FINANCIAL ACCOUNTING

PART I

SECTION 1

CPA
CIFA

STUDY TEXT

SYLLABUS

PAPER NO 1:

FINANCIAL

ACCOUNTING

GENERAL

OBJECTIVE

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

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Prepare books of original entry and basic ledger accounts under double entrysystem
- 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 cashflows

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

2 Recording transactions

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

3. Accounting for assets and liabilities

3.1 Assets

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

3.2 Liabilities

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

4. Correction of errors and suspense account

5. Financial statements of a sole trader

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

6. Financial statements of a partnership

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

7. Financial statements of a company

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

8. Financial statements of a manufacturing entity

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

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

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

10. Analysing financial statements

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

11. Introduction to public sector Accounting

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

12. Emerging issues and trends

CONTENT **PAGE**

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

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 accountingrelevance.
- **Measuring -** in accounting, this is the process of assigning monetary amounts to the accountableevents.
- **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 aledger.
- **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 inwords
- **Financial information -** this information is expressed in terms ofmoney

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 remedialsteps.

- **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 ratio and 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.

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

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 onlyif:

  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 andrebates

(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 bymanagement.

(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 thatperiod.

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 actualuse
2. Efflux of time — mere passage of time will cause a fall in the value of an asset even if it is notused,
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 theasset
ii. The estimated residual or scrap value at the end of itslife
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 thirtyyears.

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 theoriginal

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 orexhausted.

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 iscomplete.

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 CompaniesAct.

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.

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 grossloss)
2. Finding out the net profit (orloss)

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.

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

Solution

B. Osongo
Trading Account for the year ended 31 March 2010

	Sh. "000"	Sh. "000"	$h. "000"
Sales			94,600
Less: Returns Inwards			(1,372)
			93,228
Less: Cost of sales			
Opening Stock		16,523	
Purchases	53,397		
Add: Carriage Inwards	1 112		
	54,519		
Less: Returns Outwards	2, 896	51.623	
cost of goods available for sale		68, 146	
Less: Closing stock		(18,504)	(49,642)
Gross Profit			43 586

DETERMINATION OF NET PROFIT (OR LOSS)

After ascertaining the gross profit, the subsequent step is to ascertain net profit or net loss during an accounting period. Here the revenues and expenses of an accounting period are summarized to reflect the alterations in various critical areas of the firm's operations. This step indicates how the revenue (money received from the sale of products and services before expenses are withdrawn) is transformed into the net income (the result after all revenues and expenses have been accounted for). It displays the revenues recognised for a specific period and the cost and expenses charged against these revenues, including write-offs (e.g. depreciation and amortization of various assets) and taxes. The objective of the income statement is to explain to the managers and investors whether the company made or lost money during the period being reported. As pointed out earlier, gross profit or gross loss ascertained in first step, which becomes the starting point of the ascertainment of net profit or loss. It takes into consideration all remaining indirect (normal and abnormal) expenses and losses related to or incidental to business. These operating and non-operating expenses are charged and shown to the debit side of the account. After transferring the Gross Profit or Gross Loss, the sources of other incomes like commission or discount received are shown on the credit side. The credit side also includes the non-trading income like interest on bank deposits or securities, dividend on shares, rent of property let out, profit generated out of the sale of fixed assets, etc. On the debit side will appear all other expenses that appear in the Trial Balance but cannot find a place in the Trading Account. The debit side will also include the losses arising out of sale of assets and any abnormal losses.

The net income is measured by matching revenues and expenses. Net income is the difference between total revenues and total expenses.

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 aprofit
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.

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 businessin 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.

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 finishedgoods
2. Some of the expenses connected with production, such as, depreciation and repairs of machinery, are usually debited to the Profit and LossAccount.

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***

TOPIC 9

FINANCIAL STATEMENTS OF A NOT FOR PROFIT MAKING ORGANIZATION

INTRODUCTION

Non for profit organization or non-trading organization are those organizations which are established not for earning profits but for promoting art, culture, sports, education etc. Medical institution, Charitable trusts, welfare societies, educational institutions etc. are examples of non-trading organizations

The final accounts of non-trading organizations include the following:

1. Receipts and payment account
2. Income and expenditure account
3. Statement of financial position

Their main not for profit organizations prepare financial statements is to know:

i. Whether their current incomes are sufficient to meet current expenses
ii. What their financial position is at the end of each period.

Therefore, they prepare an account each. year called Income and Expenditure Account, setting out all incomes (or revenue receipts) on the credit side (Cr.) and all revenue expenses on the debit side (Dr.).

TYPES OF FUNDS AND THEIR ACCOUNTING TREATMENT

1) Subscription

It is a recurring income for nonprofit organizations. This is one of the main sources of revenue. This is shown on the credit side of income and expenditure account. Adjustment should be made to show the correct income for the period.

Subscription received for certain specific purpose like subscription for tournament fund, subscription for construction of pavilion etc. should be capitalized (that is shown on the liability side of the balance sheet)

2) Donations

The amount received from a person, firm or company by way of gift is called a donation. Donations may be specific donation or general donations.

a) Specific donations

If the donations are for a specific purpose, example donation for building, donation for library, donation for furniture etc. it must be treated as capital receipts and should be shown on the liability side of the balance sheet. The expenditure incurred on this account should be deducted and the balance should be shown until it is completely used up.

b) General donations

When the donations are given for a general purpose, it is the amount which will determine whether it is a capital or revenue receipts. Donation of a comparatively small amount must be treated as income, But if the amount of such donation is big, it must be treated as capital receipts and it should be shown on the liability side of the balance sheet.

3) Grants

Grant received from central, state or local bodies for routine expenses are treated as income. Grant for specific purpose such as constructions of buildings, purchase of x-ray equipment's Etc. is capitalized

4) Legacy

It is the amount received by the nonprofit organizations as per the will of a deceased person. It is a capital receipt and is shown on the liability side of the balance sheet, but if the amount is small it may be treated as income and may be shown on the credit side income and expenditure account.

In the absence of any specific information legacy must be preferably be capitalized.

5) Endowment fund

The fund meant for permanent means of support is known as endowment fund. It is a capital receipt

6) Entrance fees

This is the amount of fee collected on the admission of members. Accountants differ on the treatment of entrance fees. Many feel that since the amount is collected only once and as it is a non recurring in nature it should be capitalized and taken to the liability side of the balance sheet but others argue that though it is paid 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:

8) Sale of newspapers and periodicals etc.

The amount received on selling newspapers, periodicals, etc. should be treated as income and is credited to income and expenditure account

9) Expenditure stock items

Items like stationery sports, materials like bats balls etc. are called expenditure stock items the value of that type Of items which remains Unused should be deducted from the total amount spent so that only the amount actually used up is debited to income and expenditure account. Statement is as follows:

Stock of Stationery (opening)	xxx
Add purchase during the year	xxx
	xxx (balance sheet (asset Side)
Less stock of stationery (closing)	xxx
Stationery item used during the year	xxx (debited in the I and E account)

10) Sale of scraps, grass etc.

These are treated as revenue receipts and shown on the income side