advanced to customers		
Net increase in credit and receivables	XX	
Other short term negotiable securities	XX	
Increase or decrease in operating liabilities;		
Deposit from customers		XX
Negotiable certificates of deposit	XX	
Net cash from operating activities income tax	XX	
Income tax paid		<u>XX</u>
<i>Net cash from operating activities</i>		<u>XX</u>
Cash flow from investing activities		
Disposal from subsidiary Y		XX
Dividends received		XX
Interest received		XX
Proceeds from sale of non-dealing securities	XX	
Purchase of non-dealing securities	XX	
Purchase of property, plant and equipment	XX	
<i>Net cash from investing activities</i>		<u>XX</u>
Cash flow from financing activities		
Issue of loan capital	XX	
Issue of preference shares by subsidiary undertaking	XX	
Repayment of long-term borrowing	XX	
Net decrease in other borrowing		<u>XX</u>
<i>Net cash from financing activities</i>		<u>XX</u>
Effects of exchange rate changes on cash and cash equivalents	<u>XX</u>	
Net increase in cash and cash activities		XX
Cash and cash equivalents at begging of period		<u>XX</u>
Cash and cash equivalent at end of period		<u>XX</u>

Example:

The chief accountant of Gucci Ltd availed the following financial statement for the financial years ended 30th April 2011 and 2010

Income statement for the year ended 30th April 2011

	Sh.	Sh.
Sales		4,395,000
Opening stock	190,000	
purchases	<u>2,980,000</u>	
	3,170,000	
Closing stock	<u>(240,000)</u>	
Cost of sales		<u>2,930,000</u>
Gross profit		1,465,000
Profit on sale of equipment		<u>30,000</u>
		1,495,000
Expenses:		
Wages and salaries	960,000	
Depreciation	190,000	
interest	<u>25,000</u>	
		<u>(1,175,000)</u>
Profit before tax		320,000
Tax		<u>(120,000)</u>
Profit after tax		200,000
Dividends		
Interim paid	20,000	
Dividend proposed	50,000	
		(70,000)
Transfer to general reserve		<u>(120,000)</u>
Retained profit for the year		<u><u>80,000</u></u>

Statement of financial position as at 30th April 2010

	2011 Sh."000"	2010 Sh."000"
Non-current assets		
Land	600,000	450,000
Motor vehicle	400,000	370,000
Equipment	200,000	300,000
Furniture	<u>160,000</u>	<u>200,000</u>
	1,360,000	1,320,000
Current assets		
Inventory	240,000	190,000
Trade receivables	210,000	230,000
Bank balance and cash in hand	<u>90,000</u>	<u>60,000</u>
	540,000	480,000
Total assets	<u>1,900,000</u>	<u>1,800,000</u>
Equity and liabilities		
Capital reserves:		
ordinary share capital	600,000	<u>500,000</u>
share premium	150,000	100,000
general reserve	150,000	80,000
retained profits	<u>320,000</u>	<u>240,000</u>
	1,220,000	920,000
Non-current liabilities		
Debentures	200,000	300,000
Current liabilities		
Trade payables	210,000	250,000
Taxation	90,000	70,000
Accrued wages and salaries	145,000	210,000
Accrued debenture interest	5,000	10,000
Proposed dividend	<u>30,000</u>	<u>40,000</u>
	480,000	580,000
Total equity and liability	<u>1,900,000</u>	<u>1,800,000</u>

Additional information:

1. The purchase of land was financed by the issue of new ordinary shares at premium
2. An old piece of equipment was sold during the financial year ended 30th April 2011 at a profit sh. 30,000,000.

Depreciation was provided as follows in the year:

	Sh"000"
Motor vehicle	100,000
Equipment	50,000
Furniture	40,000

Required:

Statement of Cash flow in accordance with IAS 7 for the year ended 30th April 2011. Using direct method.

Suggested solution:**Gucci statement of cash flows (workings)**

	Sh. '000'
1. Receipts from customers	
Accounts receivable balance b/f	230,000
Sales for 2013	4,395,000
Accounts receivables balance c/f	<u>(210,000)</u>
<i>Cash collected from customers</i>	<u>4,415,000</u>
2. cash paid to suppliers	
Accounts payable b/f	250,000
Purchases	2,980,000
Accounts payable c/f	<u>(210,000)</u>
<i>Cash paid to customers</i>	<u>3,020,000</u>
3. cash paid for wages and salaries	
Wages and salaries accrued b/f	210,000
Expense for the year	960,000
Wages and salaries c/f	<u>(145,000)</u>
<i>Cash paid for wages and salaries</i>	<u>1,025,000</u>
4. Cash paid on interest	
Interest accrued b/f	10,000
Expense for the year	25,000
Interest accrued c/f	<u>(5,000)</u>
<i>Cash paid on interest</i>	<u>30,000</u>
5. cash paid on tax	
Tax payable bal b/f	70,000
Charge for the year	120,000
Tax payable c/f	<u>(90,000)</u>
<i>Cash paid on tax</i>	<u>100,000</u>
6. cash paid for land purchases	
Increase in share capital and premium (600,000+150,000)-(500,000-100,000)	150,000
7.cash received from equipment sale	
Balance b/f on equipment	300,000
Less depreciation	<u>(50,000)</u>
	250,000
Balance c/f on equipment	<u>200,000</u>
Disposal (carrying amount)	50,000
Add: profit on disposal	30,000
<i>Cash received from disposal</i>	80,000

8.cash paid on purchase of motor vehicle

Bal b/f carrying amount of motor vehicle	370,000
Depreciation for the year	(100,000)
Carrying amount suntotal	270,000
Bal c/f carrying amount of motor vehicle	400,000
Cash paid for addition on motor vehicle	130,000

9. cash from issue of shares 150,000

10. cash paid for dividends

Proposed b/f	40,000
Current year's paid and proposed	50,000
Proposed c/f	<u>(30,000)</u>
Cash paid for dividends	<u>60,000</u>

11. redemption of debentures(300,000-200,000) **100,000**

Statement of cash flow for the year ended 30th April 2011

	Sh	sh
Cash flows from operating activities		
Cash receipts from customers	4,415,000	
Cash paid to suppliers	(3,020,000)	
Cash paid for wages and salaries	(1,025,000)	
Interest paid	(30,000)	
Tax paid	<u>(100,000)</u>	
<i>Net cash from operating</i>		240,000
Cash flow from investing activities		
Purchase of land	(150,000)	
Proceeds from sale of equipment	80,000	
Purchase of motor vehicle	<u>(130,000)</u>	
<i>Net cash from or used in investing activities</i>		(200,000)
Cash flow from financing activities		
issuance of shares at premium	150,000	
Redemption of debentures	(100,000)	
Dividends paid	<u>(60,000)</u>	
<i>Net cash from or used in financing activities</i>		(10,000)
Net cash generated during the year		30,000
Cash and cash equivalents at beginning of period		<u>60,000</u>
<i>Cash and cash equivalent at end of period</i>		<u>90,000</u>

Question:

- a) In recent years, many financial analysts have commented on a growing disillusionment with the usefulness and reliability of the information contained in some companies' income statements.

Required:

Discuss the extent to which a company's statement of cashflows may be more useful and reliable than its income statement. (6marks)

- b) The following information has been extracted from the financial statements of Texco limited:

Income statement for the year ended 30 September 2010

	2010
	Sh."000"
Revenue	15,000
Cost of sales	<u>(9,000)</u>
Gross profit	6,000
Other operating expenses	(2,300)
	3,700
Finance cost	<u>(124)</u>
Profit before tax	3,576
Income tax expense	<u>(1,040)</u>
Profit after tax	2,536
dividends	<u>(1,100)</u>
	<u>1,436</u>

Statement of financial position as at 30 September

	2010	2009
	Sh."000"	Sh."000"
Assets:		
Non-current assets	18,160	14,500
Current assets:		
Inventories	1,600	1,100
Trade receivables	1,500	800
Bank balance	150	1,200
Total assets	<u>21,410</u>	<u>17,600</u>
Equity and liabilities:		
Capital and reserve:		
Issued capital	10,834	7,815
Accumulated profits	<u>5,836</u>	<u>4,400</u>
	16,670	12,215
Non-Current liabilities:		
Interest bearing borrowings	1,700	2,900
Deferred tax	<u>600</u>	<u>400</u>
	2,300	3,300
Current liabilities:		
Trade payables	700	800
Proposed dividend	700	600
Tax	1,040	685
	<u>2,440</u>	<u>2,085</u>
	<u>21,410</u>	<u>17,600</u>

Additional information:

1. Non-current assets:

	Property Sh"000"	Plant Sh"000"	Total Sh"000"
At 30 September 2009			
Cost	8,400	10,800	19,200
Depreciation	<u>1,300</u>	<u>3,400</u>	<u>4,700</u>
Net book value	<u>7,100</u>	<u>7,400</u>	<u>14,500</u>
At 30 September 2010			
Cost	11,200	13,400	24,600
Depreciation	<u>1,540</u>	<u>4,900</u>	<u>6,440</u>
Net book value	<u>9,660</u>	<u>8,500</u>	<u>18,160</u>

- Plant disposed of during the year ended 30 September 2010 had an original cost of sh.2,600,000 and accumulated depreciation of sh.900,000. The cash received on disposal was sh.730,000.
- All additions to non-current assets during the year ended 30 September 2010 were purchased for cash.
- Dividends were declared before the balance sheet dates.

Required:

Statement of cash flows (in conformity with IAS 7, Statement of cash flows) and associated notes, for the year ended 30 September 2010. (14 marks)

Suggested solution:

- Preference of cash flow statement over income statement.

Cash flow statement explicitly indicates how a firm sources for funds and also how it is used. Income statement on the other hand does not clearly indicate sources and application of funds.

As opposed to income statement, statement of cash flow may guard against creative accounting with income statement, especially using basis of accounting, companies may overstate revenues e.g. By including gains on disposal as part of revenue when in fact this forms part of other comprehensive income.

Some corporations fail due to poor working capital management. There is no deliberate effort in income statement to indicate in working capital items. This is well covered in statement of cash flows especially using the indirect method in presenting statement of cashflows.

Ordinarily, items not involving movement of cash e.g. depreciation; amortization and effect of deferred tax would loosely part of sunk cost. Income statement takes into account cognizance of such items before matching principle However, such items especially depreciation and amortization may not have any bearing on future planning.

b)

i. Gain/loss from disposal of NCA plant

Cash received	730
NBV (2600-900)	<u>1 700</u>
Loss on disposal	<u><u>970</u></u>

ii. Depreciation for the year.

<u>Accumulated depreciation a/c</u>			
Disposal	900	Balance b/d	4 700
Balance c/d	<u>6 440</u>	Charge for period	<u>2 640</u>
	<u><u>7 340</u></u>		<u><u>7 340</u></u>

iii. Additions to NCA

<u>NCA (cost)</u>			
Balance b/d	19 200	Disposal	2 600
Addition	<u>8 000</u>	Balance c/d	<u>2 4600</u>
	<u><u>27 200</u></u>		<u><u>27 200</u></u>

iv. tax paid for the year

<u>Tax payable a/c</u>			
C/B (paid)	485	Balance b/d	685
Balance c/d	<u>1 040</u>	Expense I/c	840
	<u><u>1 525</u></u>		<u><u>1 525</u></u>

*Expense I/c 1 040 Less: effect of deferred tax liability (200) =840

v. dividends paid

<u>Dividends payable a/c</u>			
Cash	1 000	Balance b/d	600
Balance c/d	<u>700</u>	Proposed	<u>1 100</u>
	<u><u>1 700</u></u>		<u><u>1 700</u></u>

Statement of cashflows**Cash flow from operating activities:**

	Sh"000"	Sh"000"	Sh"000"
Profit before tax		3 576	
Adjustments:			
Add:			
Depreciation	2 640		
Loss on disposal	970		
Interest expense	<u>124</u>	3 734	
<i>Changes in working capital items:</i>			
Increase in debtors	(700)		
Increase in inventory	(500)		
Decrease in payables	<u>(100)</u>	(1 300)	
Tax paid	(485)		
Interest paid	(124)	(609)	
Net cash from Operating activities			5 401

Cash flow from investing activities:

Purchase of NCA	(8 000)	
Disposal of plant	<u>730</u>	
Net cash flow from investing		(7 270)

Cash flow from Financing activities:

Redemption of long term debt	(1 200)	
Issue of shares	3 019	
Dividends paid	<u>(1 000)</u>	
Net cash flow from financing		<u>819</u>

		(1 050)
Cash and cash equivalent at the start of the year		<u>1 200</u>
Cash and cash equivalent at the end of the year		<u>150</u>

IMPORTANCE OF CASH FLOW STATEMENT

Cash Flow Statement is of vital importance to the financial management & short term financial planning. Its various uses are as follows:

1. Cash Flow Statement is prepared on cash basis hence it is useful in evaluating the cash position of an enterprise.
2. A projected cash flow statement can be prepared so that it can enable the firm to plan & co-ordinate its financial operations efficiently.
3. A comparison of historical & projected cash flow statements will reveal variations in the performance so that the firm can take immediate effective action.
4. It indicates whether a firm's short term paying capacity is improving or deteriorating over a period of time by preparing cash flow statements for a number of years.
5. It helps in planning the repayment of loans, replacement of fixed assets etc. It is also significant for making capital budgeting decisions.

6. It clearly indicates the causes for poor cash position in spite of substantial profits in a firm by throwing light on various applications of cash made by the firm.
7. Cash Flow Statement provides information of all activities classified under operating, investing & financing activities.

Limitations of Cash Flow Statement

Despite of a number of uses, cash flow statement also suffers from the following limitations:

- i. As cash flow statement is based on cash basis of accounting, it ignores the basic accounting concept of accrual basis.
- ii. Cash Flow statement is not suitable for judging the profitability of a firm as non – cash charges are ignored while calculating cash flows from operating activities.
- iii. Funds flow statement presents a more complete picture than Cash flow statement.
- iv. It is difficult to define the term "cash". There are no controversies over a number of items like cheques, stamps, postal orders etc whether they are to be included in cash.

Note:

- i. An increase in liability is a source of cash or cash inflow e.g. increase in creditors implies purchase of goods on credit. Although no cash is received we can say that creditors have given us loans which we have utilized to purchase goods from them.
- ii. A decrease in liability is an application of cash or cash outflow e.g. sundry creditors are paid off.
- iii. An increase in asset is an outflow of cash e.g. goods sold on credit.
- iv. A decrease in asset is an inflow or source of cash e.g. sale of stock, cash received from debtors.

Actual flow of cash

It is the movement of cash that results in actual inflow or outflow of from the firm e.g. When shares are issued for cash or when loan is repaid or when assets are sold for cash.

Notional flow of cash

It refers to delayed receipts & payments. Increase in current liabilities like trade creditors, bills payable, etc results in notional inflow of cash as here cash inflow is implied.

Usually increase in long term liabilities generate actual cash & increase in current liabilities generate notional cash.

RATIO ANALYSIS

Financial ratios are relationships determined from a firm's financial information and used for comparison purposes. There are basically 5 components of performance and measurements.

Ratios can be classified into:

- a) Liquidity ratios.
- b) Leverage or gearing ratios.
- c) Activity ratios.
- d) Profitability ratios.

USERS OF RATIOS

There are a vast number of parties interested in analyzing financial statements including shareholders, lenders, customers, employees, government, and competitors. In many occasions, they will be interested in different things therefore there is no any definite, all-encompassing list of points for analysis that would be useful to all these stakeholders. However, it is possible to construct a series of ratios that together will provide all of them with something that they find relevant and from which they can investigate further if necessary.

Ratio category	Examples of interested parties
Profitability	Shareholders, management, employees, creditors, potential investors
Liquidity	Shareholders, suppliers, creditors, competitors
Efficiency	Shareholders, potential purchasers, competitors
Shareholder	Shareholders, potential investors
Capital structure	Shareholders, lenders, creditors, potential investors

1. Liquidity ratios

These measure firm's ability to meet its short-term maturing obligations as and when they fall due. The lower the ratio, the higher the liquidity risk and vice versa. Failure to meet short term liabilities due to lack of liquidity may lead to poor credit worthiness, litigation by creditors and insolvency.

2. Leverage or gearing ratios

These measure extent to which a company uses its assets which have been financed by non owner supplied funds. They measure financial risk of the company. The higher the ratio, the higher the financial risk. Gearing refers to the amount of debt finance a company uses relative to its equity finance.

3. Activity ratios

These measure the efficiency with which a firm uses its assets to generate sales. They are also called turnover ratios as they indicate the rate at which assets are converted into sales.

4. Profitability ratios

They measure the management's effectiveness as shown by returns generated on sales and investment. They indicate how successful management has been in generating profits of the company.

5. Investment or equity ratios

These are used to evaluate the overall performance of a company. E.g. in determining company's dividend policy, determining theoretical value of company's securities and predicting effects of rights issue.

1. LIQUIDITY RATIOS

Current ratio

This is computed by dividing total current assets by total current liabilities:

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

Current ratio of more than one means that a company has more current assets than current liabilities.

Acid test or quick ratio

This is calculated by dividing total current assets excluding stock by current liabilities. A firm with a satisfactory current ratio may actually be in a poor liquidity position when inventories form most of the total current assets.

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{stock}}{\text{Current liabilities}}$$

2. GEARING OR LEVERAGE RATIOS

Debt ratio or capital gearing ratio

This measures the proportion of debt finance to capital employed by a company. A company is highly geared if the ratio is greater than 50%.

$$\text{Debt ratio} = \frac{\text{Total long term debt}}{\text{Capital employed}} \times 100$$

Debt equity ratio

This measures the proportion of non owner supplied funds to owner's contribution to the company. A company is highly geared if the debt equity ratio is greater than 100%.

$$\text{Debt Equity ratio} = \frac{\text{long term debt}}{\text{equity or net worth}}$$

Times interest cover

This shows number of times earnings by a company cover its current payments. The higher the ratio, the lower the gearing position and thus the lower the financial risk.

$$\text{Times interest cover} = \frac{\text{Earnings before interest and tax} + \text{Depreciation}}{\text{Interest charged}}$$

3. PROFITABILITY RATIOS**Return on capital employed (ROCE)**

This measures the efficiency with which a company uses long term funds or permanent assets to generate returns to shareholders.

$$\text{ROCE} = \frac{\text{Profit before interest and tax or operating profit}}{\text{Total Capital employed}}$$

Capital employed consists of shareholders funds (ordinary share capital, preference share capital, share premium and retained earnings) and long term debts. Capital employed can also be calculated as fixed assets plus net working capital.

Gross profit margin

This ratio shows how well cost of production has been controlled in relation to distribution and administration costs.

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

Net profit margin

This measures firm's ability to control its production, operating and financing costs

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Sales}} \times 100$$

Net assets turnover

This gives a guide to productive efficiency i.e. how well assets have been used in generating sales.

$$\text{Net assets turnover} = \frac{\text{Sales}}{\text{Capital employed}}$$

Operating profit/margin ratio

This indicates efficiency with which costs have been controlled in generating profit from sales.

$$\text{Operating profit ratio} = \frac{\text{Profit before interest and tax or operating profit}}{\text{Sales}} \times 100$$

Operating expenses ratio

This indicates a firm's ability to control production and operating costs to generate a given level of sales.

$$\text{Operatitkg expekses ratio} = \frac{\text{operatitkg expekse}}{\text{Sales}} \times 100$$

Return on investment

These measures the efficiency with which a company uses its total funds in capital employed to generate returns to owner's funds.

$$\text{Return on investment} = \frac{\text{Net profit after tax}}{\text{Capital employed}} \times 100$$

Return on equity. (ROE)

This measures the efficiency with which a company other supplier's funds to generate returns to shareholders.

$$\text{Return on equity} = \frac{\text{Earnings attributable to equity shareholders}}{\text{Equity}} \times 100$$

Equity comprises of ordinary share capital, share premium and reserves.

4. ACTIVITY RATIOS**Debtor's turnover**

This shows the number of times debtors pay within the year. It indicates how efficient the firm is in management of credit. The higher the ratio, the more efficient management is in managing its credit policy.

$$\text{Debtor's turkover} = \frac{\text{Credit sales}}{\text{Average debtors}}$$

Debtor's days or ratio

This is also called the **average collection period**. It shows the average period of credit taken by customers who buy on credit. It is compared the company's allowed credit period by suppliers to give an indication of credit administration efficiency.

$$\begin{aligned} \text{Debtor's days or ratio} &= \frac{\text{Average debtors}}{\text{Credit sales}} \times \text{Number of days ik a year} \\ &= \frac{\text{Number of days ik a year}}{\text{Debtor's turkover}} \end{aligned}$$

Creditor's turnover

This indicates the number of times creditors are paid by a company during a year.

$$\text{Creditor's turkover} = \frac{\text{Credit Purchases}}{\text{Average creditors}}$$

Creditor's days or ratio

This is also called the *average deferral period*. It indicates the average time that suppliers allow a company to settle its dues.

$$\begin{aligned}\text{Creditor's day ratio} &= \frac{\text{Average creditors credit purchases}}{\text{Number of days in a year}} \\ &= \frac{\text{Number of days in a year}}{\text{Creditor's turnover}}\end{aligned}$$

Stock or inventory turnover

This indicates the efficiency of a firm in selling its products so as to generate sales. It shows the times stock is turned over or converted into sales within a year. It shows how rapidly stock is being turned into cash through sales.

$$\text{Stock or inventory turnover} = \frac{\text{Cost of sales}}{\text{Average stock}}$$

Stock days/inventory conversion period

This indicates the number of days it takes to convert inventory into sales. The fewer the number of days, the more efficient a company is in converting stock into sales.

$$\begin{aligned}\text{Stockdays or inventory conversion period} &= \frac{\text{Average stock}}{\text{Cost of sales}} \times \text{No. of days in a year} \\ &= \frac{\text{Number of days in a year}}{\text{Inventory turnover}}\end{aligned}$$

Cash working cycle/Working capital cycle/Operating cycle

This is the period for which working capital financing is needed. The higher the working capital cycle, the higher the investment in working capital. It is the period of time that elapses between the point at which cash is spent on production or purchase of raw materials/stock to time stock is converted into cash or cash is collected from a customer.

Average collection period	xxx
Add inventory conversion period	xxx
Less average deferral period	(xxx)
Working capital cycle	xxx

Calculation of Operating Cycle

The length of the operating cycle of a manufacturing firm is the sum of:

- Inventory conversion period
- Receivables/debtors' conversion period

The inventory conversion period is the total time needed to produce and sell the product. It includes:

- Raw material conversion period.
- Work-in-Process conversion period.
- Finished goods conversion period.

The debtors' conversion period is the time required to collect the outstanding amount from customers.

A firm may acquire resources on credit and defer payments. Payables may thus arise. The payables deferral period is the length of time the firm is able to defer payments on purchase of resources. The difference between the payables deferral period and the sum of the inventory conversion period and receivable conversion period is referred to as the **operating/cash conversion cycle**.

1. Inventory conversion period.

It is the sum of raw material conversion period, working in progress conversion period and finished goods conversion period.

Raw material conversion period. - It is the average time period taken to convert raw material into work in Process.

$$\text{Raw material conversion period} = \text{Raw material inventory} / (\text{Raw material consumption} / 360)$$

Working in process conversion period. - It is the average time taken to complete the semi-finished or work in process.

$$\text{wip conversion period} = \text{Work in process inventory} / (\text{Cost of production} / 360)$$

Finished goods conversion period. - It is the time taken to sell the finished goods .

$$\text{Finished goods conversion period} = \text{Finished goods inventory} / (\text{cost of sales} / 360)$$

Debtors conversion period.

It is the time taken to convert the debtors to cash. It represents the average collection period.

$$\text{Debtors conversion period} = \text{Debtors} / (\text{Credit sales} / 360)$$

Payables deferral period.

It is the average time taken by the firm to pay its suppliers / creditors.

$$\text{Creditor deferral period} = \text{Creditors} / (\text{Credit purchase} / 360)$$

Summary

$$\text{Inventory conversion period} + \text{Debtors conversion period} - \text{Creditors deferral period} = \text{Net operating cycle}$$

Example

The following information relates to Mutongoi Limited.

	Sh.000
Purchase of raw material	6,700
Usage of raw material	6,500
Sale of finished goods (all on credit)	25,000
Cost of sales(Finished goods)	18,000
Average creditors	1,400
Average raw materials stock	1,200
Average work in progress	1,000
Average finished goods stock	2,100
Average debtors	4,700

Assume a 365 days year.

Required:

The length of the operating cash cycle.

Solution.

Raw material conversion period = Raw material inventory / (Raw material consumption/ 360)

$$= (1,200/6,500) \times 365$$

$$= 67 \text{ days}$$

Work in process conversion period = Working process inventory / (Cost of production / 360)

$$= (1000/18000) \times 365$$

$$= 20 \text{ days}$$

Finished goods conversion period = Finished goods inventory / (cost of sales/ 360)

$$= (2100/18000) \times 365$$

$$= 43 \text{ days}$$

Debtors conversion period = Debtors / (Credit sales/360)

$$= (4700/25000) \times 365$$

$$= 69 \text{ days}$$

Creditor deferral period = Creditors / (Credit purchase/ 360)

$$= (1400/6700) \times 365$$

$$= 76 \text{ days}$$

Length of operating cycle.		
<u>Inventory conversion period.</u>		
Raw material conversion period	67	
Work in process conversion period	20	
Finished goods conversion period	<u>43</u>	130
Debtors conversion period		<u>69</u>
Gross working capital cycle		199
Less: Creditor deferral period		(76)
Net Cash Operating cycle		123

Cash turnover/Operating turnover

This shows number of times a company needs to replenish its working capital in a year.

$$\text{Cash turnover or Operating turnover} = \frac{\text{Number of days in a year}}{\text{Working capital cycle}}$$

Fixed assets turnover

This indicates level of sales generated by fixed asset base of a company. It shows the efficiency with which a company utilizes its assets to generate sales.

$$\text{Fixed assets turnover} = \frac{\text{Sales}}{\text{Total fixed assets}}$$

5. INVESTMENT OR EQUITY RATIOS

Earnings Per Share (EPS)

This indicates the amount shareholders expect to generate in form of earnings for every share invested. It shows profitability of a company on a per share basis.

$$EPS = \frac{\text{Earnings attributable to equity shareholders}}{\text{Number of ordinary share}}$$

Dividend per Share (DPS)

This represents the amount of cash dividend that shareholders expect to receive for every share invested in the company.

$$\text{Dividend Per Share} = \frac{\text{Total ordinary dividends}}{\text{Number of ordinary share}}$$

Dividend pay out ratio

This indicates proportion of earnings attributable to equity shareholders that are paid out to common shareholders as dividends. It is used in analysis of dividend policy of the firm.

$$\begin{aligned}\text{Dividend Pay out Ratio} &= \frac{\text{Total common dividends}}{\text{Earnings attributed to equity shareholders}} \times 100 \\ &= \frac{\text{Dividend per share}}{\text{Earnings per share}} \times 100\end{aligned}$$

Dividend retention ratio

$$\text{Dividend Retention Ratio} = \frac{\text{Retained earnings}}{\text{Earnings attributed to equity shareholders}} \times 100$$

Dividend cover

$$\text{Dividend cover} = \frac{\text{Earnings per share (EPS)}}{\text{Dividends per share (DPS)}}$$

Earnings yield

This measures the potential return that shareholders expect to earn for every share invested in a company. It evaluates the shareholders returns in relation to the market value of a share.

$$\text{Earnings Yield} = \frac{\text{Earnings per share (EPS)}}{\text{Market price per share (MPS)}} \times 100$$

Dividend yield

This ratio measures how much an investor expects to receive from cash dividends for every share purchased or invested in a company.

$$\text{Dividend Yield} = \frac{\text{Dividend per share (DPS)}}{\text{Market price per share (MPS)}} \times 100$$

Price earnings ratio

This indicates how much an investor is prepared to pay for a company's share given its current earnings per share. The higher the price earnings ratio, the more confident investors are that the company will perform well in future.

$$\text{Price earnings ratio} = \frac{\text{Market price per share (MPS)}}{\text{Earnings per share (EPS)}}$$

1. Short term solvency or liquidity measure

Here the primary concern is the firm's ability to pay its bills over the short term without undue stress. Consequently this ratios focus on current assets and liabilities.

Illustration for business performance analysis

The following two financial statements will be used in calculation of ratios to determine business performance. The figures are in millions.

BRIDGEVIEW COMPANY LTD
STATEMENT OF FINANCIAL POSITION AS AT 31st DECEMBER

	2010	2011
Non-current Assets		
Net plant and equipment	2731	2880
Current assets		
Cash	84	98
Accounts receivables	165	188
Inventory	393	422
Total	<u>642</u>	<u>708</u>
Total assets	<u>3373</u>	<u>3588</u>
Liabilities and owners equity		
Current liabilities		
Accounts payable	312	344
Notes payable	231	196
Total	<u>543</u>	<u>540</u>
Long term debt	531	457
Owners equity		
Common stock and paid-in surplus	500	550
Retained earnings	1799	2041
Total	<u>2299</u>	<u>2591</u>
Total liabilities and equity	<u>3373</u>	<u>3588</u>

Income statement for 2011

Sales	2311
Cost of goods sold	1344
Depreciation	276
Earnings before interest and Tax	691
Interest paid	141
Taxable income	550
Taxes (34%)	187
Net income	363
Dividends	<u>121</u>
Retained earnings	<u>242</u>

Assume also that 33 million shares were outstanding at the end of 2010 and 2011. Market price per share is ksh 88.

Required: calculate the key ratios the financial statements above and state the importance of the ratios calculated.

Solution:**a) Current ratio.**

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}}$$

$$\frac{708}{540} = 1.31 \text{ times}$$

The higher the current ratio, the better the company is in covering current liabilities. But at the same time it may mean an inefficient use of assets such as having excess inventory.

b) Quick (acid test ratio)

Base inventory is the least record of current assets, the acid test ratio doesn't take consideration of inventory and therefore this ratio is written as

$$\frac{\text{current assets} - \text{inventory}}{\text{current liabilities}}$$

$$\frac{708 - 422}{540} = 0.53 \text{ times}$$

In this case the company has fewer current assets covering current liabilities.

c) Cash ratio

A very short term creditor may be interested in the cash inventory.

$$\frac{\text{cash}}{\text{current liabilities}}$$

$$\frac{98}{540} = 0.18 \text{ times}$$

d) Net working capital to total assets

$$\frac{\text{net working capital}}{\text{total assets}}$$

$$\frac{708 - 540}{3588} \times 100 = 4.7\%$$

Since net working capital is frequently viewed as a ratio of short term liquidity of a firm, it is measured relative to total assets. A relatively low value may indicate relatively low liquidity levels.

e) Interval measure

This assumes operations were disrupted but the company is still compelled to pay some short-term obligations. It tries to find out how much will current assets cover daily operating costs.

$$\text{interval measure} = \frac{\text{current assets}}{\text{average daily operating cost}}$$

Average daily operating cost from our illustration assumed to be

$$\frac{\text{cost of goods sold}}{365} = \frac{1344}{365} = 3.68$$

Therefore IM

$$ikterval\ measure = \frac{708}{3.68} = 192\ days$$

2. Long term solvency measures

This group of ratios is intended to measure the firm's long run ability to meet its obligations or more generally it's financial. These are sometimes called financial leverage ratios or leverage ratios.

i. Total debt ratio

It takes into account all debts of all maturities to all creditors.

$$\begin{aligned} Total\ debt\ ratio &= \frac{Total\ assets - Total\ equity}{Total\ assets} \\ &= \frac{3588 - 2591}{3588} = 0.28\ times \end{aligned}$$

ii. Debt-equity ratio

$$\begin{aligned} &= \frac{Total\ debt}{Total\ equity} \\ &= \frac{540 + 457}{2591} = 0.38\ times \end{aligned}$$

iii. Equity multiplier

$$\begin{aligned} &= \frac{Total\ assets}{Total\ equity} \\ &= \frac{3588}{2591} = 1.38\ times \end{aligned}$$

iv. Long term debt ratio

This ratio takes into account only long term debt and not short term obligation. The formula is

$$\begin{aligned} &= \frac{Long\ term\ debt}{Long\ term\ debt + equity} \\ &= \frac{457}{457 + 2591} = 0.15\ times \end{aligned}$$

The long term debt + equity is sometimes called firms capitalization.

v. Times interest earned

This ratio measures how well a company has its interest obligation covered.

$$\begin{aligned} Times\ interest\ earned &= \frac{EBIT}{Interest\ expense} \\ &= \frac{691}{141} = 4.9\ times \end{aligned}$$

vi. Cash coverage

The difference between cash coverage and times interest earned is that depreciation not being an item involving movement of cash is added back to EBIT.

$$\begin{aligned}\text{cash coverage ratio} &= \frac{\text{EBIT} + \text{depreciation}}{\text{interest expense}} \\ &= \frac{691 + 276}{141} = 6.9 \text{ times}\end{aligned}$$

3. Asset management/turnover ratio

Sometimes called **asset neutralization ratios**, the ratios in this category are intended to describe how efficiently or intensely a firm uses its assets to generate sales.

a) Inventory turnover and Day sales in inventory

$$\begin{aligned}\text{Inventory turnover} &= \frac{\text{Cost of goods sold}}{\text{Average inventory}} \\ &= \frac{1344}{422} = 3.2 \text{ times}\end{aligned}$$

Inventory was turned 3.2 times. It may also be imperative to use average inventory figures if they are available.

b) Day sales in inventory

$$\begin{aligned}&= \frac{365}{\text{Inventory turnover}} \\ &= \frac{365}{3.2} = 114 \text{ times}\end{aligned}$$

It tells that on average inventory sits in store for 114 days before it is sold.

c) Receivables turnover

This measures how fast receivables are collected.

$$\begin{aligned}&= \frac{\text{Sales}}{\text{Average receivables}} \\ &= \frac{2311}{188} = 12.3 \text{ times}\end{aligned}$$

This means that outstanding credit were collected and reloaded 12.3 times during the years.

d) Day sales and receivables/ average collection period

$$\begin{aligned}&= \frac{365}{\text{Receivables turnover}} \\ &= \frac{365}{12.3} = 29.67 \text{ times}\end{aligned}$$

On average credit sales were collected in 30 days.

e) Networking capital ratio or sales

Ratios measures how much would we get out of our working capital.

$$\begin{aligned}&= \frac{\text{Sales}}{\text{Net working capital}} \\ &= \frac{2311}{(708 - 540)} = 13.8 \text{ times}\end{aligned}$$

f) Fixed asset turnover

$$\begin{aligned}&= \frac{\text{Sales}}{\text{Fixed assets}}\end{aligned}$$

$$\frac{2311}{2880} = 0.80 \text{ times}$$

g) **Total asset turnover**

$$\frac{\frac{\text{sales}}{\text{Total assets}}}{\frac{2311}{3588}} = 0.64 \text{ times}$$

For every shilling invested in assets we generate sh.0.64 sales

4. Profitability measures

These measures are intended to measure how efficiently the firm uses its assets and how efficiently the firm manages its operations. The focus in the group is on the bottom line i.e. income

a. **Profit margin**

$$\frac{\frac{\text{Net income}}{\text{Sales}}}{\frac{363}{2311}} = 15.7\%$$

b. **Return on assets**

$$\frac{\frac{\text{Net income}}{\text{Total assets}}}{\frac{363}{3588}} = 10.12\%$$

c. **Return on equity**

$$\frac{\frac{\text{Net income}}{\text{Total equity}}}{\frac{363}{2591}} = 14\%$$

5. Market value measures

These ratios are crucial when comparing the earning power of an organization and its distribution (of dividend) policy with other organizations.

i. **Price Earnings ratio**

$$\begin{aligned} P/E \text{ ratio} &= \frac{MPS}{EPS} \\ EPS &= \frac{\frac{\text{Net income}}{\text{No of shares outstanding}}}{\frac{363}{88}} = \frac{363}{33} = 11 \\ P/E \text{ ratio} &= \frac{88}{11} \\ &= 8 \text{ times} \end{aligned}$$

We can interpret this to mean that Bridgeview's shares sell for 8 times to earning.

ii. **Market-Book ratio**

$$\begin{aligned} &= \frac{MPS}{BPS} \\ &= \frac{88}{2591/33} = 1.2 \text{ times} \end{aligned}$$

Book value in this case is total equity, not just common stock divided by no. of shares outstanding. The better if the ratio is more than one meaning share is doing well in the market.

iii. Dividend payout ratio

This measures amount of cash paid out to shareholders

$$= \frac{\text{Cash dividend}}{\text{Net income}} = \frac{121}{363} = 0.33$$

iv. Retention/plough back ratio

$$= 1 - \text{dividend payout ratio}$$

Because everything paid is retained.

v. Capital intensity ratio

$$= \frac{\text{firm's total assets}}{\text{sales}}$$

It's the reciprocal of assets turnover ratio.

Limitations of financial ratios

1. Different companies use different accounting policies making comparisons is unrealistic.
2. Ratios do not take of inflation tendencies
3. Different companies use different calendar financial years therefore making comparison difficult.
4. Unusual or transient events such as one time profit from sale of an asset may affect performance and give misleading results.
5. Inaccuracies from financial statements would affect the ratios.

TOPIC 11

INTRODUCTION TO PUBLIC SECTOR ACCOUNTING

DEFINITION OF TERMS

State Corporation is an entity incorporated under the Companies Act, which is solely or partly owned by the national government for commercial purposes.

State agency is an entity howsoever incorporated by the government to undertake a specific strategic government objective in delivering public service and includes any entity classified as:-

- a) An executive agency;
- b) An independent regulatory agency; or
- c) A research institution, public university, tertiary education and training institution; County Corporation is an entity howsoever incorporated, that is solely or partly owned by the county government for commercial purposes:

Commercial purpose means a function;

- (a) Whose dynamics are governed by a competitive profit making and market driven; or
- (b) That can be performed commercially but serves a strategic socio-economic objective.

FEATURES OF PUBLIC SECTOR ENTITIES

AS COMPARED TO PRIVATE SECTOR)

There is an important difference between private sector accounting and governmental accounting. The main reasons for this difference are the environment of the accounting system. In the government environment, public sector entities have differing goals, as opposed to the private sector entities' one main goal of gaining profit. Also, in government accounting, the entity has the responsibility of fiscal accountability which is demonstration of compliance in the use of resources in a budgetary context. In the private sector, the budget is a tool in financial planning and it isn't mandatory to comply with it.

Government accounting refers to the field of accounting that specifically finds application in the public sector or government. It is a special field of accounting because; -

- (a) The objectives to which accounting reports to differ significantly from that for which generally accepted accounting practice has been developed for in the private (business) sector; &

- (b) The usage of the results of accounting processes of government differs significantly from the use thereof in the private sector.

An exception exists on the above-mentioned differences in the case of public utility businesses (for example Electricity Services) that may be intended to produce a net income or profit, but a significant debate exists over whether there should be such an exception. Nationalization includes, amongst others, the argument that entities should be either private or public, and that the objectives of public entities should differ significantly from that of private entities. In other words, is the generation and reticulation of electricity with the objective to generate a profit in the public interest or not? And if it is the best way, shouldn't it then be completely private instead of having access to public funds and monopolies? '

The unique objectives of government accounting do not preclude the use of the double entry accounting system. There can, however, be other significant differences with private sector accounting practices, especially those that are intended to arrive at a net income result. The objectives for which government entities apply accountancy can be organized in two main categories:

a. The accounting of activities for accountability purposes.

In other words, the representatives of the public, and officials appointed by them, must be accountable to the public for powers and tasks delegated. The public, who have no other choice but to delegate, are in a position that differs significantly from that of shareholders and therefore need financial information, to be supplied by accounting systems, that is applicable and relevant to them and their purposes.

b. Decision-making purposes.

The relevant role-players, especially officials and representatives, need financial information that is accounted; organized and presented for the objectives of their decision-making. These objectives bear, in many instances, no relation to net income results but are rather about service delivery and efficiency. The taxpayer, a very significant group, simply wants to pay as little as possible taxes for the essential services for which money is being coerced by law.

Governmental accounting standards are currently being dominated by the accounting standards (internationally sometimes referred to as IFRS) originally designed for the private sector. The so-called Generally Recognised Accounting Practices (GRAP) that are being enforced in the public sector of countries such as South Africa, one of the front-runners in this regard is based on the Generally Accepted Accounting Practices originally developed for the private sector. The above and common sense raises the question of whether this is the best solution. It is of course cheaper and it is alleged that the history of separate development of accounting practices for government has not been successful. Even at the onset of the current fiscal crisis in Europe and other parts of the world it was argued authoritatively that the sometimes inapplicable accounting practices of the private sector being used, have contributed to the origination of, and belated reaction to, the fiscal crisis.

Examples of Entities in Public Sector

The following example of some of the entities in the public sector according to the Public Pittance Management Act:-

- a) the Government or any department of the Government;
- b) the courts;
- c) the commissions established under the Constitution;
- d) a local authority uncle-r the Local Government Act
- e) a state corporation within the meaning of the State Corporations Act
- f) the Central Bank of Kenya established under the Central Bank of Kenya Act
- g) a co-operative society established under the Co-operative Societies Act
- h) a public school within the meaning of the Education Act-
- i) a public university within the meaning of the Universities Act
- j) a college or other educational institution maintained or assisted out of public funds',

STRUCTURE OF THE PUBLIC SECTOR

Most government organizations are classic examples of vertical structure. Vertical organizational structures are characterized by few people at the top and increasing numbers of people in middle management and lower level positions. In other words, a few people make policy and decisions, and many people carry them out. Governments often lean toward them because. they create much defined job scopes and powers--each person has a clear role to play. Vertical structure is the classic bureaucracy and is epitomized and originated in one of the oldest government functions: military command.

REGULATORY STRUCTURES AND OVERSIGHT IPSASB

The international Public Sector Accounting Standards Board (IPSASB)- formerly the Public Sector Committee - of the International Federation of Accountants focuses on the accounting, auditing, and financial reporting needs of national, regional, and local governments, related governmental agencies, and the eonstituencies they serve. It addresses these needs by issuing and promoting benchmark guidance, conducting educational and research programs, and facilitating the exchange of information among accountants and those that work in the public sector or rely on its work.

The IPSASB's current activities are focused on the development of International Public Sector Accounting Standards (IPSAS) for financial reporting by governments and other public sector entities fthe Standards Project).

The IPSASB's Standards Project was established in late 1996. The objectives of the initial stage of the project were to develop by the end of November 2001:

- A background paper identifying current practices and issues in public sector financial reporting.
- A core set of IPSAS based (to the extent appropriate) on the International Accounting Standards in place as at August 1997.
- An IPSAS on the cash basis of accounting,
- Guidance on the transition from the cash to the accrual basis of accounting.

The Preface to International Financial Reporting Standards issued by the International Accounting Standards Board explains that international Financial Reporting Standards (IFRSs) are designed to apply to the general purpose financial statements of all profit-oriented entities. Government Business Enterprises (GBEs) as defined by the IPSASB are profit-oriented entities. Accordingly, they are required to comply with IFRS.

- Present to the Senate, subject to the exceptions in the Constitution, the proposal for the basis of allocating revenue among the Counties and consider any Bill dealing with county Financial matters
- Introduce into the Senate a County Allocation of Revenue Bill and a Division of Revenue Bill in accordance with Article 218(1)(b) of the Constitution at least two months before the end of the financial year;
- Examine financial statements and other documents submitted to the Senate under Part 1V of the Public Finance Management Act and make recommendations to the Senate for improving the management of government's public finances;
- Monitor adherence by the Senate to the principles of public finance set out in the Constitution, and to the fiscal responsibility principles of the Public finance Management Act.

In carrying out its functions in (a) and (b) the Committee shall consider recommendations from the Commission on Revenue Allocation, County Executive Committee member responsible for finance, the Intergovernmental Budget and Economic Council, the public and any other interested persons or groups.

The Role of Auditor General

The Kenya Constitution defines the duties of the Office of the Controller and Auditor General in broad terms, and more detailed responsibilities are provided in the Exchequer and Audit Act. Specifically, the Controller and Auditor General, who is appointed by the President, are charged with:

- Reviewing proposed withdrawals from the Consolidated Fund and, if satisfied that they are authorized by law, approving the withdrawals;
- Examining disbursements of monies appropriated by Parliament to ensure that they have been applied to the purposes to which they were appropriated and that expenditures conform to the authorities that govern them; and

- iii. Auditing and reporting on the public accounts of the Government of Kenya, the accounts of all government officers and authorities, the accounts of all courts and commissions, and the accounts of the Clerk of the National Assembly.
- iv. Consider and approve the estimates for the Kenya National Audit Office; and
- v. Determine the remuneration and other terms of appointment of the staff of the Kenya National Audit Office.

The Exchequer and Audit Act further require that the Controller and Auditor General audit and report in all accounts of the local authorities.

The Role of Internal Audit

National government entity to maintain internal auditing arrangements

Every national government entity shall ensure that it complies with the Public Finance Management Act and-

- a) Has appropriate arrangements in place for internal audit according to the guidelines of the Accounting Standards Board; and
- b) Where any regulations are in force, those regulations are complied with.

Regulations may prescribe requirements to be complied with in conducting internal audits.

A national government entity shall ensure that its arrangements for conducting internal audits include:-

- a) reviewing the governance mechanisms of the entity and mechanisms for transparency and accountability with regard to the finances and assets of the entity;
- b) conducting, risk-based, value-for-money and systems audits aimed at strengthening internal control mechanisms that could have an impact on achievement of the strategic objectives of the entity;
- c) verifying the existence of assets administered by the entity and ensuring that there are proper safeguards for their protection;
- d) providing assurance that appropriate institutional policies and procedures and good business practices are followed by the entity; and
- e) Evaluating the adequacy and reliability of information available to management for making decisions with regard to the entity and its operations.

A national government entity shall ensure that internal audits in respect of the entity are conducted in accordance with international best practices.

Every national government entity shall establish an audit committee whose composition and Functions shall be as prescribed by the regulations.

Role of Controller of Budget

The Controller of Budget is nominated by the President and, with the approval of the National Assembly, appointed by the President. To be qualified to be the Controller of budget, a person shall have extensive knowledge of public finance or at least ten years' experience in auditing public finance management.

The Controller should hold office for a term of eight years and shall not be eligible for reappointment.

The Controller of Budget shall oversee the implementation of the budgets of the national and county governments by authorizing withdrawals from public funds under Articles 204, 206 and 207 of the Kenyan Constitution.

The Controller shall not approve any withdrawal from a public fund unless satisfied that the withdrawal is authorized by law. Every four months, the Controller shall submit to each House of Parliament a report on the implementation of the budgets of the national and county governments.

In addition to this, the controller of budget and revenue allocation should ensure:

1. That all reasonable precautions have been taken to safeguard—
 - a) The collection of revenue; and -
 - b) The receipt, custody, issue and proper use of property;
2. that the applicable law has been complied with in relation to—
 - a) the collection of revenue; and
 - b) the receipt, custody, issue and proper use of property;
3. That all money, other than money that has been appropriated by Parliament, has been dealt with in accordance with the proper authority.

OBJECTIVES OF PUBLIC SECTOR FINANCIAL STATEMENTS

The information needed to aid understanding and assessments of government financial operations and to promote accountability extends beyond reporting surpluses and deficits. A government's financial statements must provide information that describes liabilities and financial assets, its non-financial assets that are available for use in providing future services, the cost of using its economic resources in the delivery of services, as well as information about investing and financing activities and potential assets and liabilities. Further, this information needs to highlight measures (for example, net debt and net economic resources) that help users assess whether the government's financial position has improved or deteriorated and explain the changes in financial position. The information reported in financial statements must also reflect the full nature and extent of the government's resources, obligations and financial affairs.

Financial statements should provide an accounting of the full nature and extent of the financial affairs and resources which the government controls, including those related to the activities of its agencies and enterprises

Financial statements should present information to describe the government's financial position at the end of the accounting period. Such information should be useful in evaluating:

- (a) The government's ability to finance its activities and to meet its liabilities and contractual obligations; and
- (b) the government's ability to provide future service

Financial statements should present information to describe the changes in a government's financial position in the accounting period. Such information should be useful in evaluating:

- (a) The sources, allocation and consumption of the government's recognized economic resources in the accounting period;
- (a) How the activities of the accounting period have affected the net debt of the government; and
- (b) How the government financed its activities in the accounting period and how it met its cash requirements

Financial statements should demonstrate the accountability of a government for the resources, obligations and financial affairs for which it is responsible by providing information useful in:

- (a) Evaluating the financial results of the government's management of its resources, obligations and financial affairs in the accounting period; and
- (b) Assessing whether resources were administered by the government in accordance with the limits established by the appropriate legislative authorities

ACCOUNTING OFFICERS

According to Section 17 of the Government Financial Management Act the treasury appoints persons, to be known as accounting officers, to be responsible for accounting for such services, as the Treasury may specify. in respect of which money is appropriated by Parliament. In specifying the services in respect of which an accounting officer is appointed, the Treasury shall ensure that all the services for a ministry, department or commission are specified for the same accounting officer.

Responsibilities of Accounting Officers

An accounting officer is responsible to the Treasury to ensure that the resources of his ministry, department or commission are used in a way that is

- a) Lawful and authorised; and
- (a) h) Effective, efficient, economical and transparent.

In carrying out his responsibilities, an accounting officer shall do the following in relation to his ministry, department or commission-

- a) Ensure that no expenditure is made unless it is lawful, authorised, effective, efficient and economical;
- b) Ensure proper financial and accounting records are kept;
- c) ensure that any financial or accounting records kept in electronic format are adequately protected which shall include ensuring that such records are adequately backed-up and adequately protected against computer viruses;
- d) Prepare and submit accounts for each financial year under the Public Audit Act, 2003 for audit by the Controller and Auditor-General;
- e) Ensure that adequate arrangements are made for the management of liabilities;
- f) Ensure that all contracts are complied with;
- g) Ensure that all applicable procedures are followed in the acquisition or disposal of property and that adequate arrangement are made for the custody, safeguarding and maintenance of property;
- h) Bring any concerns he has that a proposed decision or policy originating from his ministry, department or commission may result in resources being used in a way that is Unlawful, unauthorized, ineffective, inefficient, uneconomical or not transparent to the attention of the Minister responsible for the ministry, department or commission of the accounting officer and, if his concerns are not adequately addressed, bring them to the attention of the Treasury: and perform such other duties as may be directed by the Treasury

AUDITOR GENERAL

The Kenya Constitution defines the duties of the Office of the Controller and Auditor General in broad terms, and more detailed responsibilities are provided in the Exchequer and Audit Act. Specifically, the Controller and Auditor General, who is appointed by the President, is charged with:

- i. Reviewing proposed withdrawals from the Consolidated Fund and. it' satisfied that they arc authorized by law, approving the withdrawals;
- ii. examining disbursements of monies appropriated by Parliament to ensure that they have been applied to the purposes to which they were appropriated and that expenditures conform to the authorities that govern them; and
- iii. Auditing and reporting on the public accounts of the Government of Kenya, the accounts of
 - a) all government officers and authorities, the accounts of all courts and commissions. and the ac-counts of the Clerk of the National Assembly.
- iv. Consider and approve the estimates for the Kenya National Audit Office; and
- v. Determine the remuneration and other terms of appointment of the staff of the Kenya National Audit Office.

The Exchequer and Audit Act further requires that the Controller and Auditor General audit and report on all accounts of the local authorities.

ACCOUNTING TECHNIQUES IN THE PUBLIC SECTOR

(BUDGETING, CASE, ACCRUAL, COMMITMENT AND FUND)

Financial Accounting Techniques

Different public sector entities adopt different accounting techniques, some which are;

Budgetary Accounting

This refers to the preparation of the operating accounts in a format of a budget. Under the budgetary accounting, the concept is on forecasted cash flows and operations and this must be limited to the budget estimates. Budgetary accounting aims at:

- ensuring efficiency of managers
- Communicates the entity goals to employees
- Provides control
- Provides a yardstick or it benchmark for measuring performance of employees

Cash Accounting

Only cash inflows and outflows are recognized and recorded. It does not recognize any revenue or expenditure that has been received or paid. The resulting final accounts are just summarized cash books.

Accrual Accounting

The accruals concept states that revenues and costs are recognized as they are earned or incurred. Entities in the private sector and some in the public sector follow this system.

Commitment Accounting

This accounting technique recognizes transactions when the entity is committed to them. This means that the transaction is not recognized when cash is received or paid, nor when invoices are received or issued, but at an earlier stage when orders are issued or received. Under this technique, the entity recognizes the issue of an order as a commitment to incur expenditure and the accounts continuously record the commitments. The main purpose of commitment accounting is budgetary control rather than financial reporting.

Fund Accounting

A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or

balances and changes therein, which are segregated for the purpose of carrying on specific activities of attaining certain objectives in accordance with special regulations, restrictions or limitations.

In broad terms a single fund accounting entity is somewhat like a business accounting entity. Each business accounting entity has a set of self-balancing set of accounts sufficient to capture all the reported attributes for the whole business and all its transactions. Likewise each fund of the government has a self-balancing set of accounts sufficient to capture all the reported attributes for the government fund of this type, of the portion of government's activities and resources accounted for in a particular fund. The key difference is that one accounting entity is used to account for all activities and resources of a business, whereas each fund accounting entity is used to account for only a subset of the government's activities and resources.

A general purpose unit of the government has dual nature. Some of its activities are general government in nature, others are business type activities. The general type activities have unique sources of financing such as taxes and grants. The allocation of resources to various purposes and the control of general government activities focus heavily upon the sources and uses of the financial resources. The business type activities function and may be controlled and evaluated much like their business counterparts.

Government Funds; these are used to account for the sources, uses and balances of a government's expendable general governmental financial resources and the related current liabilities. In their simplest form, governmental funds are in essence segregations of general government working capital according to the purposes for which it is to be used.

Governmental fund accounting measures the financial position and changes in financial position, sources, uses and balances of net fund financial resources rather than net income.

Type of Funds

Governmental Funds

The General Fund; it accounts for all financial resources except those required to be accounted for in another fund.

Special Revenue Fund; accounts for the proceeds of specific revenue sources (other than expendable trusts for major capital projects) that are legally restricted to expenditure for specified sources.

Capital Project Fund; accounts for financial resources to be used for the acquisition or construction of major capital facilities (other than those financed by proprietary funds or trust funds).

Debt Service Fund/Sinking Fund; accounts for the accumulation of resources for and the payment of general long-term debt, principal and interest.

Revolving Fund; these funds provide financial resources for achieving some specified objectives. The initial appropriation in these funds is made out of the Consolidated Fund. The receipts generated in such funds are automatically used by the respective entities in accordance with the provisions of the act.

Proprietary Funds

Enterprise Fund; accounts for:

- a. Operations that are financed and operated in a manner similar to private business entities, where the intent of the governing body is that costs of providing goods and services to the general public on a continuing basis be financed or recovered primarily through user charges or
- b. Where the governing body has decided that periodic determination of revenues earned, expenses incurred and/or net income is appropriate for capital maintenance, public policy, management control accountability or Other purposes..

Internal Service Funds; accounts for the financing of goods and services provided by one department or agency to other department or agencies of the • governmental unit on a cost reimbursement basis.

Fiduciary Funds

Trust and Agency Funds; accounts for assets held by a governmental unit in a trustee_ capacity or as an agent for individuals, private organizations, other governmental units and/or other funds.

These include:

- Expendable trust funds
- Non expendable trust funds
- Pension trust funds
- Agency funds

Sources of Government Revenue These may be classified as;

- Internal Sources
- External Sources

Government Expenditure

These are the amounts which are spent by the government for different purposes. Government expenditure may be classified as:

- Recurrent Expenditure
- Development Expenditure

Recurrent Expenditure; this means revenue expenditure. It is incurred by the government on normal activities. The main expenditure heads of recurrent expenditure are General Public Administration, Defense, Education, Health, Social Welfare, Economic Services, and Other Miscellaneous Services.

Development Expenditure; this is expenditure incurred for the establishment of new agricultural and industrial projects, installation of new plant and machinery, construction of various projects, etc. Development expenditure is shown in the capital budget. It is mainly financed from external loans and grants. Internal loans are also another source of financing the development expenditure. The major steps in Government accounting are as follows:

Annual Estimates

These estimates are prepared by the various ministries and these are submitted to the Treasury. These estimates include revenue and expenditure figures for the next year.

Preparation of the Budget

The budget contains the estimates of government revenue and government expenditure for the current year. The various proposals are debated in Parliament. After approval by Parliament, the budget is implemented.

Government Spending

Specific amounts are appropriated by Parliament to different ministries. The ministries cannot spend amounts in excess of their appropriations without the approval of parliament. In each ministry there is a system of internal controls to ensure that the spending is according to appropriations and for correct purposes.

Controller and Auditor General

The Controller and Auditor General is responsible to audit the accounts of various government departments. The main purpose of this audit is to ensure that all moneys appropriated have been spent for the correct purposes.

Public Accounts Committee

This committee consists of members of parliament. The committee basically deals with the audited report of government accounts presented to it by the Controller and Auditor General.

Consolidated Fund

All revenues or other moneys raised or received by the government are paid in one fund known as the consolidated fund. No money can be withdrawn from the consolidated fund without approval from Parliament. From the consolidated fund, Parliament approves the annual budget of the government. The Appropriation bill is introduced in Parliament after the approval of the budget. The

main purpose of this bill is to issue from consolidated fund, the amounts necessary to meet expenses of different ministries.

Therefore the consolidated fund is the main source from which funds are provided to different departments of the government. This fund provides a limit within which the amounts can be spent during a particular year. This fund helps to control the expenditure of the government.

Appropriations in Aid

These are particular classes of revenue which the treasury authorizes the accounting officer to use, in addition to the amounts to be issued from the exchequer, to meet expenditure. The Appropriations in Aid are scheduled in the annual Appropriations Act and any excess over the authorized sum for Appropriations in Aid will be due to the exchequer unless the authorized sum is increased by supplementary appropriation.

Paymaster General

The Paymaster General is the principal paying agent of the government and is considered as a banker of all government departments. The Paymaster General makes the payments on the government. For this purpose, the Paymaster General arranges with the treasury for the withdrawal of cash from the Exchequer at regular intervals. The amounts withdrawn are transferred from the exchequer account to the Paymaster General account. From these amounts, the payments are made to the respective ministries. The Paymaster General maintains a separate account for each accounting unit or branch so as to show the total receipts and payments in respect of these accounts.

Vote Book

The vote book is used by each fund in the government sector. The vote book is that book in which various accounts are opened. The accounts relate to various expenditure heads and sources or revenue.

In a vote book, the vote number of any particular department or ministry is used. The amounts appropriated to that department for different purposes are recorded into the respective accounts. When expenditure is incurred for any specific purpose, it is recorded into the respective accounts. The total funds allocated for a specific purpose and the amounts spent are compared from time to time. This system helps to ensure that expenditure incurred does not exceed the amounts appropriated for a specific purpose. For various expenses different code numbers are used,

CASH BASED ACCOUNTING

Traditionally the government has operated on an annual cash basis because appropriations are voted by parliament on proposed expenditures for the forthcoming fiscal year. The Minister for Finance presents these proposals — the Budget Estimates to parliament for discussion and approval. The

proposed expenditures in the Budget Estimates include both the operating and capital expenditures within that year.

Under cash-based accounting, cash receipts, payments and balances are recorded at the time of the cash transactions, irrespective of when the related goods and services are produced or received. Cash based accounting does not recognize noncurrent assets in the financial statements. All expenditures are written off as expenses during the year they are incurred. Cash based accounting is not without advantages. These include:

1. It is a widely used and traditionally accepted measure of government's short term impact on the economy
2. It is considered tangible, easily prepared and tracked
3. For a number of government transactions, such as grants and salaries, there is not likely to be significant difference between cash and accrual

Cash-based accounting has its shortcomings too, which are cited as major reasons for many governments now moving to full accrual accounting. It has been argued that the cash based accounting provides incomplete or misleading information and perverse incentives:

1. It fails to recognize future costs associated with current government activities
2. It does not properly align costs with the provision of goods and services
3. Cash based accounting systems does not ensure sustainability of government activities as it is:-
 - a) More concerned with the current rather than focusing on the future or long term
 - b) The financial statements do not provide details about the assets held by the government and its agencies, the liabilities incurred by it are not clear and it is difficult to gauge the total picture of the government's performance
4. The budgetary process that goes with it is not based on outputs and outcomes. There is no relationship between inputs, outputs and outcomes:
 - a) The budgetary process is mainly focused on inputs which encourages which encourages lavish spending towards the end of the financial year, sometimes merely to avoid surrendering the unspent balance to the treasury
 - b) Departments have no justification whatsoever for their budget allocation except that the amount requested is similar or increased from last year's allocations. Consequently, there is no incentive for managers to justify what they have spent, leading to government inefficiencies

These shortcomings provide a strong case for moving to accrual accounting

Accrual based accounting recognizes transactions in the period when the activity generating the revenue or consuming the resources occurs, regardless of when the associated cash is actually paid or received. All working capital items (in particular loans, accounts receivable) are carefully adjusted at the end of each reporting period, to match the incurring of liabilities and the consumption of assets.

Another important feature of accrual accounting is its treatment of capital assets. The cost of a capital asset is not added to the operating cost in the year it is acquired. Instead, the capital assets are depreciated over their useful lives such that only the annual amount of depreciation is added to operating costs as the cost allocation for that year.

This treatment of capital assets improves the alignment of costs with consumption of assets and more importantly, assets do not appear to be free goods after initial purchase.

There are compelling advantages for adopting the accrual based accounting, including

- Enhancing accountability
- Encouraging use of performance based measures in the government budgeting
- Ensuring fair distribution of government funds amongst competing interests

Enhancing Financial Information and Accountability

The ultimate benefit of adopting this change of accounting philosophy is to make governments more accountable to the taxpayer/public. The traditional cash based accounting focuses on control over and accountability for cash spending. But the vision of public sector accountability has now changed and there is increased need for robust information including financial information, on which to assess performance and accountability.

Accrual accounting is a tool for decision makers that can help governments make better decisions and improve the allocation of scarce government resources. It provides more complete information out costs for use in analysis and decision making. It reports on all assets — both current and capital — ensuring the entity now which resources are available for future use. It also reports on liabilities to indicate potential demand on future resources to meet an entity's obligations.

Use of Performance Based Measures in Government Budgeting

The most important benefit of accrual accounting is the enhancement of performance based measures through the adoption of Accrual Output Based Budgeting (AOBB). It makes an ideal means of shifting the emphasis of the budgetary process away from cash inputs, towards outputs and outcomes. in the hope that this will resulting greater management efficiencies and hence better outcomes for the governments and the-citizens.

The budget shift to outcomes will mean focus on outputs, prices, agreements, flexibility in suppliers and performance benchmarking. The key benefits of AOBB include:

1. 1 Funding departments/ministries for outputs (services and products) rather than inputs (resources consumed in their production)

2. Improving the government's management of its funding of services (purchaser interest) and its resource base (ownership interest)
3. Improving the quality of performance information available to the government amid departmental managers for strategic planning, resource allocation and operation control
4. Providing a sound basis, for internal resource allocation

Ensuring Fair Distribution of Government Funds among Competing Interests

Accrual based budgeting will ensure that government funds are distributed fairly among competing interests. It is a process where 'all the actors set criteria and engage in discourse as a means of resolving issues of allocating scarce resources.

This is possible with the provision of full information necessary to manage the financial position of the government ministries and other agencies. information on assets and liabilities, income earned or expenses incurred during the financial year but not resulting in a cash transaction in that year, cash inflows and outflows, and consistent and streamlined reporting arrangements will ensure that there is fair distribution of resources.

Challenges in implementing the accrual based accounting

The adoption of accrual accounting- by any government is a challenging process. It is not just a technical process but a change in philosophy based on a broader view of public expenditure management. Some of the challenges for the government include:

- Collection of information on capital assets, and properly identifying them
- Building capacity within the public service to ensure that those using the system have sound knowledge of accrual accounting principles. This can be achieved through or extensive training,
- Making entity changes to ensure wherever possible that the purchasing, asset management and accounting functions are integrated under the new system
- Full accrual accounting should be the way forward for the government to ensure public assets are
- -utilized properly in providing intended services to taxpayers. The adoption of full accrual accounting
- Improve access to reliable financial information and internal control systems for decision makers that can help the government to make better decisions and improve the allocation of scarce government resources
- Provide a more comprehensive picture of the government entity's financial condition by reporting on all assets so that governments know which resources are available for future use
- and liabilities to indicate the potential demand on future resources to meet obligations
- Promote consistent and independently verified reporting practices and increase the likelihood of a cultural change in government spending.

Illustration

The approved estimates and actual expenditure details for the Ministry of Justice and Constitutional Affairs for the year 2009/2010 were as follows:

Code	Details	Approved Estimates	Actual Expenditure
000	Personnel Emoluments	123,280	97,520
050	House Allowance	19,550	14,260
080	Passage and Leave	41,040	667
100	Travelling and Accommodation	1,334	1,656
110	Transport expenses	16,100	13,593
120	Communication expenses	4,600	3,312
190	Miscellaneous expenses	17,480	16,882
196	Training expenses	5,980	4,738
230	Purchasing of Equipment	21,000	39,800
620	Appropriations-in-Aid	1,000	5,560

The Ministry made four equal withdrawals from the Exchequer in July 2009, October 2009, January 2010 and May 2010, totalling Sh.200, 000,000 by the year end.

Required:

- (i) The general account of vote (GAV),
- (ii) The exchequer account.
- (iii) The Pay Master General (PMG) account.
- (iv) Statement of assets and liabilities as at 30 June 2010.

Solution**General account of vote**

	Sh.000		Sh.000
A.I.A	4,560	Exchequer	240,364
Expenditure	192,428	Paymaster General Account	5,560
Balance c/d	<u>57,936</u>		
	<u>254,924</u>		<u>254,924</u>

Exchequer Account

	Sh.000		Sh.000
General Account of vote	249,364	Paymaster General Account	200,000
	<u>249,364</u>	Balance c/d	49,364
			<u>249,364</u>

Paymaster General Account

	Sh.000		Sh.000
Exchequer	200,000	Expenditure	192,428
General Account of vote	<u>5,560</u>	Balance c/d	<u>13,132</u>
	<u>205,560</u>		<u>205,560</u>

Excess Appropriation in Aid Account

	Sh.000		Sh.000
Balance c/d	<u>4,560</u>	GAV	4,560
	<u>4,560</u>		<u>4,560</u>

Statement of assets and liabilities as at 30 June 2010

	Sh.000	Sh.000
Assets		
Exchequer a/c	49,364	
Paymaster general a/c	<u>13,132</u>	<u>62,496</u>
Funded by:		
General account of vote	57,936	
Excess appropriation in Aid	<u>4,560</u>	<u>62,496</u>

Workings:-

Code	Details	Approved Estimates	Actual Expenditure
0	Personnel Emoluments	123,280	97,520
50	House Allowance	19,550	14,260
80	Passage and Lease	41,040	667
100	Travelling and Accommodation	1,334	1,656
110	Transport expenses	16,100	13,593
120	Communication expenses	4,600	3,312
190	Miscellaneous expenses	17,480	16,882
196	Training expenses	5,980	4,738
230	Purchasing of Equipment	21,000	39,800
	Appropriations-in-Aid	<u>(1,000)</u>	<u>(5,560)</u>
	GAV	<u>249,364</u>	<u>186,868</u>

REVISION EXERCISE:**QUESTION 1**

(a) Highlight purposes of public sector accounting.

Solution:

- i. To create a standard expectation of ethics and accountability for a nation's financial information.
- ii. It assists in public sector budgeting.
- iii. It helps in the establishment of a public governance system which enhances discipline decision making by those in charge of state affairs.
- iv. It enables the public assess whether there is value for money submitted as a result of the taxes paid to the state.

QUESTION 2

The following were the approved estimates and actual expenditure for the Ministry of health for the financial year ended 30 June 2013:

Item	Details	Approved estimate	Actual expenditure
		Sh."000"	Sh."000"
0300	Transport	76,500	73,100
0301	Travel and subsistence	88,400	86,700
0500	Personal emoluments	102,000	96,900
0700	Electricity expense	81,600	76,500
0240	Staff development	15,980	17,510
0900	Purchase of equipment	166,600	166,600
0400	Other allowances	116,960	113,390
1000	Appropriations- in-aid	133,960	125,800

Drawings from the Exchequer during the financial year ended 30 June 2013 amounted to Sh.127, 500,000.

Required:

- i) General account of vote.
- ii) Exchequer account.
- iii) Paymaster general account.

Solution:

ITEM	DETAILS	APPROVED Estimate Sh '000'	ACTUAL Expenditure Sh '000'
0300	Transport	76,500	73,100
0301	Travel & subsistence	88,400	86,700
0500	Personal emoluments	102,000	96,900
0700	Electricity expenses	81,600	76,500
0900	Purchase of equipment	166,600	166,600
0400	Other allowances	<u>116,960</u>	<u>113,390</u>
	G.A.V	632,060	613,190
	A.I.A	<u>(133,960)</u>	<u>(125,800)</u>
	Exchequer	<u>498,100</u>	<u>487,390</u>

i)

General account of vote a/c

	Sh.000		Sh.000
Expenditure	613,190	Exchequer	127,500
		Appropriation in Aid	133, 960
		Balance c/d	<u>351,730</u>
	<u>254,924</u>		<u>254,924</u>

ii)

Exchequer Account

	Sh.000		Sh.000
General Account of vote	127,500	Paymaster General Account	127,500
	<u>127,500</u>		<u>127,500</u>

iii)

Paymaster General Account

	Sh.000		Sh.000
Exchequer	127,500	Expenditure	613,190
Appropriation in Aid	133, 960		
Balance c/d	<u>351,730</u>		
	<u>613,190</u>		<u>613,190</u>

QUESTION 3

Uzuri County Council authorised the construction of a city hall on 1 July 2012. The hall was expected to cost Sh. 160,000,000. The project was to be financed as follows:

Sh. 80,000,000 from a 6.5% bond issue
 Sh. 64,000,000 from a government grant
 Sh. 16,000,000 from the general fund

The following transactions and events took place during the year ended 30 June 2013:

1. The county council transferred Sh. 16,000,000 from the general fund to the city hall capital fund. The capital project fund was for the purpose of construction of the city hall.
2. Planning and architects fees amounting to Sh.6,400,000 were paid.
3. The contract was awarded for Sh. 152, 000,000.
4. The 6.5% bonds were sold for Sh. 80,320,000 and the amount of the premium transferred to the debt service fund.
5. The contract was certified 50% complete and an invoice for Sh.76,000,000 was received from the contractor.

The contractor was paid the invoiced amount less 10% retention

Required:

- i. Journal entries to record the above transactions.
- ii. Statement of revenue and expenditure of the capital project fund for the year ended 30 June 2013.
- iii. Statement of financial position of the capital project fund as at 30 June 2013.

Solution:

(i) Journal entries

	Sh.000	Sh.000
General fund account	16,000	
Capital project fund account		16,000
<i>Being transfer from the general fund to capital fund account</i>		
Planning and architect fees account	6,400	
Cash account		6,400
<i>Being planning architect fees paid</i>		
City hall building account	152,000	
Commitment/contractor account		152 000
<i>Being contract award for city hall building</i>		
Cash account	80,320	
6.5% bond account		80,000
Debt service fund		320
<i>Being sale of 6.5% bond and transfer to service fund</i>		
Commitment/contractor account	76,000	
Cash book		68,400
Retentions		7,600
<i>Being payment to the contractor</i>		

ii) Statement of revenue and expenditure

Uzuri County Council

Statement of revenue and expenditure for the construction of city hall for the year ended 30 June 2013

	Sh.000	Sh.000
Revenue:		
Bond issue	80,000	
Government grant	64,000	
General fund transfer	<u>16,000</u>	
	160,000	
Other revenue:		
Bond premium	320	160,320
Expenditure:		
Planning and architects fees	6,400	
Contractor expenditure/commitment	<u>152,000</u>	<u>(158,400)</u>
Surplus		<u>1,920</u>

iii) Statement of financial position

Uzuri County Council

Statement of financial position as at 30 June 2013 Building (city hall)

	Sh.000
Assets	
Building (city hall)	158,400
Cash (80,320 - 6,400 - 68,400)	<u>5,520</u>
	163,920
Financed by:	
65% bond issued	80,000
Government grant	64,000
Debt service fund	320
Retention	7,600
Capital project fund balance	<u>12,000</u>
	163,920