PRINCIPLES OF ACCOUNTING

PART I

SECTION 2

CS
CCP
CICT

STUDY TEXT

SYLLABUS

PAPER NO 5: PRINCIPLES OF 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 including non-complex group structures

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
- Prepare financial statements for non-complex group structures

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
- Qualities of useful accounting information
- Reguratory framework of accounting (regulatory bodies such as ICPAK, IFAC, IASB, Accounting standards (IAS/IFRS), their importance and limitations and professional ethics)
- Accounting concepts/principles

2 Recording transactions

- Source documents (quotations_ purchases order, statement of account. remittance advice, receipts, petty cash vouchers_ sales arid purchase invoices, credit notes and debit notes, bank statements)
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- Double entry and the ledger; general ledger, sales ledger, purchases ledger
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- 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

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- 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

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- Objectives of public sector financial statements
- Objectives of IFSAS
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Revised on: January 2017

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 communes 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

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 arc 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-16 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 riot 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, naive 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. Sonic 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

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 5h 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.

3I Sold goods to Mukulima Sh 15,000 and was allowed a I 0% trade discount.

i) Record the above transactions in the books of original entry.

ii) 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
		432,000

Sales Daybook

Date 2007	Details	Amount (sh)
May 10	Mbaraka	97,000
	Ndigiri	120 000
		217,000

TOPIC 3

ACCOUNTING FOR ASSETS AND LIABILITIES

ASSETS

PROPERTY, PLANT AND EQUIPMENT - lAS 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 '.if 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 lAS 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 In 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 tinder 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 pastern 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 trite 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 & Lass 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 cast 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;

$$\frac{\text{Cost minus} \ - \ \text{EstimatedScrap Value}}{\textit{Estimated Life}}$$

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.

Salaries and wages a/c			
	Sh '000'		**Sh '000'**
Bank	65,000	Balance b/d	30,000
		P&L	85,000
		Balance c/d	35,000
	150,000		150,000

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	1,615,000
	2,397,500		2,397,500

Bank statement as at 30 June 2001

	Shs
Balance as per cashbook	1,615,000
Add:	
Unpresented cheques	22,500
	1,637,500
Less: Uncredited cheques	(98,500)
Error	(832,500)
Bal as per bank statement	706,500

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	600.000	300.000	300,000
	1.350.000	670.000	680,000
Current Assets:			
Inventory		122,800	

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 no 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 booth the credits and the debits or an error that understates both the debits and the credits by the same amount. E.g. if If the purchases returns was overstated by shsSh2000 2000 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 shs20 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 exampleentering, entering shsS870 h 870 as shsS h 780. itIt 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

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:

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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 gale of ponds on credit to Kenyani was recorded by debiting Kenyani's account.

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 i ics-uidoti to ineuiporate the effect of closing stocx 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	XX	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	XX		
	XX		XX

INTR TRADING ACCOUNT (VERTICAL FORMAT)

	Sh	Sh	Sh
Sales			XXX
Less: Returns Inwards			(XX)
Net sales			XX
Opening stock	XX		
Purchases	XX		
Add: Carriage Inwards	XX		
	XX		
Less: Returns Outwards	XX		
Cost of stock available for sale		XX	
Less: Closing stock		(XX)	
Cost of sales			(XX)
Gross Profit			XX

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		17 800
		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		(520,380)
Gross Profit		**236 660**

Illustration

The following details for the year ended 31 March 2010 arc 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
Sal es	94,600
Stocks: 31 March 2010	14,323

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 1062 (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 fonnal 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 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) 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 hills 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.

W3

Premises A/c

	Sh.		**Sh.**
Balance b/d	1,800,000	Balance c/d	2.400,000
Revaluation	600,000		
	2,400,000		**2,400,000**

W4

Plant A/c

	Sh.		**Sh.**
Balance b/d	740,000	Revaluation	40,000
		Balance c/d	700,000
	740,000		**740,000**

W5

Inventory A/c

	Sh.		**Sh.**
Balance b/d	1,247,580	Revaluation	164,000
		Balance c/d	1,083,580
	1,247,580		**1,247,580**

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	646,520
	1,762,180		**1,762,180**

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 don 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	600	2,000	
		4,500	6,500
Salary: Bright			**9,300**
Balance of profits shared:			
Hirst	4,650		
Bright	3,100		
Warhust	1,550		
			9,300

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 2Q06 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;-

(a) An appropriation account for the year ended 31 December 2006

(b) The current accounts for both partners

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

There 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 capita]: 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 it's "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.

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	33,000	
	42,660	
Less Closing stock	10,660	
		32,000
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	170	
		26,585
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		23,000
Less Appropriations:		14,815
Ordinary divindeds	6,000	
Preference divindeds	3,000	
Transfer to general reserves	4000	
		13,000
Retained profit c/f		1,815

M Fry
Statement of financial position as at 31 December 2007

Fixed Assets	**Cost Shs.000**	**Dep. Shs.000**	**NBV Shs.000**
Premises	135,000		135,000
Equipment	25,000	5,000	20,000
Vehicles	16,000	1,600	14,400
	176,000	6,600	169,400
Current Assets			
Stock		10,660	
Debtors	12,400		
Less provision	620	11,780	
Prepayments		320	

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 did 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 consists 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 of 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 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 powder and lighting

NB: ***prime cost + indirect manufacturing costs=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	Xx
	Xx
Less closing stock of loose tools	Xx
Cost of loose tools consumed	**Xx**

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)	
Cost of materials available for production		**(xxx)**
Less closing stock (R.M)		Xxx
Cost of raw materials used		xxx
Add Direct labor		xxx
Direct expenses		xxx
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	xxx	
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		xxx
Finished goods at transferred price		**xxx**

REVISION EXERCISE

QUESTION 1

Mboyamak limited manufacturer's farm 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

2. Rent is to be apportioned between the factory and office in the ratio of 3:1
3. Finished goods are transferred from factory to sales at mark up of 20%
4. The values of opening and closing inventory are given at the transfer price

Required;-

i) Manufacturing account for the year ended 31 December 2012
ii) 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	(1,445,000)	
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 (¾ × 260,000)	195,000	1,111,000
Gross cost of production		9,821,150
Add work in progress at start		1,555,000
Less work in progress at end		(1,230,000)
Cost of finished goods		10,146,150
Add profit mark up 20%		2,029,230
Cost of finished goods transferred to trading		**12,175,380**

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	(1,442,000)	(11,896,380)
Gross profit		4,034,720
Less expenses		
Rent(¼ × 260,000)	65,000	
Depreciation on office equipment	115,000	
Office salaries	1,670,950	
Office Electricity	221,000	(2,070,950)
Net profit		**2,962,770**

TOPIC 9

FINANCIAL STATEMENTS OF A NOT FOR PROFIT MAKING ORGANIZATIONS

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 o I non recurring in nature it should be capitalized and taken to the liability side of the balance sheet but others argue Mai though it is paid is each members 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:

W7

Gym Equipment Account

	Shs '000'		**Shs '000'**
Balance b/d	250,000	Depreciation	25,000
		Balance c/d	225,000
	250,000		**250,000**

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.

TOPIC 10

GROUP ACCOUTS

INTRODUCTION

Key Definitions

Subsidiary: an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent).

Parent: an entity that has one or more subsidiaries.

Holding/parent company – this is an entity that has one or more subsidiaries.

Group – This is the parent and all its subsidiaries

Non-controlling interest (NCI) – It is that portion of net assets of a subsidiary attributable to equity interest which are not owned directly or indirectly through subsidiaries by the parent.
Institutional Requirement

Consolidated financial statements: the financial statements of a group presented as those of a single economic entity.

Control: the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities
A subsidiary company is a company in which the investing company (also called parent or parent company) controls the financial and operating policies of the subsidiary company.

Control is usually based on ownership of more than 50% of voting power, but other forms of control are possible.

Other forms include:
According to IAS 27 four other situations where control can exist are when the parent has power to:

1. Over more than half the voting rights by virtue of an agreement with other investors.
2. To govern the financial and operating policies of an entity under statute or an agreement
3. To appoint or remove the majority of the members of the board of directors
4. To cast the majority of votes at a meeting of the board of directors

Example:
Z is considering an investment on west, the capital structure of which is as follows 10,000 A voting ordinary shares 10,000 B non-voting ordinary shares. Both classes of shares have the same dividend rights:

Describe the appropriate group accounting for west if

i. Z purchases 6,000 of A ordinary shares.__(60%)
ii. Z purchases 10,000 B and 4,000 A ordinary shares__(associate)

Answer to Example

i. It is the voting share that gives Z the influence on west. Z should control west in this case. West will therefore be treated as a subsidiary because Z owns 60% of the voting shares in west.
ii. As Z has less than 50% of the voting shares this time Z will not probably be able to control west therefore west will not be treated as a subsidiary

IAS 27 requires that consolidated financial statements shall include all subsidiary of the parent. The two exceptions to these rules are:

1. Lack of effective control – the excluded should be accounted for as an investment in accordance with IAS 39

Subsidiary held for resale – held for resale subsidiary is treated as a current asset investment and valued at lower of the carrying amount and fair value less cost to sell

In most cases, control is evidenced (but not limited) to owning more than 50% of the ordinary share capital of the subsidiary company. Control may also be exercised in the following ways;

i) The parent company owning more than 50% or the voting rights in the company or subsidiary company.
ii) The parent company being able to appoint majority of the directors in the board of directors.
iii) The parent company carrying out favourable transactions with the subsidiary e.g. sale and purchase of goods at a price below the market value.

The substance of the relationship between parent company and subsidiary company is the effectively, the parent company controls the subsidiary company. This means that the parent company controls the assets of the subsidiary company and is liable to the debts of the subsidiary company.

1AS 27 therefore requires that the parent a company should include the financial results of the subsidiary company in its own financial statements. The process involves adding the assets, liabilities and incomes and expenses of the subsidiary company to those of the parent company while excluding inter-company transactions and balances. This process is called **consolidation** and the combined financial statements are called **Group accounts or consolidated accounts.**

The purpose of consolidated accounts is to:

1. Present financial information about a parent undertaking and its subsidiary undertakings as a single economic unit.
2. Show the economic resources controlled by the group
3. Show obligations of the group and
4. Show the results the group achieves with its resources

Consolidated financial statements under the entity concept
Consolidated financial statements are prepared by replacing the cost of investments with the individual assets and liabilities underlying the investment. If the subsidiary is partly owned, all assets and liabilities of subsidiaries are consolidated, but the non-controlling shareholders interest in those net assets is presented.

Principles of consolidation

1. **Non-conterminous**

Some companies in the group may have differing accounting dates in practice; such companies will often prepare financial statements up to the group accounting date for consolidation purposes.
For purpose of consolidation, IAS allows use of financial statements made up to date not more than three months earlier or later than the parent reporting date, with due adjustment for significant transactions or other events between the dates.

2. **Uniform accounting policies**

All groups companies should have the same accounting policies. If the group member uses different accounting policies, its financial statements must be adjusted to achieve consistency before they are consolidated

3. **Eliminating intra-group transactions**

This must be eliminated on consolidation in order to achieve the main objective of group financial statements, i.e. to show the position of the group as if it were a single economic entity. A group cannot trade with itself, nor can it make a profit out of itself. In a similar way cannot increase its sales or its net assets by transferring assets and liabilities between members of the group

Related parties
Two parties are considered related if
1. One party has the ability to control the other party or
2. One party has the ability to exercise significant influence over the other party or
3. The parties are under common control. Therefore
   1. A company that is a subsidiary is a related party of its parent company
   2. This means that the financial statement may have been affected by related party transactions

Types of transactions that may occur between the parent and subsidiary (related parties) and their impact on the financial statements of the individual company and the group are:

Transactions	**Potential impact**
Sales and purchases	Favourable prices, affecting profits, advantageous settlement terms, affecting receivables and payables
Finance	Favourable rates of interest, affecting profits
Non-current assets	Favourable terms for cost financing
Promotion services	At minimal or no cost, affecting profits
Guarantees for loans and overdrafts	Without which they wouldn't have been granted

Even when related party transactions are at arm's length, it's important to realize that they are related party transactions. This is because it is quite possible that they would not have occurred but for the relationship.

ACCOUNTING FOR ONE SUBSIDIARY

Preparation of Consolidated Financial Statements

IFRS 3 requires that the acquisition method of accounting be applied in accounting for business combinations.

This entails;

1. Identifying the acquirer (parent)
2. Measure the cost of business combination (cost of investment)
3. Allocate at the date of acquisition the cost of business combination to the assets acquired and liabilities or contingent liabilities assumed i.e. the net identifiable assets representing the equity interest acquired.

Preparation of consolidated statements of financial position (CSFP)

In the preparation of consolidated statement of financial position, the draft statement of financial position of the parent company and those of the subsidiary (ies) are combined on a line by line basis by adding together like items of assets, liabilities and equity.

However, in order that Consolidated statement of financial position presents financial information about a group as that of a single enterprise, the following adjustments or considerations have to be made;

1. Investment in the subsidiary.

The investment in the subsidiary appearing as a Non-current asset in the parent books does not appear in consolidated statements. However it is credited to the Cost of control account in the determination of goodwill or discount on acquisition.

2. Goodwill on acquisition

Goodwill is the difference between the value placed upon a firm and the value of its net asset.

IFRS 3 defines goodwill as the future economic benefits that are not separately identifiable.

Net Assets = Asset – Liabilities

Net Assets is the shareholder's interest in a company which can also be determined by considering the shareholders fund.

Share holders fund comprises of; Ordinary share capital, Share premium, Reserves and Retained TI.

Goodwill is then determined as follows

Cost of investment Less: Fair value of Net Account acquired	xxx (xxx) **xx**

Goodwill on acquisition can be determined using two methods;

i) **Partial method** – This is where only the goodwill of the parent portion of net assets in the subsidiary is considered or is determined.

ii) **Full method** – Where goodwill of the subsidiary as a whole is considered. In this case NCI is measured at fair /full value.

Negative goodwill

Goodwill arising on acquisition is one form of purchased goodwill. It is the different between the cost of investment and the fair value of net assets acquired. This difference can be negative i.e. the fair value of net assets acquired may exceed the cost of acquisition. IFRS refer to these as Burgan purchase and in this case the entity should re-asses the amount at which it has measured the cost of investment and the fair value of the acquiree net assets in order to identify any error.

Any excess after the reassessment should be recognised in the income statement as an income, immediately during the period it arises.

ILLUSTRATION

H limited acquired 75% of the ordinary shares in S limited on 1st January 2011 when S limited retained earnings was sh 15,000. The market of S limited ordinary shares as at that date was sh 1.6 share. H limited and S limited statement of financial position as at 31st December 2011 was as follows:

	H ltd Sh	**S Ltd Sh**		**H Ltd Sh.**	**S Ltd Sh.**
Assets			**Equity and Liabilities**		
Non – Current			Ordinary share capital (Sh1		
Property,plant & equipment	60,000	50,000	loss)	100,000	50,000
Investment in S Ltd	68,000	-	Returned earnings	70,000	25,000
Current Assets	20,000	15,000	Accounts payables	10,000	10,000
Inventory	32,000	20,000			
Cash and bank bal	180,000	85,000		180,000	85,000

Required

a) Determine the value of goodwill using the two methods
b) Consolidated H of financial position on the assumption that Non-controlling interest (NCI) is valued at fair value

b) Equity method of consolidation(allowed alternative treatment)
This is the allowed alternative treatment under IAS 31 and the benchmark treatment under IAS 38 (investment in associates). Therefore, under this method the interest in joint venture is accounted for as if it were an investment in associate.

REVISION EXERCISE

QUESTION 1

Given below are the comparative balance sheets of Tausi Ltd., a trading company, for the years ended 31 October 2000 and 2001:

	2001		2000	
Assets	**Sh.'000'**	**Sh.'000'**	**Sh.'000'**	**Sh.'000'**
Non-current assets:				
Goodwill	23,500		32,650	
Premises	200,000		80,000	
Plant and machinery	290,100		278,200	
Office equipment	126,250	639,850	87,360	478,210
Current assets:				
Stock	88,890		67,815	
Debtors	57,890		52,015	
Bank	9,210	155,990	-	119,830
		795,840		598,040
Capital and Liabilities				
Capital:	425,000		250,000	
Ordinary shares	75,000		160,000	
10% redeemable preference shares	33,000		-	
Share capital	30,000		-	
Capital redemption reserve	38,000		12,000	
General reserve	22,300		11,200	
Profit and loss account		623,300		433,200
Non-current liability				
Bank loan		63,000		50,000
Current liabilities				
Creditors	49,820		40,290	
Current tax	30,500		28,500	
Proposed ordinary dividends	26,000		18,000	
Accruals	3,200		5,420	
Bank overdraft	-	109,540	22,630	114,840
		795,840		**598,040**

The following additional information is provided:

1. Some of the redeemable preference shares which had been issued at par, were redeemed at a premium of 2%. To finance the redemption and comply with the Companies Act requirements, the company simultaneously carried out the following:
   - Issued 5,500,000 additional ordinary shares of Sh.10 at a total premium of Sh.34,700,000.
   - Transferred sufficient amounts to the capital redemption reserve.
   - Financed the premium on redemption out of the premium received on issue of the additional ordinary shares.
2. Preference dividends are paid at the end of each financial year on shares outstanding then.
3. Part of plant and machinery which had cost Sh.60,000,000 on acquisition and on which Sh.42,000,000 accumulated depreciation had been provided was sold for Sh.25,000,000 during the year.
4. Included in the depreciation charge for the year is Sh.15,100,000 in respect of plant and machinery.
5. New office equipment was purchased in the year for Sh.55,000,000. There was no disposal of office equipment during the year.
6. It is the company's policy not to depreciate premises. The change in the premises account balance was due to a revaluation of the asset.
7. The revaluation reserve arising in (6) above was all to finance the issue of fully paid-up bonus shares of Sh.10 each to ordinary shareholders.
8. A new bank loan of Sh.25,000,000 was received in the year. Bank interest of Sh.8,000,000 was also paid in the year.
9. Current tax liability is in respect of the tax charge for the respective year.
10. During the year ended 31 October 2001 an interim dividend of Sh.14,000,000 was paid.

Required:

Cash flow statement in accordance with IAS 7.

Solution:

Tausi Limited
Cash Flow Statement

	"Shs 000"	"Shs 000"
Net profit before		145,100
Adjusted for – depreciation – equipments		16,110
Plant & machinery		15,100
Gain on disposal		(7,000)
Goodwill amortized		9,150
Interest		8,000
Cash flow from operation before working capital		186,460
changes		(21,075)
Increase in stock		(2,200)
Decrease in accruals		(5,875)
Increase in debtors		9,530
Increased in debtors		166,840

TOPIC 11

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 post 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.

TOPIC 12

FINANCIAL STATEMENTS OF PUBLIC SECTOR ENTITIES

DIDEFINITION 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 ur 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 pablic interest or not? And if ii is the best way, shouldn't it then be completely private instead of having access to putnie 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 he accountable to the public for powers and tasks delegated. The public, who have no other choice but to delegate. arc in a position that differs significantly front 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 mole-players, especially officials and representatives, need financial information that is accounted; organized and presented for the objectives of their decision-making. These objectives hear, 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 punkt,. Sector of countries such as South Africa, one of the front-runners in this regard is based nil 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 iti alleged that the history-Of separate development of accounting practices for government has not beo 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.

(a) 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
(b) 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;
(c) 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;
(d) 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 frdm 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 voups.

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:

i. Reviewing proposed withdrawals from the Consolidated Fund and, if satisfied that they are 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 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 O•lice.

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.

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 Electricity	102,000	96,900
0700	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.

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