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# **CPA SECTION 1**

# FINANCIAL ACCOUNTING

**STUDY TEXT** 

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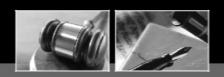


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ACCOUNTING TOINTRODUCTION



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# **CHAPTER ONE**

# INTRODUCTION TO ACCOUNTING

### **▶** OBJECTIVES

After studying this chapter, you should be able to:

Define accounting and explain the phases of accounting
Explain the branches of accounting
Identify the users of financial information
Understand the basic financial accounting equations and define assets, liabilities and capital
Prepare an account in the T form
Identify the characteristics of good information
List and explain the principles, concepts and conventions underlying the accounting reports
Understand the regulation of accounting profession

### **▶** INTRODUCTION

This chapter forms the basis of all accounting work.

The first part deals with the nature of accounting and the phases of the accounting process. The basic accounting equation will be introduced and the regulations of accounting profession introduced.

## **▶** DEFINITION OF KEY TERMS

- 1. **Accounting**: Accounting may be defined as the process of identifying, measuring, recording and communicating financial information in order to permit users to make informed decisions.
- **2. Accounting equation**: This is a mathematical description of the relationship betweenassets, liabilities and capital.
- **3. Accounting policies** are the specific principles, bases, conventions, rules and practicesapplied by an entity in preparing and presenting financial statements.
- **4. Assets:** Items of value to an organization.
- **5. Liabilities**: Obligations by the organization to other parties.
- **6. Capital**: Resources put into the business by its owners

# EXAM CONTEXT

www.masomonsindi.com This is a very important chapter, which set the basis of accounting ideas and conventions. Expect questions on all aspects, including the framework.

# **▶ INDUSTRY CONTEXT**

All professions require that one understands the basics. Accounts and its braches such as auditing are not an exception. Most accounting fundamentals are contained in this chapter. A clear understanding of this chapter's content will not only help one pass the exam but also in application of accounts in the industry.

#### NATURE AND PURPOSE OF ACCOUNTING 1.1

Accounting, as a preamble, could be termed the language of business. It is the common media through which people of all walks can effectively communicate business matters and understand one another equally.

It is the language accountants use to communicate i.e. record business transactions and summarize results of business operations. Accounting can be defined as the art of recording, classifying and summarizing in a significant manner, and in terms of money, transactions and events which are of a financial character, and interpreting the results thereof.

It encompasses the recording of information of economic value to a business. The information then forms the basis for judgment by the users.

# PHASES OF THE ACCOUNTING PROCESS

From the above definition, we can clearly see that accounting is a process that can be divided into four phases;

Recording phase: involves the routine and mechanical process of writing businesstransactions and events in the books of accounts - also called books of original entry or simply journals - in a chronological order in accordance with the entity's and other established accounting rules and procedures.





- Classifying phase: involves sorting and grouping of similar transactions into 2. theirrespective classes by posting them into a ledger.
  - A **ledger** is a group of accounts of a similar nature

An account is the basic record of accounting which measures increases or decreases in a particular asset, liability, income or expense account.

- 3. **Summarizing phase**: this involves the preparation of financial statements or reports. Itis usually done periodically e.g. monthly, annually etc.
- 4. Interpretation: this refers to the analysis of the accounting information. It involvescommunication of financial information to help users in making economic decisions.

This is the reason why accounting is called the language of business.

# **BRANCHES OF ACCOUNTING**

### Accounting, in all its broadness, can be sub-divided into areas of specialization;

- Financial accounting; concerns itself with the collection and processing of accounting data and reporting to interested parties inside and outside the firm.
- Tax accounting: deals with the determination of the firm's tax liability which could be. b.
- Value added tax (VAT), customs duty, Pay as you earn (PAYE), corporation tax etc. **Cost accounting**; helps establish costs relating to the production of a good or service C. and allocating it to the various factors that contributed to the cost of production.
- Managerial accounting; deals with the generation of accounting information to be used d. categorically by the firm's internal management in their day-to-day decision making.
- Auditing; concerns itself with the vouching and verification of transactions from the e.

financial accounting to determine that they are a true representation of the business' activity i.e. the true and fair view of the company's state of affairs.

# **USERS OF FINANCIAL INFORMATION**

- 1) Management – management of business entities need accounting information to assistfor planning and decision making. They will need the information to prepare budgets and compare with the actual results of operations. They will also be interested in the cost consequences of a particular course of action to assist them in making decisions
- 2) Present and potential investors - they need accounting information to assess therisk inherent in, and the return provided by their investments. They need information to decide whether they should maintain, increase, decrease of dispose altogether their investments.
- 3) Employees are interested about the stability and profitability of their employer. It isa source of stability for them and they need to know whether to start searching for employment elsewhere or keep their current postings. They are also concerned about the ability to provide remuneration, retirement benefits and employment opportunities.

- 4) Lenders. They are the givers of some part of the company's capital. They need to know if the loans and the corresponding interests will be paid when due.
- **5) Customers**. They require financial data in order to anticipate price changes and toseek alternative sources of supplies when necessary.
- **6)** The government. Governments and their agencies require information to regulate theactivities of the enterprises. They also need the financial information to determine level of taxation and also in preparation of national statistics.

### The general purpose of accounting can therefore be summarized into five purposes;

i. Helps in decision making

- ii. Ascertain the value of the business
- iii. Know the profit and or loss position
- iv. Ascertain the assets and liabilities of the firm
- v. Know the cash and wealth of the business

1.2 THE BASIC ACCOUNTING EQUATION

Fast forward Capital = Assets - liabilities

FINANCIAL STATEMENTS AND ELEMENTS OF FINANCIAL STATEMENTS

there are two main financial statements available to users; the statement of financial position and the income statement.

### **Balance sheet**

It shows the financial position of the entity at a given point in time.

The accounting equation is reflected in the balance sheet. The equation, normally called the book keeping equation is:

Assets – liabilities = capital





The equation shows that for a firm to operate, it needs resources (assets) which have to be supplied by external parties including creditors (liabilities) and from the owner (capital).

Business transactions will always affect two items of the accounting system.

Assets and liabilities are valued according to accounting conventions.

**Assets** could be defined as being resources controlled by an enterprise as a result of past eventsand from which future economic benefits are expected to flow to the enterprise.

Current assets are those assets whose benefits are expected to flow within a period of less than six months. They form part of the enterprise's operating cycle or are held for trading purposes e.g. inventory, accounts receivable (debtors), cash in hand and cash at bank.

Non-current assets have their benefits expected to flow for a period of more than 12 months. They are tangible and intangible assets acquired for retention by an entity for the purpose of providing a service to the business.

Examples of tangible non-current assets include buildings, equipment, and machinery.

Intangible non-current assets include goodwill, copyrights, patents, royalties.

A liability is defined as a present obligation of the enterprise arising from past events, thesettlement of which is expected to result in an outflow of resources embodying economic benefits from the enterprise.

They represent claims on the business by the outsiders.

Current liabilities are expected to be settled in the normal course of the entity' operating cycle and within 12 months.

Equity is the residual interest in the assets of the enterprise after deducing all the liabilities.

# П

# THE ACCOUNTING EQUATION AND THE STATEMENT OF FINANCIAL POSITION

The accounting equation is the basis of financial accounting.

Transactions are recorded using the double entry system of book keeping showing the two-fold effect that is done to maintain equality of the equation. The double entry system requires the use of an account.

**An Account** is the most basic accounting record. It summarizes the increases and decreases ina particular asset, liability, revenue, expense or a capital item.

An account is divided into two sides; the left being the **debit** and the other the credit side. To debit therefore will mean to enter an amount on the left hand side of an account and vice-versa.

The double entry concept states that "for every debit entry, there is a corresponding credit entry".

# The basic double entry rules for accounts are:

FINANCIALA	CCOUNTING		msindi.com
The basic doubl	e entry rules for accou	Ints are:	
Assets	An increase	Debit Debit	1
7100010	A decrease	Credit	
Liabilities	An increase	Credit	1
	A decrease	Debit	
Capital	An increase	Credit	1
	A decrease	Debit	
Revenue	An increase	Credit	1
Expenses	An increase	Debit	1

# QUALITIES OF GOOD ACCOUNTING INFORMATION

For accounting information to be able to effect the purpose for which it was meant, there are certain attributes that it must fulfill. These include:

- (a) Understandability. For accounting information to be considered useful, it must be well understood by the parties for which it was prepared for. The parties must be able to derive satisfaction from the financial data represented by accounting.
- **(b)** Relevance. The accounting information should be able to influence the important decisions in the company. The information should be verifiable, neutral and truthful.
- (c) Reliability. Reliability means that the accounting information should have differing methods or ways of doing it and yet arrive at the same or similar conclusions.
- (d) Comparability. The accounting information should be able to be compared with other information from different organizations or of the same organization at differing periods.
- (e) Timely. If the accounting information is not availed to the deserving user at the time ofneed, then it may as well be useless. For accounting information to be useful, it must be presented to the party in need at the time of the need.

### LIMITATIONS OF ACCOUNTING INFORMATION

#### Historical 0

Accounting information is prepared based from past period monetary transactions. It is hardly feasible that what happened in the past will hold on in the future and so the accounting information may be considered irrelevant on that basis alone.

### Too quantitative rather than qualitative

Accounting information consists of too many figures and less of explanations. For any system to be useful, it must strike a balance between quantitative and qualitative measures.





# o Only comparable to similar businesses

Accounting information makes it only comparable to businesses of similar nature. It is difficult to compare a service oriented organization to a manufacturing based firm.

# 1.3 THE PRINCIPLES, CONCEPTS AND CONVENTIONS UNDERLYING THE ACCOUNTING REPORTS

**Fast forward** – Prudence, substance over form and materiality should govern the selection andapplication of accounting policies.

After defining what accounting is all about, we now need to know the environment that accounting operates. Just like any other field of study, accounting has developed its own concepts that govern its application. These concepts form the fundamental accounting assumptions underlying the preparation of financial statements.

# THE CONCEPTS

There are four main concepts:

# Going concern

It is assumed that the operation will continue in operational existence into the foreseeable future. This implies that the management should view all the available information in the light of the foreseeable future, but not only for the current period.

# Accounting period convention

Also known as the time concept. It is assumed that the continuous lifetime of the entity is divided into small equal periods to ease the burden of reporting. These subdivisions are called the financial year.

# ■ Business entity concept

The assumption is that the business is a separate legal entity; distinct from the owners and the management. The financial affairs of the business entity are recorded and reported separately from those of the owners of the capital or the managers

# ■ Monetary principle

It is assumed that the financial impact of the business entity is broken down into transactions that are assessed and quantified in some unit of measure. The underlying assumption is that, for the sake of commonness, the unit of measure is a monetary one.

# THE ACCOUNTING PRINCIPLES

### Historical cost

Postulates that assets should be recorded at cost, at the purchase price or at the acquisition price. This ignores the effects of inflation on cost as the assets are kept by the business over the years.

It recognizes that for example a building purchased 40 years ago for Sh 29,000 would be reported today in the statement of financial position at that historical price even though its actual worth today may be Sh 2.9 million.

However, this problem has been overcome by asset revaluation as an alternative to the historical cost of accounting.

# Monetary principle

This principle holds that accounting will only endeavor to deal with those items to which a monetary value can be attached. As such, financial statements reflect only the items that can be measured in monetary terms. Goodwill for example is never shown in the statements because it has no monetary measurement.

# Accrual concept

The accruals concept is also known as **matching concept**.

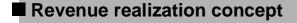
In the principle, revenues and costs are recognized when earned or incurred and not as the monetary attachment is received or paid. What this means is that the time when the revenue is received or the expense is incurred is completely disregarded. This leads into two scenarios; prepayments and accruals

**Prepayments** occur when money is received for a period that it has yet to be earned, or an expense is paid for but has not yet been incurred.

**Accruals** occur when the expense for the money is being paid for has already been incurredi.e. the expense belongs to a past period, or when an income is received way after the period of earning has expired.







It states that a sale should be recognized when the event from which it arises has taken place and the receipt of cash from the transaction is reasonably certain. Revenue can be recognized at different levels of selling such as when the inquiry is made, during delivery, at issue of invoice or when payment is made.

Revenue realization demands that only when the money receivable is reasonably certain of reception should accountants recognize it as income. For instance, it may not be prudent to recognize a sale when a customer makes an inquiry because the requisition may be revoked well before the goods are even ordered or delivered.

## ■ Prudence

Prudence states that where alternatives exist, the one selected should be one that gives the most cautious presentation of the financial position of the business. Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities and losses.

Where a losses foreseen, it should be anticipated and taken immediately into account. In other words, accountants should never anticipate for gains but must always provide for losses.

# Consistency

The items in the financial statement should be presented and classified in the same manner from one period to the next unless there is a significant change in the nature of the operations of the business, or a review of its financial statement presentation demonstrates that relevance is better achieved by presenting items in a different way, or a change is required by a new international standard.

### For instance, an entity is not allowed to change form LIFO to FIFO or otherwise unless:

- there is a significant change in the business
- there is a new accounting order
- It helps present the information better.

# Materiality

Information is material if its non-disclosure could influence the decisions of users. Materiality depends on the size and the nature of the item being judged. Strict adherence to accounting rules is not necessary in accounting for trivial items such as loose tools, e.g. a stapler should not be capitalized, and a bribe cannot be itemized under expenses.

# Duality

Duality principle emphasizes the double entry book-keeping entry that every transaction has two effects, for every debit there is a corresponding, equal and opposite credit entry. As such it forms the basis of the double entry system of book keeping.

## Substance over form

Some transactions have a real nature that differs from their legal form. This principle states that whenever it is legally possible, the real substance prevails over the legal form.

# 1.4 THE REGULATION OF ACCOUNTING PROFESSION

# ☐ THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB)

The IASB is an independent, privately funded accounting standard setter based in London.

The 14 members of the IASB come from nine countries and have a variety of backgrounds with a mix of auditors, preparers of financial statements, users of financial statements and an academic. The board consists of 12 fulltime members and two part-time members.

In March 2001 the International Accounting Standards committee (IASC) was formed as a not-for-profit corporation incorporated in the USA. The IASC foundation is the parent entity of the IASB.

From April 2001 the IASB assumed accounting standards setting responsibilities from its predecessor body, IASC. This restructuring was based upon the recommendations on shaping IASC for the future.

# Objectives of the International Accounting Standards Board

- 1. To develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in general purpose financial statements.
- 2. To provide the use and vigorous application of those standards.
- 3. To work actively with the national accounting standard setters to bring about convergence of national accounting standards and IFRS to high quality solutions.



# THE INTERNATIONAL FEDERATION OF ACCOUNTANTS (IFAC)

The IFAC is a private sector body established in 1977 and which now consists of over 100 professional accounting bodies from around 80 different countries. The IFAC's main objective is to co-ordinate the accounting profession on a global scale by issuing and establishing international standards on auditing, management accounting, ethics, education and training. The

IFAC has separate committees working on these topics and also organizes the world congress of accountants, which is held every five years. The IASB is affiliated with the IFAC.

# INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS BOARD (IPSAB)

Regulation of public not-for-profit entities, principally local and national governments and governmental agencies, is by the IPSAB, which comes under the IFAC.

**Fast forward** – ICPAK, RAB and KASNEB jointly form the framework of regulation of theaccounting profession in Kenya.

It is important to put accounting into practical perspective. This will be made possible by looking at the institutions that regulate the climate within which the accounting profession is practiced.

The Accounting Act was enacted by the parliament into chapter 531, Laws of Kenya in 1977.

The Act then established the Institute of Certified accountants of Kenya (ICPAK), the Registration of Accountants Board (RAB) and the Kenya Accountants and Secretaries National Examinations Board (KASNEB).

The three jointly form the framework of regulation of the accounting profession in Kenya.

# ■ Role of ICPAK

- 1. To provide standards of professional competence and practice among its members.
- 2. To promote research into the subjects of accountancy, finance and related matters, and the publication of books, periodicals, articles and journals in that connection.
- 3. To promote the international recognition of the institute.
- 4. Advise the examinations board on matters relating to examination standards and policies.
- 5. Carry out any other functions prescribed for it under any other provision or under other written law
- 6. Do anything incidental or conducive to the performance of any of the preceding functions

# **Role of KASNEB**

- 1. Prepare syllabuses for accountants and secretaries examinations
- 2. Make rules in relation to the examinations
- 3. Issue certificates to candidates who have satisfied the examination requirements.

### Role of RAB

- 1. Register the accountants that have been certified by the examination body to have fulfilled the examination requirement.
- 2. Issuance of practicing certificates to those wishing to render the accounting services to the public

# **CHAPTER SUMMARY**

Accounting may be defined as the process of identifying, measuring, recording and communicating financial information in order to permit users to make informed decisions.

More simply, accounting could be explained as keeping records about the transactions a business, or other organisation, takes part in so as to be able to gauge how well the organisation is doing.

Accounting may be split into four main categories:

- a) Financial accounting
- b) Auditing

- c) Cost accounting
- d) Management accounting

The reason why the accounting process is carried out by organisations is to enable users of financial information such as the government and investors to take profitable courses of action on the basis of the financial information provided.

The accounting equation may be presented as follows:

### Assets = Liabilities + Capital

### Accounting information should be:

- a) Comprehensible
- b) Complete
- c) Reliable
- d) Relevant

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# CHAPTER QUIZ

- 1. What is financial reporting?
- 2. What are the two main financial statements drawn by accountants?
- 3. List 5 general purposes of accounting?
- 4. Assets Capital =....?
- 5. List 5 qualities of good accounting information?

# ANSWERS TO CHAPTER QUIZ

- 1. A way of recording, analyzing and summarizing financial data.
- 2. The statement of comprehensive income and the statement of financial position (also known as the balance sheet).
- 3. Helps in decision making.
  - Ascertain the value of the business.
  - Know the profit and loss position.
  - Ascertain the assets and liabilities of the firm.
  - Know the cash and wealth of the business.
- 4. Liabilities.

- 5. Understandability.
  - Relevance.
  - Reliability.
  - Comparability.
  - Timely.

# **PAST PAPER ANALYSIS**

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# **CHAPTER TWO**

# **ACCOUNTING PROCEDURES AND TECHNIQUES**

### **▶** OBJECTIVES

After studying this chapter, you should be able to:

- Define bookkeeping and distinguish it from accounting
- Explain the accounting cycle
- Prepare book of original entry and the various ledgers
- Distinguish between real, nominal and personal accounts
- Understand and prepare two column, three column and petty cashbook
- Prepare a bank reconciliation statement
- Prepare initial accounts
- Record transactions with regard to assets, liabilities, capital, income and expenses
- Balance off accounts and extract a trial balance
- Identify the different types of errors and pass journal entries to correct them

### **▶** INTRODUCTION

In this chapter we will introduce bookkeeping, books of original entry and take you through the accounting cycle. We will finally explain how to extract the trial balance and use it to detect errors and how to correct them.

### **▶ DEFINITION OF KEY TERMS**

**Assets:** an asset can be defined as resources present in a business organization that have probable future economic benefit. They include cash, land and buildings stock e.t.c.

Assets can either be defined as current, non-current or intangible.

**Current Assets:** these are assets consumed in one year or are expected to benefit the firmwithin a period of not more than one financial year e.g. stock, cash at hand, cash at bank, debtors, prepayments e.t.c

**Non-current Assets:** these are assets whose economic benefits to the organization are achieved for a period exceeding one financial year. Examples would be land and buildings, motor vehicles, plant and machinery, computers e.t.c

**Intangible Assets:** these are assets of economic value to the business enterprise but cannot bephysically felt or seen e.g. goodwill, patents, copyrights e.t.c

These are obligations that a business is expected to meet within a certain duration. They can also be defined as total funds owed for assets supplied to a business or expense incurred but not paid yet.

Liabilities can either be short term or long term. Short term liabilities are "be met within duration of one financial year. Payment for a share holders e.t.c. on the other hand long exceeding one financial year e a "bapital: this is

Capital: this is defined as the total of all resources invested and left in business by its owner.

Revenue/Income: this can be defined as the monetary value of all goods and services sold to customers by a business enterprise

Expenses: This can be defined as the monetary equivalent of all resources/assets that havebeen consumed during a given period to generate the revenues for the business organization in a given accounting period.

### **► EXAM CONTEXT**

Most question set will require a thorough understanding of this chapter since it forms the basis of most accounting work.

## **► INDUSTRY CONTEXT**

This chapter also acts as a foundation to more complex accounting. This chapter details simple accounting, books of original entry and bank reconciliation. These are accounting activities done on a daily basis by accounts assistant and act as source document for final financial statements. Auditor will always assess these to be able to approve final financial statements.

# **BOOK KEEPING**

Fast forward - Book keeping is intended to record all the accounting data in such a way that onecan make a deduction based on it.

Book keeping defined as the process of recording business transactions (data) in a systematicmanner. It can also be defined as that part of accounting that is concerned with recording data.





Book keeping is intended to record all the accounting data in such a way that one can make a deduction based on it. The deductions could be such as:

- How much sales has been achieved over a given period of time, be it a day, a month, or a year.
- How much is owed to the creditors.
- How much is available in the bank, among others.

The whole process of book keeping is in the form of a cycle i.e. the accounting cycle.

# 2.2 THE ACCOUNTING CYCLE

The accounting process can be perceived as a cycle which starts with the occurrence of a transaction, recording of the transaction and finally the preparation of the financial statements. Financial statements are reports on results of all the transactions that occur during the year and the position of the business as at the last date of the accounting period. A transaction is an activity which involves the exchange of goods and services for another thing of value e.g. when the business purchases goods for sale, sells goods to customers on credit, pays for services e.g. telephone.

A transaction is first recorded in the source documents e.g. the cash sale receipt, the invoices received from creditors, debit and credit notes issued and received etc

The daybooks as the name suggests they are filled daily showing all the transactions that occurred during the day. Such information is obtained from the source documents.

The data in the day books is then filled in the ledger accounts and a trial balance extracted as the end of the accounting period. Adjustments e.g. for prepayments and accruals are then made and an adjusted trial balance is drawn reflecting these changes.

From this trial balance, the final statements are prepared i.e. the statement of comprehensive income which reveals whether the company made a profit or loss from the transactions carried out in the year, and the statement of financial position which tells of the financial position of the business in terms of its assets and liabilities as at that closing date.

After these, the closing entries are made to prepare the accounts to receive the data for the following financial period and a closing trial balance extracted.

This marks the end of journals

For every transaction entered into the business enterprise, there is the primary book where it will be initially recorded. This is known as books of original entry.

# 2.3 BOOKS OF ORIGINAL ENTRY

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Fast forward - Accounts can be divided into personal accounts and impersonal accounts.

Books of original entry can be defined as the books in which we first record a transaction. These books essentially record the following details of a transaction:

- date of the transaction
- the name of the person/ firm with whom the transaction took place
- the details of an item bought or sold e.g. a motor vehicle stock e.t.c
- details for cross referencing
- the amount (shown in monetary terms) of the transaction

Books of original entry are known as journals or daybooks. Both terms are used interchangeably. The commonly used books of original entry are:

# i. PURCHASES JOURNAL

This journal is used to record all purchases made on credit only.

Example

### **PURCHASES JOURNAL**

Date	Details Folio	Amount (Sh)	
1/12/2006	J. Chege	PL 009	4,200
1/12/2006	A. Mbole	PL 011	6,700
4/12/2006	J. Chege	PL 009	9,200
5/12/2006	B. Gummo	PL 010	2,100
8/12/2006	H. Njeri	PL 014	4,100
8/12/2006	A. Mbole	PL 011	10,400
9/12/2006	J. Chege	PL 009	8,500
10/12/2006	A. Mbole	PL 011	<u>6,100</u>
			51,300





# ii. SALES JOURNAL

A sales journal records credit sales only.

### >>> Example

## **SALES JOURNAL**

Date	Details	Folio	Amount
			(Sh)
1/4/2006	J. Kamau	SL 001	5,000
1/4/2006	P. Otieno	SL 002	4,000
2/4/2006	E. Muteti	SL 003	3,200
3/4/2006	P. Otieno	SL 002	4,700
4/4/2006	J. Kamau	SL 001	4,200
5/4/2006	A. Kioko	SL 005	6,700
6/4/2006	J. Kamau	SL 001	2,800
			30,600

# iii. RETURN OUTWARDS JOURNAL

It records goods returned by the business to the suppliers for the reason that they are either tampered with, are not of the kind ordered for, are damaged, or are in excess of the amount ordered.

## >>> Example

### **RETURN OUTWARDS JOURNAL**

Date	Details Folio	Amount (Sh)
9/12/2006	A. Mbole	PL 011 1,100

# iv. RETURN INWARDS JOURNAL

This journal is used to record all the goods that are returned to the business by the customers because they were not the kind ordered for or were in excess e.t.c

### >>> Example

### **RETURN INWARDS JOURNAL**

Date	Details	Folio	Amount (Sh)
8/4/2006	J. Kamau	SL 001	800
9/4/2006	A. Akiko	SL 005	500
			1,300

# v. CASH BOOK

This is a book of original entry that is used to record all cash received or paid out by the business via the cash till or via the business' bank account. A cash book is a unique journal since it acts both as a book of original entry as well as a ledger account where all transactions affecting cash are recorded. It shall be dealt with in detail later on in this chapter.

# vi. GENERAL JOURNAL: (ALSO REFERRED TO AS THE JOURNAL PROPER)

All other transactions not falling into any of the above journals are recorded in this journal.

In the general journal the following details relating to the transaction are included; date, the name of the account to be debited, the name of the account to be credited and a brief narration or description of the transaction as illustrated below.

### **GENERAL JOURNAL**

Date	Details	Debit(Dr)	Credit(Cr)
_/_/_	Account to be debited	****	
	account to be credited	128	****
	(a brief narrative to describe the above transaction)	0,	





# A general journal has the following uses:

- Recording the purchase or sale of fixed assets on credit
- Correction of errors in the ledger accounts
- Adjustment of ledger entries
- Writing off of bad debts

P	OS	STI	N	G
---	----	-----	---	---

When all transactions have been entered into the specific journals, they are then entered into their respective accounts in the ledger in a process referred to as posting. An account is a place where all details relating to a particular asset, liability or capital, is recorded. There could be an account for motor vehicles, another for buildings, another one for a specific creditor and yet other separate accounts for each debtor e.t.c.

#### Accounts can be divided into two:

- Personal accounts
- Impersonal accounts.

Personal accounts are accounts dealing with customers and suppliers i.e. debtors and creditors. Impersonal accounts on the other hand can further be divided into:

Real account used for recording possessions like land, motor vehicles, buildings, furniture and fittings.

Nominal account used for recording capital, income and expenses.

All accounts are prepared in a 'T' format and thus generally referred to as T- accounts. The T-accounts have two sides; the debit side on the left and the credit side on the right of the account as shown below.

### <Name of the account>

Dr Cr

DATE	PARTICULARS	AMOUNT (Sh)	DATE	PARTICULARS	AMOUNT (Sh)
					$\sim$
					3
					1

Every transaction in a business affects two accounts. One of the accounts is debited while the other is credited by the same amount giving rise to double entry book keeping i.e. for each entry recorded in the journals there will be a debit and a credit entry in two separate accounts in the ledger.

- A brief example would be when we buy a motor vehicle for cash. Two items will be affected:

   We will have a new asset; known as a car (a motor vehicle)
   On the other hand, the asset cash will be car.

  Generally a transactic effect.

reflected in the accounts as follows:

- When we increase an asset we make a debit entry to the asset account
- (ii) When we decrease an asset we make a credit entry to that account
- (iii) When we increase our liabilities or capital, we make a credit entry
- (iv) When we decrease our liability or capital we make a debit entry to that account.

# Uses of special journal

- They facilitate grouping transactions which are alike together, recording them to provide relevant transaction details.
- It facilitates easier mechanization of the recording process
- It makes the posting work easier because numerous ledger accounts take the totals.
- They minimize possible errors.

#### 2.4 THE LEDGER

Fast forward - All accounts that do not fall under either the sales or purchases ledger are held under the general ledger.

The ledger is a book in which various accounts are kept. There are three main types of ledgers:

- i. Sales ledger
- Purchases ledger ii.
- iii. General ledger

# (i) SALES LEDGER

After all transactions have been recorded in the sales journal, the next step is to post these transactions using double-entry book keeping into the various ledgers. The sales ledger is made up of individual accounts of the debtors i.e. customers who have purchased from us on credit.



# To maintain double entry, the sales ledger is posted as follows:

- For all the customers in the sales journal, debit their individual accounts in the sales ledger.

  Make the corresponding credit entry in the sales account which ledger.

  having too many entries in the sales account which is the sales acc
- ii.

To avoid having too many entries in the sales account, we sum up all the individual debtors account and post the total to the credit side of the sales account in the general ledger. This total should equal to the total as reported in the sales journal i.e. the first book in which the all the credit sales were initially recorded before being posted to the ledger accounts. The two totals will however be equal if and only if double entry concept was adhered to in the posting process.

Recall the sales journal illustrated earlier. The transaction recorded in this journal can be posted as follows in the sale ledger:

### J. Kamau

Dr			Cr

DATE	PARTICULARS	AMOUNT	DATE	PARTICULARS	AMOUNT
1/4/2006	sales	5000			
4/4/2006	sales	4200			
6/4/2006	sales	2800			
			1		

### E. MUTETI

DATE	PARTICULARS	AMOUNT	DATE	PARTICULARS	AMOUNT
2/4/2006	Sales	3200			
			1		

## P. OTIENO

Cr Dr

DATE	PARTICULARS	AMOUNT	DATE	PARTICULARS	AMOUNT
1/4/2006	Sales	4000			
3/4/2006	Sales	4700			

### A. KIOKO

Dr

DATE	PARTICULARS	AMOUNT	DATE	PARTICULARS	AMOUNT
5/4/2006	sales	6700		770	
				0/	
1	l				

Dr

# (ii) PURCHASES LEDGER

After all the transactions have been entered on the purchases journal, the entries are then posted in the purchases ledger. The purchases ledger is made up of individual creditors' account. Every credit purchase made by customers is recorded on the credit side of their individual account in the purchases ledger. The totals of this ledger are then posted to the debit side of the purchases account in the general ledger, again to avoid having too many individual creditors' entries in the purchases account. This total should equal the total of the purchases journal, if the posting process was done correctly.

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Cr

Recall the purchases journal illustrated earlier. The transaction recorded in this journal can be posted as follows in the purchases ledger:

### J. CHEGE

					<b>O</b> .
DATE	PARTICULARS	AMOUNT	DATE	PARTICULARS	AMOUNT
			1/12/2006	purchases	4200
			4/12/2006	purchases	8500
			9/12/2006	purchases	9200

### B. GUMMO

Dr Cr

		AMOUNT			AMOUNT
DATE	PARTICULARS	(Sh)	DATE	PARTICULARS	(Sh)
			5/12/2006	purchases	2100

### A. MBOLE

Dr Cr

		AMOUNT			AMOUNT
DATE	PARTICULARS	(Sh)	DATE	PARTICULARS	(Sh)
			1/12/2006	Purchases	6700
			8/12/2006	Purchases	6100
			10/12/2006	Purchases	10400
				0120	





Dr Cr

		Amount			
Date	Particulars	(Sh)	Date	Particulars	Amount (Sh)
			8/12/2006	purchases	4100

# (iii) GENERAL LEDGER

All other accounts that do not fall under either the sales or purchases ledger are held under the general ledger. Such accounts would include:

- (i) Fixed assets accounts e.g. furniture and fittings account, plant and equipment account
- (ii) Expenses accounts e.g. electricity account insurance, expense account e.t.c
- (iii) Return inwards account
- (iv) Return outwards account

## >>> Example 1

Given the following details; enter them in the sales journal, purchases journal, general journal, and then post them to the relevant ledger accounts.

### Year 2006

May 2	Credit sales to E. Kamau	Sh 12,800	
"2	Credit purchases to H Opati	Sh 9,600	
"4	Credit sales to J Omondi	Sh 11,700	
"7	Credit sales to N.Kimanzi	Sh 20,700	
"8	Credit sales to P.Amino	Sh. 4,900	
"12	credit Credit purchases from M. Kibaki	Sh 7,200	
"13	Credit sales to E. Kamau	Sh 42,000	~
"13	Credit Credit purchases from G.Njenga	Sh. 9,700	128
"15	return Return inwards from J Hadija	Sh. 200	O
"16	return Return outwards to K Nyongesa	Sh.1, 200	

"20	credit Credit purchases from H. Opati	Sh. 11,200
"21	credit Credit purchases from E. Joe	Sh 4,900
"23	credit Credit purchases from O. Mbiyu	Sh. 4,500
"27	bought Bought motor vehicle cash	Sh 20,000
"30	Sales to E Williams	Sh. 10,600

# Suggested solution:

# Entries in the sales ledger

# E. Kamau

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2006	Sh	2006	Sh
2/5 sal	es 12800		
13/5 sa	es 42000		

# J. Omondi

2006		Sh	2006	Sh
4/5	sales	11700		

# N.kimanzi

2006		Sh	2006	Sh
7/5	sales	20700		

# P. Amimo

2006	Sh	2006	Sh 3			
8/5	sales4900		170			
			128			
			0,			







	Sh	2006	Sh nh	•
sales	10600		*	
	sales			

# J. Hadija

		,		
2006	Sh	2006		Sh
		15/5	Return inwards	200

# **Entries in the Purchases ledger**

# H. Opati

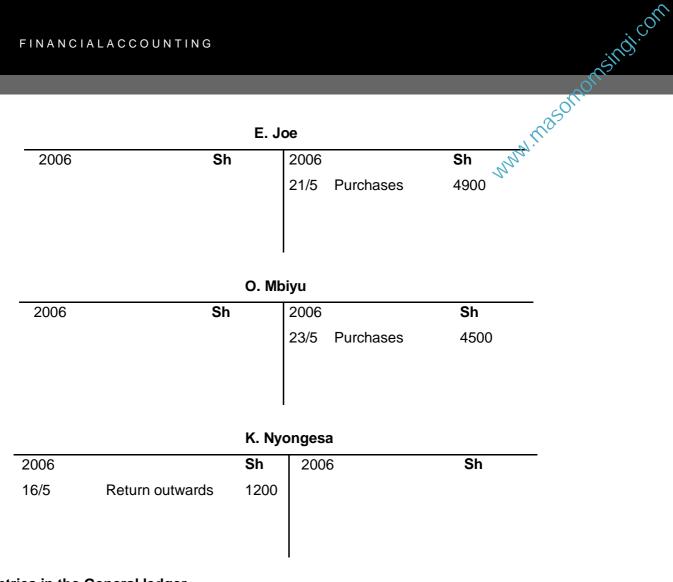
2006	Sh	2006	2006		
		2/5	Purchases	9600	
		20 /5	Purchases	11200	

# M. Kibaki

2006	Sh	2006	Sh
		12/5	Purchases 7200

# G. Njenga

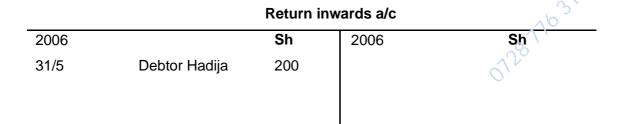
Sh	2006		Sh
<b>3</b>	13/5	Purchases	9700
			0128
	Sh		



# **Entries in the General ledger**

# Purchases control a/c Sh 2006 2006 Sh 31/5 Credit purchases47100

# Sales ledger control a/c Sh 2006 2006 Sh 31/5 Credit sales102700







#### **Return outwards**

-		•		·. <i>Q</i> .
2006	Sh	2006		Sh N
				10
		315	Creditor K. Nyongesa	1200

#### **Motor vehicle**

2006		Sh	2006	Sh
27/5	Cash	20000		

# 2.5 CASH BOOKS

A cash book is a document or a record of all transactions involving cash in business organization. It keeps track of all incoming and outgoing cash i.e. cash receipts and payments.

# TWO COLUMN CASH BOOK

Usually a business maintains two cash books; cash-in-hand cash book and cash-at-bank cash book. A cash-in-hand cash book records all transactions relating to cash paid out or received through the cash till. The cash at bank cash book handles transactions relating to cash that goes through the bank e.g. payments by cheque. Normally these two cash books are combined to form a two column cash book, the two columns being the cash and bank column.

A contra entry, for cash book items, is where both the debit and the credit entries are shown in the cash book, such when cash is paid into bank or withdrawn.

A withdrawal of cash from bank would appear in the cash book as a debit for cash and a credit for bank of the same amount and vice versa for a deposit. Both the debit and credit entries are in the same book. When this happens it is known as a contra item.

## Format of a two column cash book

Dr. TWO COLUMN CASH BOOK

Cr.

Date	Particulars	Folio	Cash	Bank	Date	Particulars	Folio	Cash	Bank

# >>> Example

Mr. Tamaa started a business on 1st January 2007.during the first month of trading the following transactions took place.

Wrote a personal cheque and deposited into the business bank account

Sh800,000 Withdrew Sh200, 000 from the bank and put it into the cash till.

2nd Jan, Purchased goods by cheque Sh70,000

3rd Jan, Bought furniture for cash Sh25,000 3rd

Jan, Bought equipment on credit Sh75,000 4th

Jan, Sold goods for cash Sh100,000

5th Jan, Bought goods and paid by cheque Sh.200,000 6th

Jan, Bought a motor van paying by cheque Sh.210,000

10th Jan, Obtain loan from the bank Sh.500,000

12th Jan, Sold goods on credit Sh75,000

16th Jan, Sold goods payment made by cheque Sh.100,000

16th Jan, Received a cheque from a debtor Sh.60,000

30th Jan, Took Sh10,000 from the cash till personal use.

Using the given details write up a two column cash book for Mr. Tamaa for the month of January 2007





Mr.Tamaa

# TWO COLUMN CASH BOOK FOR THE MONTH OF JANUARY 2007

Dr.							Cr.
DATE	PARTICULARS	CASH	BANK	DATE	PARTICULARS	CASH	BANK
2005				2005			
Jan				Jan			
1	Capital		200,000	02	Cash ©		200,000
2	Bank ©	200,000		02	purchases		70,000
4	Sales	100,000		03	furniture	25,000	
10	Loan		500,000	05	Purchases		200,000
16	Sales		100,000	06	Motor van		210,000
16	Debtors		60,000	30 31	Drawings Balance c/d	10,000 265,000	780,000
		300,000	1,460,000			300,000	1,460,000

#### Feb 1 Balance b/d

#### 265,000 780,000

# Notes

- (i) It is important to note that only transactions involving cash are entered into the cash book. Credit sales and credit purchases are not entered until the customer pays or the supplier is paid.
- (ii) When cash is withdrawn from bank and put in the cash till the entry made to capture this transaction is referred to as a contra entry. A contra entry affects both sides of the cashbook; the bank column on one side and a cash column on the other. A contra entry may also arise if cash from the cash till is deposited into the bank account. It's denoted by a 'c' indicated in the folio column.
- (iii) When all transactions have been entered into the cash book we then balance it off. Normally the cashbook will have debit balance in both the cash and bank columns. However, a bank overdraft will result into a credit balance in the bank column. A bank overdraft is a facility offered by the bank where the account holder is allowed to withdraw more cash than the remaining balance in his account.
- (iv) The debit side of the cash book generally records cash/bank receipts while the credit side records cash/bank payments.

# THREE COLUMN CASH BOOKS

Sometimes businesses maintain a three column cash book. The additional column is the discounts column, i.e. discount received on the credit side and the discount allowed on debit side.

Format of a three column cash book:

#### THREE COLUMN CASH BOOK

Dr. Cr.

			Disc.					Disc	
Date	Particulars	Cash	Allowed	Bank	Date	Particulars	Cash	received	Bank

# **Example:**

Enter the following transactions in a three column cash book.

- (i) Balance brought forward cash Sh 4700 bank Sh 17000
- (ii) Cash sales Sh 20000 (discount 8%)
- (iii) Cash sales Sh 42000
- (iv) Cash purchases Sh 18000 (discount 10%)
- (v) Sales paid for by cheque of Sh 40000 after deducting a 20% discount
- (vi) Paid Sh 50000 by cheque after deducting 20% cash discount.
- (vii) Purchases by cheque Sh 12000





#### Dr.

#### THREE COLUMN CASH BOOK

		Disc.	Cash				Disc.	Cash	
Date	Particulars	Allowed		Bank	Date	Particulars	Received	7.	Bank
2006					2006				
April					April				
1	Balance b/f	-	4700	17000	4	Purchases	1800	16200	-
2	Sales	1600	18400	-	5	purchases	12500	-	50000
								-	
2	Sales	-	42000	-	6	Purchases	-		12000
			-			Balance		48900	
5	Sales	10000		40000	30	c/d	-		-
30	Balance c/d	-	-	5000					
		11600	65100	62000	]		14300	65100	62000

#### **Notes**

(i)

It is important to check whether the amounts of sales or purchases are shown as gross or net of discount.

From (v) above, the amount is shown as net and for the purposes of knowing the discount, we work backwards so as to ascertain the discount amount as follows:

Net amount = Sh 40,000

Discount allowed = 20%

Therefore the net amount = Gross amount (n) x (100-20) %

$$n = 40000 = Shs.50000$$

Therefore discount allowed = Sh 50,000 - 40,000 = Sh 10,000

(ii) The amounts of both discounts allowed column and discounts received are treated as follows:

# **Discount allowed**

The totals will be posted to the debit side of the discount allowed account in the general ledger.

# | 2006 | Sh | 2006 | Sh | 30/4Debtors | 11600 | /5 |

#### Discount received

The totals of the discounts received column will be posted to the credit side of the discounts received account in the general ledger.

2006	Sh	2006		Sh
		30/4	Sundry creditors	14300

# 2.6 BANK AND CASH BOOK RECONCILIATION

**Fast forward** – Differences between the cash and the bank statement arise for three reasons; errors, usually in the cash book, omissions, such as bank charges not posted in the cash book and timing differences, such as un-presented cheques.

At the end of a particular period (mostly one month) the balances of the cash book should be extracted and in many instances, the cash at bank balance in the cash book does not agree with the bank statement over the same period though theoretically it should. This is a normal occurrence and the two needs to be reconciled so that any material errors can be identified as early as possible. The causes of the disagreement may be as a result of:

- (i) Items that appear on the cash book but not on the bank statement.
- (ii) Items that appear on the bank statement but not on the cashbook
- (iii) Errors when entering amounts in the cash book
- (iv) Errors by the bank while posting transactions



# Items that appear on the cash and not on the bank statement

# (i) Un-credited amounts (cheques/deposits)

This item mainly affects the cheques. Due to the nature of the cheque clearing process, a firm may deposit a cheque and thus debit the cashbook, but by the time the bank statement is being prepared, the amounts are not yet available. The cheque could also bounce and before the bank can communicate to the account holder, the balances in the bank statement and in the cash book will not tally.

#### (ii) Un-presented cheques

These are the cheques issued to the suppliers by the firm and shown as payments in the cash book. The suppliers may hold the cheque for a number of days before presenting it to the bank for payment and thus the bank will not have recorded such a payment in the bank statement hence will reflect a different balance from that in the cash book.

# Items appearing in the bank statement and missing in the cash book

- i) Direct Credits: when a customer deposits either cash or a cheque directly into the business' bank account without informing the business.
- **ii) Bank Charges:** when the bank debits (decreases) the account of the business with charges e.g. cheque book charges, ledger fees, commissions on electronic funds transfer both incoming and out going e.t.c.
- **Direct Debits**; when the bank pays/ honors a standing order, deducts loan payment from the account e.t.c
- **iv) Interest Income**; when the bank credits (increases) with the amount of interest earned on the account.
- v) Dishonored Cheques; when a cheque earlier deposited is dishonored
- vi) Interest charges with regard to bank facilities e.g. overdraft, credit card e.t.c.

# ☐ Errors while entering the amounts in the cashbook would include

- Overstatement/understatement of receipts and payments in the cash book
- Mis-posting of deposits or payments in the cash book.

Bank reconciliation is used to bring the two balances into agreement i.e. the back balance in the cash book and the bank balance in the bank statement.

The first thing to do while reconciling a bank statement is to update the cashbook. This is done by entering all the transactions that ought to be in the cashbook but were missing, as well as correct all errors in the cash book.

# Such entries would include

- Bank charges
- Direct credits and debits
- Dishonored cheques
- Overstatement/understatement of receipts in the cashbook
- Over/understatement of payments in the cash book
- Misposting of deposits or payments in the cash book

The second step is to prepare a bank reconciliation statement which expected to make adjustments on the balance in the bank statement to agree with the new balance obtained from the adjusted cashbook.

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# The following items will now be shown under the bank reconciliation statement

- Un-presented cheques
- · Un-credited deposits
- Errors in the bank statement
- The updated cash book balance

The Format of a bank reconciliation statement

# Format 1

#### <Name of business>

#### BANK RECONCILIATION STATEMENT AS AT

Sh Sh

Balance as per bank statement xxx

Add:
Un-credited cheques xxx

Errors that reduce bank balance xxx xxx

Less:
Un-presented cheques xxx

Errors that increase bank balance xxx (xxx Balance as per updated cash book xxx





## Format 2

#### <Name of business>

#### **BANK RECONCILIATION STATEMENT**

Sh Sh

Balance as per updated cash book

XXX

Add:

Un-presented cheques

XXX

Errors in the bank statement that increase bank balance xxx xxx

XXX

Less:

Uncredited cheques

XXX

Errors on bank statement that reduce bank balance

xxx (xxx)

Balance as per bank statement

XXX

#### Note:

#### Errors in the bank statement that reduce bank balance

Understatement of deposits into the bank account Overstatement of payments from the bank account

#### Errors that increase bank balance

Overstatement of deposits Understatement of payments

#### >>> Example:

On 31st December 2006 the cash book of H. Njeri showed a balance at the bank of Sh Sh8, 100. The bank statement however showed a balance of Sh 6,700. Going through the bank statement she found out that:

- (i) A cheque received from Taifa Ltd on 1st December for Sh 600 and entered into the cash book did not appear on the bank statement
- (ii) A cheque paid to E. Kamara Sh 700on 25th December had not been presented
- (iii) A cheque received from N Njiru on 24th December Sh 600 and entered into the cash book was returned dishonored. No entry in this regard was recorded I the cash book
- (iv) Bank charges amounting to Sh 100 had not been entered into the cash book
- (v) The bank received directly Sh 1000from E.A.B.L as dividends on 18th December on behalf of H. Njeri
- (vi) A cheque payment of Sh 2000 to Olivia had been entered in error Sh200 in the cashbook

# Required

- (a) Make the necessary entries to update the cash book
- (b) Prepare a bank reconciliation statement for H. Njeri for the month of December 2006

# Suggested solution

#### **Corrected Cash Book**

	FINANCIALACCOUNTI	N G			asingi.
Sugg	jested solution	=			nasomon'
		Corrected	l Cash B		
2006		Sh	2006		Sh
5	Balance b/f	8,100	/5	N. Njiru (dishonored)	600
	Direct credit	1,000		Bank charges	100
				Error in cheque to Olivia	1,800
				Balance as per cash book	6,600
		9,100	1		9,100
			╛		

# **BANK RECONCILIATION STATEMENT**

#### H. NJERI

# BANK RECONCILIATION STATEMENT AS AT 31ST DECEMBER 2006

Balance as per updated cash book	6,600
----------------------------------	-------

Add:

700 Un-presented cheques; E. Kamara

Errors that increase bank balance XXX 700

7,300

Less: uncredited cheques; Taifa 600

Errors that reduce bank balance (600)XX

Balance as per bank statement as at 31st December 2006 6,700

# November 1992 Q

A trainee accountant working for a sole trader, Juma Mambo Leo had prepared the following summary of the cash book for the month of March 1999

Cash book	Sh		Sh
Opening balance b/d	561000	Payments	4,189,000
Receipts	3748000	Closing balance c/d	120,000
	4309000		4309000



Whilst checking the cash book against t the bank statement you find the following discrepancies;

- (i) Bank charges of Sh 8000 shown in the bank statement have not been entered in the cash book
- (ii) The bank has debited a cheque of Sh 37000 in error in the account of Juma Mambo Leo
- (iii) Cheques totaling Sh 96000 have not been presented to the bank for payment.
- (iv) Dividends received for Sh 4200 have been credited on the bank statement but not yet recorded on Juma Mambo Leo's cash book
- (v) There were cheques received of Sh 484000 which were entered in the cash book but not yet credited by the bank.
- (vi) A cheque of Sh 17000 has been returned by the bank marked as 'refer to drawer' but no entry relating to this has been made in the books.
- (vii) The opening balance in the cash book should have been Sh 651000 and not Sh 561000
- (viii) The bank statement shows that there is n overdraft at 31st march 1999 of Sh 198000

# Required

- (i) State and briefly explain two purposes of a bank reconciliation statement.
- (ii) Entries necessary to correct the cash book
- (iii) A bank reconciliation statement as at 31st march 1999

(KASNEB)

# Suggested solution

(i) Purposes of a bank reconciliation statement

Bank reconciliation is an attempt to explain the differences between the cash book's cash at bank balance and the balance shown in the bank statement

#### It is prepared for the following reasons;

- To update the cash book with some relevant entries appearing in the bank statement e.g. bank charges, direct debit and credit dishonoureddishonored cheques e.t.c
- To detect or prevent errors or frauds that relate to the cash book
- To prevent or prevent errors or frauds that relate to the bank

#### (ii) The first step will be to update the cash book as follows:

#### **Corrected Cash Book**

2006	Sh	2006	n <sup>^</sup>	Sh
Balance b/d	120000		Bank charges	8000
Dividend received	42000		Returned cheque	17000
Error in opening balance	90000		Balance as per cash book	227000
	252000			252000

# **Bank reconciliation statement**

#### As at 31st march 1999

Sh Sh

Balance as per updated cash book 227000

Add:

Un-presented cheques 96000

Errors that increase bank balance ---

96000

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Less:

Uncredited cheques 484000

Errors that reduce bank balance 37000

(521000)

Balance as per bank statement (overdraft) (198000)

Reinforcement question may 2003 q2 (solution at the back)

# 2.7 THE PETTY CASH BOOK

Fast forward – Most businesses keep petty cash on the premises, which is topped up from the main account.

Majority of business payments are made by cheque. However for some amounts, the cashier need not write a cheque for each.

Examples of such payments includes when a staff member is given some bus fare from office to town on official duty, when stationery is bought e.g. pens e,t,ce.t.c. Such transactions involve fairly small amount s which does not warrant the writing of a cheque. For this reason most businesses maintain a petty cash usually handled by the petty cashier. The petty cashier is usually given a certain amount to use in the payments, called a cash float. The petty cashier maintains records of all the expenses paid out (either by keeping receipts or preparing petty cash vouchers which are signed against). After some time the petty cashier will request to be reimbursed for all the amounts paid out of the cash float given to him. This system of reimbursing some amount to the petty cashier after a certain period of time to maintain the **cash float** is known as the imprest system.





The petty cash book maintains columns relating to specific expenses e.g. traveling entertainment, stationery, general office expenditure, postage e.t.c. it is upon a business enterprise to determine the number of expenses account to maintain under the petty cash system.

# ■ Format of a petty cash book

					Expenses				
Receipts	Date	Detail	Payment	Postage	Stationery	General	Travel	Entertainment	The
			amount			expense			ledger

The ledger column is used to record the amount paid by petty cash to a person/ business with whom we have an account. A good example is when we pay creditors the amount owed using the petty cash.

#### >>> Illustration

Given the information below write up a petty cash book with the following columns; :

- i. Postage and telegram
- ii. Stationery
- iii. Traveling
- iv. Office expenses
- v. The ledger
  - i) January 1 received petty cash Sh 20000
  - ii) January 1 paid for sugar Sh 700
  - iii) January 2 bought pencils and pens Sh 800
  - iv) January 4 bus fare Sh 400
  - v) January 5 telegram Sh 1500-
  - vi) January 8envelops Sh 900
  - vii) January 9paid David (trade creditor) Sh 6000
  - viii) January 9 coffee Sh 200
  - ix) January 15 cleaning Sh14000

0128176317

					Expenses			an an	
Receipts	Date	Detail	Payment	Telegram	Stationery	Travel	Office	General	The
			amount	Postage					ledger
20000	Jan	Petty cash							
	1	Sugar	700.00					700.00	
	2	Stamps	1200.00	1200					
	3	Pencils	800.00		800.00				
	4	Bus fare	400.00			400.00			
	5	Telegram	1500.00	1500.00					
	8	Envelopes	900.00				900.00		
	9	David	6000.00						6000.00
	9	Coffee	200.00					200.00	
	15	Cleaning	14000.00				14000.00		
		Total	13100	2700.00	800.00	400.00	2300.00	900.00	6000.00

The ledger column is used to record any payments made to supplier with whom we have an account. in In the illustration above David is one such supplier.

At the end of a certain period of time the respective expenses columns are summed up and posted to specific expenses accounts in the general ledger. The petty cashier is also given a cheque/ cash as reimbursement for the amount expensed (in this case shsSh13100 Sh 13100 will be reimbursed to the cashier to make the original float of shsSh20000Sh 20000)

#### **Further exercises:**

#### Q1 K.A.S.N.E.B. ADOPTED

- (a) Differentiate between a petty cash book and a three column cash book.
- (b) Explain why it is important for a bank to prepare a bank reconciliation statement.
- (c) You have recently been employed in a medium sized company and deployed in the accounts department. Your section head has given you the following extracts form the cashbook for the month of April 2003.

The head of section further informs you that all receipts are banked intact and all payment s are made by cheque. On investigation you discover the following:

- (i) Bank commissions and charges amounting to shsSh272000 Sh 272000 entered on the bank statement had not been entered in the cash book.
- (ii) Cheques drew\an amounting to shsSh534000 Sh 534000 had not been presented to the bank for payment.
- (iii) Cheques amounting to shsSh Sh 1524000 had been entered in the cash book as paid to the bank but had not been credited by the bank till may 2003
- (iv) A cheque of shsSh44000 Sh 44000 had been entered in the cash book as receipt instead of a payment
- (v) A cheque of shsSh Sh 50000 had been debited by the bank by mistake





- (vi) A cheque received for shsSh Sh 160000had been returned unpaid. No adjustment has been made in the cashbook
- (vii) All dividends receivable are credited directly into the bank account. During the month of April 2003 divindedsdividends totaling shsSh142000were Sh 142000 were credited into the bank account. No entries have been made in the cash book.
- (viii) A cheque drawn for shsSh12000has Sh 12000 has been incorrectly entered into the cash book as Sh 132000
- (ix) The balance brought forward in the cash book should have been
- (x) Sh (Confirm this) The bank statement as at 30th April showed an overdraft of ShSh2,324,000

# 2.8 INTRODUCTION TO INITIAL ACCOUNTS

So far we have looked at books of original entry. After the initial recording, the transactions are then entered into individual accounts in the ledger. The accounts are either personal or impersonal.

Personal accounts deal with individuals (debtors and creditors)

Impersonal accounts are either real or nominal. Real accounts record assets (things of value) while nominal accounts record revenues, expenses and capital.

# RECORDING TRANSACTIONS WITH REGARD TO LIABILITIES

When we increase our liabilities it means we have obligations to fulfill in the future. On the other hand for all these obligations we have an asset to be exchanged for the liability that we take up.

All increase in liabilities:

Dr. Asset account

Cr. Liability account

# >>> Illustration (i)

On 3rd June 2004 Ramani stores bought stock on credit from Jitegemea stores. The stock was worth shsSh200000Sh 200000

Dr. Purchase account 200000

Cr. Jitegemea Stores (creditor) shsSh200000Sh200000

(To record purchase of stock on credit)

For most businesses expenses, the services are first offered and then paid for later.

# Illustration (ii)

Electricity for June 2005 was Sh.40000 it was paid for at a later date.

Dr. Electricity account Sh.40000

Cr. Accrued expenses shsSh.40000

# RECORDING TRANSACTIONS WITH REGARD TO CAPITAL

When the owner injects more capital into the business

Dr. Cash/bank

Cr. Capital account

Sometimes however the capital may not be in the form cash but he may introduce his own asset to be used in the business. In that case the particular asset account will be debited instead of cash.

# Illustration iii

On 1st January 2005 Mr. Makhoha started a business. He decided to make a building which he previously rented out to be his operating premises. In addition, he deposited Shs1000000 Sh 1000000 into the business' bank account. The building was worth Sh 400000.

#### The entry will be as follows.

Dr. bank Sh 1000000

Dr. Building Sh 400000

Cr. Capital SH 1400000

The entries will appear as follows in the specific accounts.

	Bank a/c Sh						
27/5	Capital	1000000	/5	072877633			





Building a/c							
27/5	Capital	1400000	/5		W.		
		Capital a	ı/c				
		Sh			Sh		
27/5			/5	Bank	1000000		
				Building	400000		

# RECORDING TRANSACTIONS WITH REGARD TO INCOME

When we make sales the following is possible:

- The customer to pay in cash
- The customer to purchase on credit

#### >>> Illustration

Lenana store sold goods worth shs Sh 90000 to Batian stores on 25th November 2006 Batian stores immediately paid for the goods worth Sh 20000 a cheque. The transaction will be recorded as follows:

# Bank a/c Sh Sh 90000 Cash 20000 sales **Sales** Sh 90000 bank

# >>> Illustration II

If Batian stores did not pay immediately, the entries made by Lenana stores would have been as follows.

Dr. Batian stores a/c debtor Sh 90000

Cr. Sales account Sh 90000

On the day that Batian stores will pay, the following g entries will be made.

Dr. Cash/bank Sh 90000

Cr. Batian stores a/c debtor Sh 90000

#### Batian Stores debtor a/c

Julium Olom	o dobt		
Sh			Sh
90000	/5	Cash	90000
Sale	es a/c		
Sh			Sh
	/5	Batian stores a/c debtor	90000
Bar	nk a/c		
Sh			Sh
90000	/5		
	Sh 90000 Sale Sh	Sh   90000   /5	Sales a/c Sh /5 Batian stores a/c debtor  Bank a/c Sh

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# RECORDING TRANSACTIONS WITH REGARD TO EXPENSES

All expenses have debit entries.

If we incur a business expense and pay for it in cash,

Dr. Expenses account

Cr. Bank account

#### >>> Illustration

Kimuchu wholesalers' motor vehicle was repaired at a cost of shsSh12000 which 12000 which was paid immediately in cash.

The entries to record the above transactions would be as

follows Dr. Motor vehicle repairs Account Sh120000

Cr. Cash account Sh 120000

If we incur one expense and pay for it later the entries made will be as

follows. Dr. Expenses account

Cr. Creditors account

#### >>> Illustration

If Dubai wholesalers took their motor vehicle for repair to Toyota E.A for repairs. The entries would be as follows:

Dr. motor vehicle repairs account

Cr. Toyota E.A account (creditor)

When Dubai wholesalers later pay for the repairs, the following entries will be made.

Dr. Toyota E.A account (creditor)

CR cash account

This will eliminate the balance in the Toyota E.A account provided they pay for the repairs in full.

However it is important to note that not all business expenses involve movement in cash. Some do not involve movement of cash and are recognized in the book as provisions. An example would be depreciation and doubtful debts provision. The entries in such accounts will be:

# Dr. Expenses account

Cr. Provision for (specific expense)

# >>> Illustration

For the month of May 2006 XYZ Co. Ltd incurred depreciation expense on motor vehicles Sh.400000.

The entries will be as follows

Dr. Motor vehicle depreciation account Sh 40000

Cr. Provision for depreciation on motor vehicle account Sh 40000

# Motor vehicle depreciation account

-	Sh			Sh
27/5	Provision for depreciation on 40000	/5	Bank	90000
	motor vehicle account			

# Provision for depreciation on motor vehicle account

	Sh		Sh
27/5		/5	Motor vehicle depreciation 40000 account

The provision for depreciation and for doubtful debts will be covered more comprehensively later on in this course.



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When balancing off accounts we add up the debit side of each account and compare it with the sum of the credit side of the same account. The difference is put as the balance carried down (Balance c/d) on the side that is less such that the two sides now balance.

On the opposite side of the balance c/d and below the balancing totals, the opening balance for the next accounting period is indicated as balance brought forward (balance b/f)

# >>> Example I

Enter the following transactions in a cash account and then balance it off showing clearly the balances c/d and balances b/f

i)	Balance brought forward in the cash till at 2000	1 May 2006
ii)	Cash sales of 10000	4 May 2006
iii)	Cash received from debtors 2500	11May 2006
iv)	Expenses paid 4500	7 May 2006
v)	Cash purchases 9700	11May 2006

#### **Cash account**

2006		Sh	2006		Sh
1/5	Balance b/f	2000	7/5	Expenses	4500
4/5	Sales	10000	11/5	Purchases	9700
8/5	Debtor	2500	31/5	Balance c/d	300
		14500			14500
1/6	Balance b/f	300			

# When balancing off accounts:

- i) The totals should appear on the same line on the credit and the debit side
- ii) A single line should be drawn above the totals and a double line below the totals on both the credit and debit sides.
- iii) The balance C/D can be on either side depending on which side has the higher amount.

However in common practice the following can be deduced concerning the balance by the various accounts:

• All assets have debit balances
• All liabilities Have credit balances
• Capital always has credit balances
• Income accounts:

- Expenses accounts have debit balances.

A credit balance means that the totals on the credit side as higher than those on the debit side hence the balancing figure (balance c/d) goes to the debit side. A debit balance occurs when the debit side is higher than the credit side hence the balancing figure (balance c/d) goes to the credit side.

# The purposes of balancing off accounts would be

- Identify how much is outstanding in a particular account. Ee.g. how much credit sales are yet to be paid for?
- Determine the expenses that have been incurred
- To determine how much the business owes to the suppliers
- To identify transactions that may have been omitted for debtors.

In balancing off accounts you will realize that not all accounts have a balance at the end of a particular period. An example would be when a particular customer purchased goods on credit worth Shs.400000and later paid the entire amount of Shs400000 before the accounts were balanced off. His account will have no balance to carry forward to the next period and would not be included in the balances appearing in the sales ledger.

# >>> Example II

Mr. John Kimuto bought goods worth Sh 50000 from Katune Electronics on 1st January 2007. He paid the amount on 15th January 2007.

On 18th and 20th of the same month he bought other goods on credit worth Sh 14000 and 40000 respectively, and paid shs Sh 54000 by cheque on 28th. Prepare John kimuto's account in the books of Katune Electronics as at 30th January 2007

# Mr. John Kimuto a/c

2007		Sh			^	Sh
1/1	Sales	50000	15/1	bank	3	50000
18/1	Sales	14000	28/01	Bank	170	54000
20/1	sales	40000			120	
					0,	
		104000	]			104000





However assuming the same transactions only that he was able to pay shsSh14000 instead of shsSh54000 his account would appear as follows:

#### Mr. John Kimuto

2007		Sh			Sh
1/1	Sales	50000	15/1	bank	50000
18/1	Sales	14000	28/01	Bank	14000
20/1	sales	40000	30/1	Balance c/d	40000
		104000			104000
01/2	balance b/d	40000	<u> </u>		

This balance of shs Sh.40000 will be included in the sales ledger at the end of the month. It will be shown under John Katune. At the end of the period the total amount of the sales ledger will represent the amount owed to the business by customers. i.e. debtors.

# RECORDING TRANSACTIONS WITH REGARD TO ASSETS

All accounting in the business organization will fall under the defined terms.

Increase in an asset can be due to any of the following:.

- i) Buying a new asset either in cash/bank
- ii) Revaluing existing assets
- iii) Buying a new asset on credit

For all the above entries we make a debit to the assets account and credit to the respective account as follows.

# Cash purchase:

- i) Dr. Motor vehicle account
  - Cr. Cash/bank
- ii) Dr. Motor vehicle a/c` (with increase in value) Cr. revaluation
- iii) Dr. Motor vehicle a/c
  - Cr. Creditor a/c

When we increase an asset, we make a debit entry into the account.

For example; on 7th June 2006, Mr. Matatu bought a motor vehicle for cashssh Sh hs50000. The following will be the entry

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Dr. assetsAssets account (motor vehicle) 50000

Cr. Cash at bank account 50000

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When we decrease an asset, we make a credit entry into the account.

# Decrease in an asset can be as a result of of:

- Selling an existing asset for cash
- Selling an existing asset on credit
- Revaluation of an asset below its net book value
- Writing off an existing asset for no value.

#### The transaction is recorded as follows:

# Selling an existing asset on cash:

Dr. Cash/bank account (with cash received)

Cr. Asset account

# ■ Selling an existing asset on credit:

Dr. Debtor account (with the sales value)

Cr. Asset account

# ■ Revaluation of existing assets:

Dr. Asset revaluation account

Cr. Asset account

Sometimes the current assets may be disposed at a value higher than their book value. This results into a gain on disposal. The same asset can be disposed at a lower value than its book value resulting to a loss on disposal.





In this case transactions are recorded as follows:

# ■ Gain on disposal:

Dr. Cash/ bank/ debtor account (selling price of the asset) Cr.

Asset account (with the book value of the asset)

Cr. Gain on disposal account (with the amount of the selling price above the book value)

# Loss on disposal:

- Dr. Cash /bank/ debtor account (with the selling price of the asset)
- Dr. Loss on disposal account (with the amount of selling price below the book value) Cr. Asset account (with the book value of the asset)

#### >>> Illustration 1

Doe Co. LTD sold on e of the existing machinery for Sh 200000. The machinery was received in cash. The entry will be as follows:

Dr. cash 200000

Cr. Machinery 200000

# Machinery a/c

	Sh			Sh
27/5		/5	Cash	200000

#### **Cash account**

	Sh	Sh
Machinery	200000	103
		08/1
		071

#### >>> Illustration 2

When preparing the financial statements for the year 2005, Doe Co. Ltd hired the services of a professional valuer, to revalue an existing motor vehicle which they thought had a book value of less than what was shown as the net book value due to the bad state of the roads. The professional valuer valued it for Sh 50000 while us the net book value was Sh 80000.

The recording will be as follows:

Dr. Revaluation account Sh (80000 - 50000) Sh 30000

Cr. Motor vehicle account ShsSh30000

# Machinery a/c

	Sh			Sh
27/5		/5	revaluation account	30000

#### Revaluation account

	Sh			Sh
27/5		/5	Cash	200000

# 2.10 EXTRACTION OF THE TRIAL BALANCE

At the end of a given period, all the accounts are balanced off and the balances brought forward are then extracted and used to prepare what is known as a trial balance.

A trial balance can be defined as a list of account tittles and their balances in the ledger on a specific date shown in debit and credit columns.

If the double entry in the respective was done correctly then the trial balance should balance i.e. the debit and the credit balances should equal.

However strange, as it may seem, a balanced trial balance is no guarantee that posting was done correctly since there are some errors that could pass unnoticed and the trial balance still balances. These will be discussed later on this chapter.





A trial balance should have the exact date in which it was extracted. This is because, a trial balance is a "snap-shot" of a particular day and any other day would have a trial balance with totally different figures.

## >>> Illustration

Record the following transaction s for the month of November for M.S Suppliers. Balance off all the accounts and extract a trial balance as at 30th November 2006

#### Year 2006

November 1 Started Started business with Sh.175000 in cash

November 2 Put Put Sh140000 of the cash into the bank account

November 3 Bought goods for cash worth Sh.7500

November 4 Bought Bought stationery on credit Sh.17000 from Nzomo

November 5 Bought goods on credit from Isaac Sh 18000, Philips Sh.24500, Timothy Sh.5500 Mathew Sh17000

November 6 Paid rent by cheque Sh.2750

November 7 Sold goods on credit to Njeri Sh 4500, Onyango Sh7500 Muiru Sh 9500

Tinga Sh 8000

November 8 Bought Bought furniture from Irungu Suppliers on credit Sh 24000

November 12 Paid Paid salaries and wages Sh 6000 cash

November 14 Returned goods to Timothy Sh 3000, Philip Sh 2000

November 15 bought Bought an old motor van by cheque Sh 35000

November 16 received Received loan from Henry by cheque Sh 30000

November 17 Goods returned to us by Njeri Sh1000 Sh1000 Muiru Sh

2000 November 18 Cash sales Sh 450

November 21 Sold goods on credit to Pauline Sh5750, Onyango Sh 50100 Tinga Sh 4500

November 24 We paid the following by cheque Philips Sh 2250 Timothy Sh2500

November 25 Received a cheque from Pauline Sh 5750, onyango Sh 12500

November 28 Received a further loan from Henry Sh 10000 cash November

30 Received Sh 25000 Received Sh 25000 from Tinga in cash.

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# Suggested solution

# Cash a/c

	FINANCIALACCOUNTING				on Singl. Com
Sugge	ested solution				WWW. Masolmorn
		Cash	า a/c		
2006		Sh	2006		Sh
1/11	Capita	175000	2/11	bank	140000
18/11	Sales	4500	3/11	Purchases	7500
28/11	Henry	10000	12/11	Salaries and wages	6000
30/11	Tinga	25000	30/11	Balance c/d	61000
		214500			214500
1/12/	Balance b/d	61000			

# Capital a/c

2006		Sh	2006		Sh
30/11	Balance c/d	175000	1/11	Cash	175000
			1/12	Balance b/d	175000

# Bank account a/c

2006		Sh	2006		Sh
2/11	Cash	140000	6/11	Rent	2750
16/11	Loan Henry	30000	15/11	Motor van	35000
25/11	Pauline	5750	24/11	Philips	22500
25/11	Onyango	12500	24/11	Timothy	2500
			30/11	Balance c/d	125500
		188250	J		188250
30/11	Balance b/d	125500			





## Sales returns a/c

2006		Sh	2006		Sh	,
17/11	Njeri	1000	30/11	Balance c/d	3000	
17/11	Muiru	2000				
		3000	1	_	3000	
30/11	Balance b/d	3000	-	_		

# Purchases a/c

2006		Sh	2006		Sh
3/11	Cash a/c	7500	30/11	Balance c/d	72500
5/11	Isaac	18000			
	Philips	24500			
	Timothy	5500			
	Mathew	17000			
		72500	1	<del>-</del>	72500
1/12	Balance b/d	72500		_	

# Sales a/c

2006		Sh	2006		Sh
30/11	Balance c/d	61750	7/11	Njeri	4500
			7/11	Onyango	7500
			7/11	Muiru	9500
			7/11	Tinga	8000
			18/11/	cash	4500
			С		
			21/11	Pauline	5750
			21/11	Onyango	5000
			21/11	Tinga	17000
		102250	1		61750
			1/12	Balance b/d	61750
			ı		O 1

#### Purchases returns a/c

ANCIAL	A C C O U N T I N (	G				msindi.com
		Purchase	s return	s a/c		_w.masomo.
2006		Sh	2006		Sh	whi
31/11	Balance b/d	5000	14/11	Timothy	3000	•
			14/11	Philip	2000	
		5000	•		5000	
			1/12	Balance b/d	5000	

# Furniture a/c

2006		Sh	2006		Sh
8/11	Irungu suppliers	24000	31/11	Balance c/d	24000
1/12	Balance b/d	24000			

# Motor van a/c

2006		Sh	2006		Sh
15/11	bank	35000	31/11	Balance c/d	35000
1/12	Balance b/d	35000			

# Rent a/c

2006		Sh	2006		Sh
6/11	bank	2750	31/11	Balance c/d	2750
1/12	Balance b/d	2750			

# Salaries and wages a/c

2006		Sh	2006		Sh
12/11	cash	6000	31/11	Balance c/d	6000
1/12	Balance b/d	6000			

# Stationery a/c

2006		Sh	2006		Sh 🔨
4/11	Nzomo	8500	31/11	Balance c/d	8500
1/12	Balance b/d	8500			<del>_</del> <del>_</del> ,





# Njeri a/c

2006		Sh	2006		Sh	_
7/11	sales	4500	17/11	Sales returns	1000	
			31/11	Balance c/d	3500	
		4500	_		4500	_
1/12	Balance h/d	3500	_			-

# Onyango a/c

2006		Sh	2006		Sh
7/11	sales	7500	25/11	bank	12500
21/11	sales	5000			
		12500			12500

# Tinga a/c

2006		Sh	2006		Sh
7/11	sales	8000	30/11	Cash	25000
21/11	sales	17000			
		25000			25000

# Muiru a/c

2006		Sh	2006		Sh
7/11	Sales	9500	17/11	Sales returns	2000
			31/11	Balance c/d	7500
		9500			9500
1/12	Balance b/d	7500	1		

# Nzomo a/c

2006		Sh	2006		Sh
31/11	Balance c/d	8500	4/11	Stationery	8500
			1/12	Balance b/d	8500

# Isaac a/c

2006		Sh	2006		Sh
31/11	Balance c/d	18000	5/11	Purchases	18000
			1/12	Balance b/d	18000

# Philip a/c

NCIALACCOUNTING					osindi.com
					<i>'01'</i>
		Philip a	a/c		Sh white
2006		Sh	2006		Sh wh
14/11	Purchase returns	2000	5/11	Purchases	24500
24/11	Bank	22500			
		24500	<u> </u>		24500

# Timothy a/c

2006		Sh	2006		Sh
14/11	Purchase returns	3000	5/11	Purchases	5500
24/11	bank	2500			
		5500			5500

# Mathew a/c

2006		Sh	2006		Sh
31/11	Balance b/d	17000	5/11	Purchases	17000
		-	1/12	Balance b/d	17000

# Irungu supplies a/c

2006		Sh	2006		Sh
31/11	Balance c/d	24000	8/11	furniture	24000
			1/12	Balance b/d	24000

# Pauline a/c

2006	Sh	2006	Sh
21/11 Sales	5750	25/11	bank 5750
		-	

# Loan Henry a/c

2006		Sh	2006		Sh 3
31/11	Balance b/d	40000	16/11	bank	30000
			28/11	Cash	10000
	_	40000			40000
	_		1/12	Balance b/d	40000





# M.S SUPPLIES TRIAL BALANCE AS AT 30<sup>TH</sup> NOVEMBER 2006

	Dr.	Cr.
Cash	61000	
Bank	125500	
Capital		175000
Sales returns	3000	
Purchases	72500	
Sales		61750
Purchases returns		5000
Furniture	24000	
Motor van	35000	
Rent	2750	
Salaries and wages	6000	
Henry loan account		40000
Stationery account	3500	
Njeri(SL)	8500	
Tinga (SL)	-	
Muiru (SL)	7500	
Nzomo (PL)		8500
Isaac (PL)		18000
Mathew(PL)		17000
Irungu(PL)		24000
-	349250	349250

#### Note:

So many businesses have a large number of suppliers and customers and hence instead of bringing each individual debtor/ creditor balance in the trial balance, we bring total of the accounts obtained form the sales ledger and the purchase ledger. These two show the figures of debtors and creditors respectively.

# 2.11 ERRORS NOT AFFECTING THE TRIAL BALANCE

If double entry is followed when recording all transactions into the books of accounts, then the trial balance would balance. However there are some errors that would occur while entering the transactions but this would not affect the balancing of the trial balance.

The following are the errors that do not affect the balancing of the trial balance

# (i) 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 shs Sh 90000 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.

# (ii) 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 shs Sh 200000 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.

# iii) 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 shs Sh 20000 sold to D. Waithaka but posted to P. Waithaka's account in the sales ledger. The transaction would be as follows.

Dr. P. Waithaka 20000

Cr. Sales 20000

# The correct entry would have been

Dr. D Waithaka 20000

Cr sales 20000







To correct such an error, the following entry will be passed in the books.

Dr. D. Waithaka 20000

CR. D Waithaka 20000

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.

### iv) 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 2000

Cr. Sales returns Sh 2000

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.

### v) 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 cold eithercould either be understated or overstated.

### >>> Example

Purchases worth shs20000 Sh 20000 recorded as Sh 200000 in both the purchase account and the cash account.

#### The incorrect entry would appear as follows

Dr. Purchases 200000

Cr. Cash/ bank200000

STUDY TEXT

#### The correct entry should have been

Dr. Purchases account 20000

CR. Cash/bank 20000

#### To correct the error, we make the following entries.

Dr. Cash at bank Sh 180000

Cr. Sh180000

### vi) 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 shsSh 100000 the wrong entry would appear as follows.

Dr. Sales 100000

Cr. P. Kameme 100000

#### The correct entry would have been

Dr P Kameme 200000

Cr. Sales 200000

#### 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 100000

Cr. Sales 100000

(To cancel the initial entry in the accounts)

Dr. P Kameme shsSh 100000 Cr.

Sales 100000

(To Record the correct entry)

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### The accounts would appear as follows:

#### P. Kameme a/c

2006		Sh	2006		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	100000
			correct entry)	

### Vi) 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. itlt 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 9260 entered as Sh 6290 on both cash book and sales ledger

#### The wrong entry would appear as follows.

Dr. Cash Sh 6290

Cr. Sales Sh 6290

#### The correct entry would have been

Dr. Cash Sh 9260

Cr. Sales Sh 9260



#### To correct the above entry

Dr. Cash (9260 - 6290) Sh 2970

Cr. Sales (9260 - 6290) Sh 2970

#### >>> Exercise: 1

# Show the journal entries required to correct the following errors. Entries; narratives must be shown.

1) Ccommissions received shs Sh 44000 had been credited to rent receivable account

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- 2) bank Bank charges shsSh 3850 had been debited to rent account
- 3) Ccompletely omitted from the books of account is a payment of sundry expenses by cheque shsSh 1150
- 4) purchase Purchase of fixtures Sh 23700 had been entered in purchases account
- 5) Rreturn inwards of shs Sh 41650 had been entered on the debit side of the return outwards account
- 6) aA loan from R. Simiyu shsSh25000 had 25000 had been entered on the credit side of capital account
- 7) Loan interest shs Sh 2500 had been debited in the premises account
- 8) Goods taken for own use shs1250had worth Sh 1250 had been debited to purchases account and credited to drawings account.

#### Suggested solution:

1) Dr Rent received account 44000

Cr. Commissions received 44000

(Correction of an error where commission received was credited to rent received)

2) Dr. bank charges a/c 3850

Cr. rent a/c 3850

(To correct wrong debit of bank charges in the rent account

3) Dr. Sundry expenses a/c 1150

Cr. Bank a/c 1150

(To record omitted payment of sundry expenses)

4) Dr. Fixtures 23700

Cr. Purchases a/c 23700

(To correct error of principle where purchases of fixed assets is treated as purchase)

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5) Dr. Return outwards 41650

Cr. Return inwards 41650

(To correct entry return inwards in the debit of return outwards a/c)

6) Dr Capital account 25000

Cr. R. Simiyu a/c 25000

(To correctly record loan received from R. Simiyu)

7) Dr Loan interest a/c 2500

Cr. Premises a/c 2500

(To correctly record interest on loan)

8) Dr drawingsDrawings a/c (1250 x 2) 2500

Cr. Purchases a/c (1250x2) 2500

#### **Note**

We double the figures when correcting errors of complete reversal of entries like that in (8) above. This is because if an amount was debited instead of being credited in the same account, a single credit entry would just cancel the initial debit. However the second credit entry will now enter the required credit entry. Instead of showing the two credit entries separately, the amount involved is doubled and a single entry made but with a double value made.

#### 2.12 SUSPENSE ACCOUNT

Due to poor double entry or other errors not falling in the category described above, the trial balance may fail to balance. In most cases the error causing this may take long to be identified. Before then the accountant is allowed to open up an account known as the suspense account. To this account, he assigns the balance equal to the difference between the credit and debit sides of the trial balance to ensure that the trial balance balances. For example if the debit side exceeds the credit side by Sh100000, suspense account will be assigned a credit balance equal to Sh100000 thus balancing the trial balance. Later on when the cause of the error is identified, journal entries are passed against the suspense account till its balance is cleared thus eliminating it from the books.

Basically all errors affecting the balancing of the trial balance necessitate the creation of a suspense account. A few of such are discussed below.

Making a wrong corresponding entry e.g. if cash sales of shs Sh 20000 are made and a debit entry correctly made in the cash book. However the sales account is credited with Sh Sh2000. This means that the credit side of the trial balance will be understated by Sh 18000. A suspense will thus be created and assigned accredit balance of Sh 18000 to make the trial 'appear' balanced awaiting identification and correct of the error.

Once the error is identified then journal or uspense account as follows:

Dr St.

Dr. Suspense account 18000

18000 Cr. Sales account

(To correct the error understating the credit balances of the trial balance)

Students are however cautioned that the suspense account should not be used to balance the trial balance unless the examiner specifically asks the students to do so.

### 2.13 VALUATION OF INVENTORY

There are three basis approaches to valuing inventory that are allowed by GAAP -

### (a) First-in, First-out (FIFO):

Under FIFO, the cost of goods sold is based upon the cost of material bought earliest in the period, while the cost of inventory is based upon the cost of material bought later in the year. This results in inventory being valued close to current replacement cost. During periods of inflation, the use of FIFO will result in the lowest estimate of cost of goods sold among the three approaches, and the highest net income.

### (b) Last-in, First-out (LIFO):

Under LIFO, the cost of goods sold is based upon the cost of material bought towards the end of the period, resulting in costs that closely approximate current costs. The inventory, however, is valued on the basis of the cost of materials bought earlier in the year. During periods of inflation, the use of LIFO will result in the highest estimate of cost of goods sold among the three approaches, and the lowest net income.



### (c) Weighted Average:

Under the weighted average approach, both inventory and the cost of goods sold are based upon the average cost of all units bought during the period. When inventory turns over rapidly this approach will more closely resemble FIFO than LIFO.

Firms often adopt the LIFO approach for the tax benefits during periods of high inflation, and studies indicate that firms with the following characteristics are more likely to adopt LIFO - rising prices for raw materials and labor, more variable inventory growth, an absence of other tax loss carry forwards, and large size. When firms switch from FIFO to LIFO in valuing inventory, there is likely to be a drop in net income and a concurrent increase in cash flows (because of the tax savings). The reverse will apply when firms switch from LIFO to FIFO.

Given the income and cash flow effects of inventory valuation methods, it is often difficult to compare firms that use different methods. There is, however, one way of adjusting for these differences. Firms that choose to use the LIFO approach to value inventories have to specify in a footnote the difference in inventory valuation between FIFO and LIFO, and this difference is termed the LIFO reserve. This can be used to adjust the beginning and ending inventories, and consequently the cost of goods sold, and to restate income based upon FIFO valuation.

### **CHAPTER SUMMARY**

Book keeping defined as the process of recording business transactions (data) in a systematic manner. It can also be defined as that part of accounting that is concerned with recording data.

The accounting process can be perceived as a cycle which starts with the occurrence of a transaction recording of the transaction and finally the preparation of the final statements which report on results of all the transactions that occur during the year and the position of the business as at the last date of the accounting period.

### The commonly used books of original entry are:-

- Purchases Journal.
- Sales journal.
- Return outwards journal.
- Return inwards journal.
- Cashbook.
- General journal.

When all transactions have been entered into the specific journals, they are then entered into their respective accounts in the ledger in a process referred to as posting.

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### **CHAPTER QUIZ**

- 1. What is the difference between the cash book and the petty cash book?
- 2. Which is the source document for petty cash book?
- 3. Name the reason for making a journal entry?
- 4. Which ledger is used to keep individual customer accounts?
- 5. What is the purpose of the trial balance?

### **ANSWERS TO CHAPTER QUIZ**

- 1. The cash book records amounts paid into out of the bank account. The petty cash book records payment of small amounts of cash.
- 2. Receipt and claim forms.
- 3. Most commonly to correct an error.
- 4. Receivables ledger.

5. To test the accuracy of the double entry bookkeeping.

### **PAST PAPER ANALYSIS**

12/06, 6/06, 12/04, 6/04, 6/03, 12/02

### **EXAM TYPE QUESTIONS**

### **QUESTION 1**

Skates drew up the following trial balance as at 30 September 2002. You are to draft the trading and statement of comprehensive income for the year to end 30 September 2002 and a statement of financial position as at that date.

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	Dr	Cr
	Sh	Sh
Capital		3,095,500
Drawings	842,000	
Cash at bank	311,500	
Cash in hand	29,500	
Debtors	1,230,000	
Creditors		937,000
Stock 30 September 2001	2,391,000	
Motor van	410,000	
Office equipment	625,000	
Sales		1,309,000
Purchases	9,210,000	
Returns inwards	55,000	
Carriage inwards	21,500	
Returns outwards		30,700
Carriage outwards	30,900	
Motor expenses	163,000	
Rent	297,000	
Telephone charges	40,500	
Wages and salaries	1,281,000	
Insurance	49,200	
Office expenses	137,700	
Sundry expenses		
	<u>28,400</u>	
	17,153,200	17,153,200

#### **QUESTION 2**

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

#### 19x8

- Balances brought forward: Cash Sh .230; Bank Sh .4,756. Mar 1
- The following paid their accounts by cheque, in each case deducting 5 percent 3 Discounts: R Burton Sh 140; E Taylor Sh. 220; R Harris Sh 800. "4 Paid rent by cheque Sh.120.
- J Cotton lent us Sh 1,000 paying by cheque.
- "8 We paid the following accounts by cheque in each case deducting a 21/2 per cent cash discount: N Black Sh 360; P Towers Sh 480; C Rowse Sh 300.
- "10Paid motor expenses in cash Sh 44.
- 12 H Hankins pays his account of Sh. 77, by cheque Sh 74, deducting Sh 3 cash discount.
- 15 Paid wages in cash Sh. 160.
- The following paid their accounts by cheque, in each case deducting 5 per cent 18 cash discount: C Winston Sh 260; R Wilson & Son Sh 340; H Winter Sh 460.
- 21 Cash withdrawn from the bank Sh 350 for business use.
- 24 Cash Drawings Sh 120.
- 25 Paid T Briers his account of Sh 140, by cash Sh 133, having deducted Sh 7 cash discount.
- 29 Bought fixtures paying by cheque Sh 650.
- 31 Received commission by cheque Sh 88.

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# **CHAPTER THREE**

### PREPARATION OF FINANCIAL STATEMENTS

#### **▶** OBJECTIVES

After studying the following chapter you should be able to:

Understand and prepare statement of comprehensive income (income statement) and statement of financial position using the various formats
Make accounts' adjustments for prepayments and accruals, discounts and account for bad debts
Calculate depreciation chargeable using straight-line method, reducing balance method, sum of years digit method, Depletion units method and units of output method and account for it
Prepare a property, plant and equipment schedule  Define the various statement of financial position items; assets, liabilities and capital

#### **▶ INTRODUCTION**

**Fast forward** - A statement of comprehensive income is the sales (revenue) for the businessless all the expenses incurred to generate the sales. The end product is ether profit or loss.

The main objective of every business organization is to make profit. However, in some instances, businesses end up make losses. It is important to measure the performance of a business organization in certain predefined periods to asses whether the business organization is making profits or losses.

### **▶** DEFINITION OF KEY TERMS

- Statement of comprehensive income- formerly known as the income statement basically represents the performance of a business. It is the sales (revenue) for the business less all the expenses incurred to generate the sales. The end product is ether profit or loss.
- Statement of financial position- formerly known as the balance sheet is a statementwhich shows the assets of a business at a given point in time and the claim thereof against the assets, the claims can either by the capital injected or liabilities to third parties

#### **► EXAM CONTEXT**

www.masomomsindi.com er This is a very important chapter and as you will see in past paper analysis at the end of this chapter, it has been tested in every seating since June 2003.

#### **▶ INDUSTRY CONTEXT**

All stakeholders of any entity will be very keen on the financial statements because of the simple fact that they shows to what extent the company made or lost money and its asset base. Stakeholders will assess entity abilities by how much profit is reported in comparison to previous years and rival entities to make mainly investment Decisions.

### The main reasons for preparing the statement of comprehensive income are:

- i) To compare the actual profit to the expected profits
- ii) For planning purposes i.e. to identify areas that need attention in future
- iii) To obtain funds from lenders based on one's profitability
- iv) To inform prospective owners on the performance
- In computation of taxes to ensure that the correct amount is remitted to the tax v) authorities.







A statement of comprehensive income basically represents the performance of a business. It is the sales (revenue) for the business less all the expenses incurred to generate the sales. The end product is ether profit or loss.

A statement of comprehensive income can be prepared in two formats; the vertical or horizontal format. The horizontal format is however the most common one.

#### HORIZONTAL FORMAT

# **Xyz Statement of comprehensive income**For the period ended xxxxxx

		Sh	Sh
Sales		XX	
less return inwards		(xx)	
net sales			Xxx
less cost of sales			
opening stock		XX	
add purchases	XX		
carriage inwards	XX		
	XX		
less return outwards	(xx)		
net purchases		XX	<u></u>
goods available for sale		XXX	
less closing stock		(xx)	<u></u>
cost of sales			Xxx
gross profit			Xxx
add other incomes			
discount received			Xxx
profit on disposal of assets			Xxx
income from investments			Xxx
other incomes e.g. interest received from bank			Xxx
			Xxx
less expenses			^
administrative expenses		XX	2
operating expenses		XX	16
selling and distribution expenses		XX	\ \
total expenses		120	(xxx)
net profit for the period		0,	Xxx

#### **Notes**

- (i) Carriage inwards forms part of the cost of sales. It represents the amount paid for the transportation of goods into the business premises before they are sold.
- (ii) Carriage outwards is a business expense. It represents the amount paid to transport goods to the customer's premises.
- (iii) All costs incurred to put the goods into saleable condition form part of the cost of sales e.g. cost of transportation to the warehouse, insurance while goods are on transit to the warehouse, warehouse expenses.
- (iv) Incase the net sales are less than cost of sales the difference is referred to as gross loss
- (v) If the expenses are more than the gross profit the difference is referred to as net loss
- (vi) Other incomes represent that portion of revenues not directly related to the main business e.g. commissions, rent receivable e.tc

#### >>> Illustration 1

Given the following trial balance for BCD Ltd draw up a statement of comprehensive income BCD Ltd for the year ended 31 December 2007

	Sh	Sh
Sales		205,500
Purchases	129,000	
Opening stock	16,000	
Rent	42,000	
Lighting expenses	8,000	
General expenses	17,000	
Fixture and fittings	4,800	
Debtors	148,000	
Creditors		37,000
Bank	14,300	
Cash	2,800	
Drawings	14,000	
Capital		128,000
Commissions		24,000
Returns inwards	4,600	
Return outwards		6,000
		3,
	400,500	400,500
	<u> </u>	

The closing stock as at  $31^{\rm st}$  march 2007 was Sh 9000





#### Suggested solution

### **BCD Company Ltd**

### Statement of comprehensive income

### For the year ended 31 December 2007.

	Sh	Sh
Sales		205500
Less: return inwards		(4600)
Net sales		200900
Cost of sales		
Opening stock	16000	
Add: purchases	129000	
Less: return outwards	(6000)	
Cost of goods available for sale	139000	
Less: closing stock	(9000)	
		(130000)
Gross profit		61900
Other incomes		
Commission received		24000
Total income		85900
Expenses		
Rent	42000	
Lighting expenses	8000	
General expenses	17000	
		(67000)
Net profits		18900

#### Notes

- Closing stock is not found in the trial balance since there is no double entry in the stock. The closing balance of the stock is obtained by actual counting of the stock at hand at the end o the accounting period.
- Opening businesses will have no opening stock, however for the subsequent periods there may be opening stock. The closing stock at the end of one period becomes the opening stock for the next period.

Sometimes items of income and expenses will not be expressly stated as income or expense. For instance the commissions, rents e.t.c may not be indicated whether they are incomes expenses. It will be upon you to identify whether it's an income or an expense identifying the column under which it falls. All income accounts have credit balances while the expenses have debit balances in the trial balance. The same case applies to the returns inwards and outwards. Return inwards which represent an increase in stock have a debit balance while return outwards have a credit balance.

### 3.2 ACCOUNTS ADJUSTMENTS

Before preparing a statement of comprehensive income for a particular period, there are adjustments that are made to particular accounts to ensure the profit and loss statement shows accurate results of profits and losses. These accounts include:

- i) Prepayments accounts
- ii) Accruals accounts
- iii) Bad and doubtful debts accounts
- iv) Depreciation account
- v) Discounts allowed accounts
- vi) Discounts received accounts
- vii) Commissions received accounts
- viii) Commissions paid account

#### PREPAYMENTS AND ACCRUAL ACCOUNTS

### ■ (I) PREPAYMENTS ACCOUNTS

These could either be prepaid incomes or prepaid expenses.

### Prepaid expenses

For some businesses expenses may tend to be prepaid in nature. An example would be insurance premiums or, rent and rates. This are usually paid for one year upfront. However the period for which the expenses relate may not match with the accounting year. Take for instance a business that commences operations on 1<sup>st</sup> January 2006. Beginning 1<sup>st</sup> April 2006 they pay for insurance for one year. The premiums would thus cover the period 1<sup>st</sup> April 2006 to 31<sup>st</sup> march2007. On the other hand the business accounting period would cover from 1<sup>st</sup> January 2006 to 31<sup>st</sup> December 2006. Therefore by the end of the accounting period, premiums with respect to three months would not have been expensed, yet they have already been paid for. This is what results to a prepayment which is an asset to the business at the end of the accounting period.

#### **Example:**

Jumba Agro vet started business on 1st January 2005. On 1<sup>st</sup> May 2006 they acquired a go down next to BOC Gas Suppliers. They immediately insured it against fire paying insurance premiums Sh1200000 to cover the go down for the next one year.

Show the entries as they would appear in the accounts on 31<sup>st</sup> December2006.



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	2 50	

Bank a/c			
2005	Sh	<b>Sh</b> 2005	
		1/5 insurance	1200000
2005	Ins <b>Sh</b>	surance a/c	Sh

2005		<b>S</b> n	2005		5n
1/5	Bank	1200000	31/12	Prepaid insurance	400000
				P&L a/c	800000

#### Pre paid insurance

	Sh	Sh
31/12 Insurance a/c	400000	

The prepaid amount is arrived at as follows:

May - Dec = 8 monthsJan - April = 4 months<u>8</u> x 1200000 = Sh 800000 .....expenses for the year 12 4 x 1200000 = Sh 400000 .....prepaid amount

The prepaid amount shown in the prepaid insurance account represents an asset that will be under the current assets in the balance sheet. It represents the amount of money (current asset) that could still be lying in the bank had the company opted to pay for 8 months only to the close of the year i.e. May – December

#### (i) prepaid income

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Prepaid income on the other hand represents income already received yet the services or the goods have not been delivered e.g. for a business dealing in renting out houses and they receive rent for consequent periods then a certain portion of this rent at the end of the accounting period will relate to the next accounting period. Such incomes received in advance form a liability to the business since they remain indebted to deliver the service already paid for. It appears as under the current liabilities section of the balance sheet.

Example

On 1<sup>st</sup> April 2006 Josmumo enterprise received rent for 12 months amounting to 3h 144000 for a part of a building they had rented out since it was not being used. The rent money received covered the period beginning 1<sup>st</sup> April 2006 and ending 31<sup>st</sup> March 2007. Show this train the books of Josmumo as at 31<sup>st</sup> December 2006 i.e. of financial veer

Solution:

On receiving cash

Dr. Cash/Bank Sh 144000

Cr. Rent income Sh 144000

At close of accounting period

Dr. rent income a/c 36000

Cr. Rent received in advance a/c 36000

#### Cash/bank

2006		Sh			Sh
1/4	Rent income	144000			
		Dont in a	ama		
		Rent inc	ome		
2007		Sh			Sh
30/5	Rent in advance	36000	/5	Bank/ cash	144000
		Rent received	in adva	anaa ala	
			iii auva	ince a/c	
		Sh			Sh
			/5	Rent income	36000
					^
					3

The balance in the rent received in advance account is posted in the statement of financial position as a short-term liability. This is simply because the money for the period 30<sup>th</sup> March has been paid yet the services have not been delivered. This is in line with the revenue recognition principle. The balance of Sh 36000would thereby be in the incoming years of income



In the subsequent accounting period:

Dr. Rent received I advance a/c

Cr. Rent receivable (income) account

# II) ACCRUAL ACCOUNTS

Accrual accounts affect both the incomes and expenses.

### Accrued expenses

Accrued expenses represent that portion of expenses that has been used but has not been paid for. It is common for established businesses to consume services first and pay for them later, say after 30 days e.g. motor vehicle repairs. On the other hand there are expenses that cannot be determined in advance until they have been consumed e.g. electricity telephone e.t.c. A common occurrence with such accounts is that by the time the final statements are being prepared, a portion of the expenses will not have been paid most likely because the bills have not been received. These expenses need to be recognized in the period in which they were incurred. This will be in line with the matching concept which states that expenses should matched with income.

#### >>> Illustration

JKT Enterprises prepares its financial statements for periods ending 31<sup>st</sup> December. On 31 st December 2005 a bill for electricity amounting to Sh 27000 had been received by the accountant. Other bills received for the period amounted to Sh 210000. These had been paid for as at 31<sup>st</sup> December 2005.

#### Required:

Show the necessary entries with regard to electricity:

- i) Dr. Electricity expense a/c 210000
   Cr. Cash/ bank 210000
   (To record electricity expense for the year paid for)
- ii) Dr. Electricity expense 27000
   Cr. Accrued electricity for the period
   (To record accrued electricity expense for the period.)

You will note that there are two debits to the electricity expense account. This represents the total of electricity expense incurred in the year. The entries will appear as follows in their respective accounts:

	Electricity ex	pense a/c	an ras
	Sh		NA Sh
Cash/bank/	210000	/5 P & L	237000
Accrued electricity	27000		
	Cash/b	ank	
	Sh		Sh
		Electricity expense	210000
Ac	crued electricity	expense	
	Sh		Sh
Balance c/d	27000 /5	Electricity expense	27000

The total of Sh 237,000 will be taken to the expenses account in the statement of comprehensive income

Balance b/d

27000

The balance b/d in the accrued expenses account is taken as a current liability to the balance sheet. Once the payment is made in the following period

Dr. accrued expenses a/c 27000

Cr. Cash/ bank 27000

This would then eliminate the accrued account (the liability will then have been paid off)

#### Accrued expense a/c

2006	Sh	2006		Sh
05/01 Cash/bank	27000	01/01	Balance b/d	27000
			(	
	Cash/bar	'nk	1/6	9
	Sh	2006	100	Sh
		05/01	Accrued expenses	27000





#### Accrued income

It is usual phenomenon for business enterprises to sell goods on credit. This would then mean that at the close of the financial period, there are some amounts yet to be cleared by the customer.

For the main line of business this income is captured in the books of original entry i.e. general ledger sales ledger. Therefore revenue owing for direct sales is already in the books (in the sales account in the general ledger and the debtors account in the sales ledger) and no further entries are needed.

However, there may be other types of revenues for the business all of which have not been received at the end of the financial period. Such would include rent and commission receivable e.t.c. Since they do not form major part of the sales they are usually not systematically recorded as the other business sales. There is need therefore at the end of the period to recognize them.

#### >>> Example

Due to empty spaces in the warehouse XYZ Ltd Decided to sublet it at a monthly fee of Sh20000. The payments were supposed to be made at the end of every month on 31<sup>st</sup> December when XYZ was preparing its financial statements. The rent for December was still outstanding. Adjust for it in the books.

#### Rent received (income)

2006	Sh	2006	Sh
		bank	220000
		Rent receivable	20000
	Bank/cash		
	Sh		Sh
Rent received	220000		•
	Rent receival	ole	
	Sh		Sh
Rent income	20000		31
		200	16311

### 3.3 DISCOUNT RECEIVED AND ALLOWED

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Fast forward - Discounts given to encourage bulk purchasing are referred to as trade discounts

### DISCOUNT ALLOWED

Represent an amount allowed to a customer on his sales amount usually given as an incentive for bulk purchasing or for prompt payment.

Discount given to encourage bulk purchasing are referred to as trade discounts. Usually they do not feature in the books of account since the invoiced amount is usually net of such discount and the invoice itself is the source document for sales.

The discount given to encourage prompt payment is referred to as the cash discount. After a credit purchase the customer is offered a discount at a certain rate if he /she pays within given period e.g. a 2% discount if payment is made 10 days from the invoice date otherwise the credit period may be 30days.

Such terms will be indicated as 2/10 net 30

The sale is recorded at the invoice value and if the customer qualifies for the discount it is recognized in such a way as to reduce the customer's account by the amount of the discount.

Discount allowed is deducted from the sales to get a net figure of sales in the trading account.

The conventional way of treating discounts in the P& L is to view them as finance charges. This then makes discount allowed fall under operating expense and discount received as income.

#### ■ The entries for discount allowed as follows:

Dr. Discount allowed

Cr. Debtors account

#### >>> Illustration

Mr. Jomens bought goods from us worth Sh100000. The terms were 5/15 net 30 days. Seven days later he settled his account fully. Show the following entries in the ledger accounts.



#### Solution:

The terms 5/15 net 30 days will be interpreted as follows:

Jomenes qualifies for a 5% cash discount if he pays within 15 days. The maximum credit period is 30 days.

#### The discount then would be

 $5/100 \times 100000 = Sh 5000$  if he pays within 15 days

Since he paid d within 7 days he qualifies for the cash discount.

The entries for the discount allowed would be as follows:

Dr, discounts allowed a/c 5000

Cr. Jomenes a/c 5000

If he paid on the 16<sup>th</sup> day he would have to settle the whole amounted Sh 100000 and would not qualify for the discount.

#### The journal entries for the transaction as a whole would be:

Dr. Jomenes account Sh 100000

Cr. Sales account Sh 100000

When he pays on the 7<sup>th</sup> day:

Dr. cash/Bank Sh 95000

Cr. Discounts allowed 5000

Cr. Jomenes account100000

The ledger account would appear as follows.

#### Sales a/c

Sh		Sh
100000	Jomenes	100000
Cash a/c		3
Sh		√\ <sup>©</sup> Sh
	100000	100000 Jomenes

	Jomenes a/c		N.Mas
	Sh		Sh
Sales	100000	Discount allowed	5000
		Cash	95000
	100000		100000

The balance in the discount allowed account is transferred to the statement of comprehensive income as an expense.

#### Discounts received

The discount received represents cash discount received by a business when it pays its suppliers for the amounts outstanding. They are given as incentive to encourage prompt payment of the amounts owing to the suppliers. It is important to note that discount received do not represent a Decrease in the purchase price of goods but rather as an income to the business. This is the most conventional way of treating discount received. Some scholars however argue that discounts received and allowed are a reduction to the purchase price and the selling price respectively. The entries in the books of accounts are as follows:

Dr. Creditor accounts

Cr. Discounts received

#### >>> Illustration

Mabati enterprises ole Mlango suppliers Sh200000. it pays on time to qualify for a 10% cash discount. Show how the entries would appear in the books of Mabati enterprises.

Amount of Discount =  $200000 \times 10/100 = Sh20000$ 

#### The entry would appear as follows:

Dr. Mlango Enterprises 20,000

Cr. Discount received 20,000.

For a deeper understanding of the double-entry, all the entries since we bought the supplies to the time full settlement was made on purchases would be:

Dr. Purchase's a/c 200000

Cr. Mlango enterprises 200000





#### On payment:

Dr. Mlango enterprises 200000

Cr. Cash/bank 180000

Cr. Discount received 20000

### The accounts would appear as follows.

#### Purchases a/c

lango enterprises 200000 Balance c/d 200000		Sh		Sh
	Mlango enterprises	200000	Balance c/d	200000
	ango chiciphises	200000	Dalarioc o/a	

### Mlango enterprises a/c

	Sh		Sh
Cas/bank	180000	Purchases	200000
Discount received	20000		
	200000		200000

#### Cash/bank

	Sh		Sh
Rent income	20000	Mlango enterprises	180000
		-	

#### **Discount received**

	Sh		Sh
Rent income	20000	Mlango enterprises	20000
			11631

The balance in the discounts received account is taken to the statement of comprehensive income as an income under other incomes.

PROVISION FOR BAD AND DOUBTFUL DEBTS www.masdr.edural.edur A large portion of sales for most of the business organizations are made on credit. The business thus undertakes the risk that some of the sales may not end up being paid. Indeed some of the sales are not paid for and such are referred to as bad debts.

They are a common business expense as long as credit sales exist. Usually they occur in the following situations:

- Bankruptcy of a business enterprise
- Debtor refusing to pay a particular invoice
- (iii) Debtor refusing to pay part of the invoice.
- (iv) After they have been outstanding for a long period of time as learnt from experience.

#### When it occurs a bad debt is treated as follows:

Dr. bad debts expense (to recognize an expense)

Cr. Debtors account (to clear the asset; debtor)

#### PROVISION FOR BAD DEBT

When it is certain that some amounts will not be collected, it is prudent to clear the debt from the books and charge as an expense in the P& L account. However it's hard to tell before hand that a certain debt will not be paid. For this reason most business make an estimation of the amount of debts that will not be paid in a given accounting period, and charge it as an expense in the statement of comprehensive income of that accounting period This amount will usually be very subjective sometimes based only on past experiences which might not necessarily recur in future. The amount set aside to cater for future debts that might never be paid for in future is referred to as the provision for bad debts. It's also known as provision for doubtful debts.

Provision for bad debts should be recognized while preparing the financial statements. It serves two main purposes:

- To match expenses and revenues by recognizing the part of a debt that will never be (i) paid for
- To recognize a figure of debtors that is close to the realizable amount of debtors as possible.



### ■ Decrease in provisions

As indicated earlier, the provision for bad debts is a very subjective estimate. As such it's prone to constant adjustments due changing circumstances under which it is made. For example:

Assume from the books of Mali Raha Stores the total amount of debtors for the previous period was Sh 400000. Assume further that Mali Raha had estimated that out of this amount 50000 i.e. (12.5% of the debtor's balance) would not be bad debt. However after a careful consideration they discover that this figure was overestimated. It's agreed that a figure 10% of the balance of debtors is what should be maintained as provision for bad debts. In the current period the balance of debtors is Sh 450000.

The entries as they would appear in the books. Maintain a rate of 10% for provision of bad debts would be:

#### Provision for bad debts = 450000x 10/100 = Sh 45000

This would be the amount of the provision for the year. However in the previous year, Sh 50000had already been provided for. Therefore instead of increase in the provision this time w reduce it to Sh45000 as this is the balance that should appear in the closing balance of the provision account.

The reduction in provision for is treated as income in under "other incomes" in the statement of comprehensive income

#### The entries would be:

Dr. Provision for doubtful debts (50000 - 45000) 5000

Cr. Profit & loss account/statement of comprehensive income. 5000

To record reduction in provision for doubtful debts.

#### The accounts would appear as follows:

#### Provision for bad debts account

	Sh		Sh
Statement of comprehensive	5000	Balance b/d	50000
income	45000		3
Balance c/d			116
	50000		50000

#### Extract of the Statement of comprehensive income for the current period

Sales xxx Less: cost of sales (xx)

Gross profit xxx

Other incomes:

Reduction in provision for depreciation 5000

Less

Expenses xxx

Net profit xxx

In the balance sheet, the balance of debtors should be net of provision of doubtful debts carried forward.

For the example earlier given:

#### Statement of financial position Extract As At ending date of the current period

Non current assets xxx

**Current assets:** 

Debtors 450000 Less Provision for bad debts (45000)

(ii) During the following accounting period the statement of financial position would be as follows (assume the case of increase in provision).

## ■ Increase in provision for bad debts

A company may find it necessary to increase the amount asset aside for bad debts to a figure higher than that provided for in the previous period. In such a case the amount by which the provision is increased is treated as an expense in the statement of comprehensive income for the period in which the increase is made.

#### The accounting entries would be:

Dr. Expense (an expense account in the P&L)

Cr. Provision for bad debts



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From the example of Mali Raha Store above, if the provision for bad debts was to be increased from 50000 for the previous period to 55000 for the current period the increase of 5000 would be accounted for as follows:

Dr. P&L account 5000

Cr. Provision for bad debts account 5000.

(To record the increase in the provision for bad debts by 5000)

#### Provision for a/c

	Sh		Sh
Balance c/d	55000	Balance b/d	50000
		Profit and loss a/c	5000
	55000		55000

#### Extract of the Statement of comprehensive income for the current period

Sales	XXX
Less: cost of sales	(xx)
Gross profit	xxx
Less expense:	
Increase in provision for bad debts	(5000)
Net profit	XXX

The balance of debtors in the statement of financial position would now be reported net of 55000 i.e. the new provision for bad debts. This is as shown in the following statement of financial position extract:

#### Statement of financial position Extract As At ending date of the current period

Non	curren	t asset	ts .	XXX
-----	--------	---------	------	-----

**Current assets:** 

**Debtors** 450000 **Less** Provision for bad debts **(**55000)

#### Points to note

(i) The statement of financial position figure for debtors is given as:

#### Gross figure less provision C/F or

Gross figure less doubtful debts as a percentage of debtors.

(ii) The figure of provision of bad debts in the P&L should be balance of doubtful debts carried forward less provision provided for in the previous year. i.e. the increase or Decrease in the provision .

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- (iii) Incase during the year there were some bad debts written-off then the provision for bad debts should be provided for after deducting such bad debts.
- (iv) In cases of examination questions, if bad debts appear on the trial balance then the figure of debtors in the statement of financial position is net of such debts and should not be adjusted further. This is so because of the rule of double entry. For bad debts to appear in the trial balance the entries that have been passed are as follows:

Dr. bad debts a/c xxx Cr.

Debtors a/c xxxx

If however the bad debts appear in the additional information, then the following entries need to be passed in the books to adjust the debtors figure:

Dr. bad debts

Cr. Debtors

After these the provision for bad debts is adjusted as usual.

### 3.4 DEPRECIATION

#### Fast forward - There are two major methods of charging depreciation:

straight line method

reducing balance method

Depreciation can be defined as that part of the original cost of fixed assets that are consumed during its period of use in the business.

Depreciation can also be defined as the loss in the value due to of usage of an asset. Almost all business assets have a given time duration for their existence and as they are used/consumed their value keeps on Declining.



#### **CAUSES OF DEPRECIATION**

#### Depreciation caused by the factors discussed below;

- i) Physical deterioration
- ii) Economic factors
- iii) Time
- iv) Depletion

#### i) Physical deterioration

Almost all assets are affected by wear and tear. Example motor vehicle, furniture used in the office, e.t.c.

#### ii) Economic factors

These are factors that are not related to the physical condition of an asset but are largely due to economic conditions e.g.

a) Obsolescence: this is when an asset becomes out of date. For example, the typewriters are fast becoming obsolete and being replaced with computers. Thus

even if it were new, it would be overtaken by events. Technological advancements are the largest contributors to the obsolescence.

**b) Inadequacy:** this happens when an asset can no longer be used mainlydueto

growth of size of a business. For example a start up business in the transportation industry is using a small pick-up and as it grows it may find large tracks more economical and convenient.

#### iii) Time

Time is also a key contributor to depreciation in the sense that even if an assetwasleft unused; its value would fall considerably with passage of time.

#### iv) Depletion

This is the case of exhaustion of natural resources with time. As extractionofsuch assets continues they become of lesser value e.g. mines oil fields, quarries, e.t.c

### **DEPRECIATION AS AN EXPENSE**

Depreciation is an operating expense in the business that reflects the loss in value of an asset during a given accounting period. Depreciation is recognized in line with such concepts as matching concept whereby we match revenues of a particular period with the expenses incurred in the same period.

### Methods of charging depreciation

There are two major methods of charging depreciation;

i) Straight line method

ii) Reducing balance method

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# Other methods are:

- Revaluation method
- Depletion unit method
- Machine hours method
- Sum of years digit method

Depreciation is arrived at by simply taking the total cost of the assets less any amounts received during its disposal. The resulting figure ids known as the residue value.

The depreciation will be the difference between the cost and the amount received. The problem arises when an asset is used for more than one accounting period. We therefore can only estimate how much to allocate to each accounting period. The methods used are:

# Straight line method

This method assumes that an asset is depreciated uniformly over its useful life.

Useful life in this case is taken in form of years.

Depreciation is calculated as follows:

Depreciation = Cost estimated disposal value (residue value)

number of expected years of usage

The depreciation could also be calculated as a percentage of total cost. The percentage is calculated as follows.

No. of expected years of usage x 100

For example if the number of useful years is five years, we can calculate the percentage of depreciation each year as

Therefore each year our calculation would be as follows:

(Cost-estimated residue value) x 20%







# >>> Example 1

X Itd bought furniture worth Sh 200000. The furniture was expected to last 8 years and would be disposed off for Sh 40000 at the end of the eighth year. Show how depreciation to be allocated in each of the accounting period for the 8 years using the straight line method of depreciation.

Depreciation = 
$$\frac{200000 - 40000}{8}$$
 = Sh 20000

Each year the depreciation charge would be Sh 20,000

If an asset is estimated not to have any residue value at the end of its life time, depreciation equals to the total cost of the asset divided by its life time.

# >>> Example 2

If the furniture in example 1 had a nil residue value, depreciation allocated each year would be:

Depreciation = 
$$200000 - 0$$
 = Sh 25000

8

# Reducing balance method

In this method, the depreciation is charged at a fixed percentage over the remaining cost of an asset. It's a method conveniently for assets that are assumed to have a higher depreciation rate over their first few years of use. More so, advocates of this method argue that the cost of running an asset is not depreciation only but also costs to do with maintenance and repairs.

They argue that during the first year, costs of repairs and maintenance will be minimal and hence charge minimal depreciation during the first years to match the low repairs and maintenance cost. During later years, depreciation charge will be minimal whereas repairs and maintenance will have increased significantly. This will therefore tend to give a uniform cost of running an asset. However this is not always the case.



# >>> Example 3

An equipment is bought for Sh300000 and depreciation is to be charged at 25% on the reducing balance method show the calculation of depreciation charge for the first years of use.

#### You will realize that:

During the first year depreciation was higher then becoming smaller and smaller as the years go by.

To obtain the percentage for reducing balance we use the following formulae:

#### Where:

- r Is the rate of depreciation to be applied
- **n** is the number of useful life
- **s** is the net residue value (this must be a significant figure or else the answer will be absurd)
- c s the cost of the asset

# **Machine-hour method**

Under this method, the asset is depreciated on the basis of the number of hours operated during a specific accounting period. Compared to the number of hours expected to run during its life time.

# >>> Example 4

XYZ Co. Ltd bought a machine for Sh 120000. The machine is expected to run for Sh 20000 during its life time and have a scrap value (residue value) of Sh 20000. During its first year of operation it was run for 5000 hours. Calculate the depreciation charge for that year.



no. of hours run during the year

depreciation = · depreciable

amount= shs25000total expected running hours (during its life time)

Depreciable amount = cost - scrap (residue value) = 120000 - 20000 = Sh 100000

depreciation =  $\frac{20000}{20000} \cdot 100000 = \text{shs} \cdot 25000$ 

Alternatively we can get the depreciation amount per hour run and then multiply by the number of running hours during accounting period.

depreciation amount per hour=

total expected no. of running hours

$$=\frac{100000}{20000}$$
 = shs5 per hour

Total during the accounting period will be

Charge per hour X no of hours

 $= 5 \times 5000$ 

= Sh 25000

# Sum of all years digit method

Under this method, a higher amount of depreciation is charged during the initial year of service and a lower amount as the asset becomes old. The depreciation charge is calculated by taking the sum of years the asset is expected to last and then comparing it with the number of years the asset is expected to last during an accounting period as follows. For an asset expected to last 3 years it will be:

1<sup>st</sup> year expected to last 3 years

2<sup>nd</sup> year expected to last 2 years

3<sup>rd</sup> year expected to last 1 year

Sum 6 years

during first year: no. of yearsexpected to last as at this year x depreciable amount

no .of years expect to last as at this year

during first year: sum of all ye rs expected tolast � depreciable amount

sum of all years expected to last

: 3 x depreciable amount

6 : \* depreciable amount

# >>> Illustration

Calculate the depreciation amount per year for a machine costing Sh225000 And expected to last for five years with no residue value

Sum of years 
$$1^{st} = 5yrs$$
  
 $2^{nd} = 4yrs$   
 $3^{rd} = 3yrs$   
 $4^{th} = 2yrs$   
 $5^{th} = 1yrs$   
Sum 5yrs

$$1^{st} = 5 x 225000 = 75000$$

$$15$$

$$2^{nd} = 4 x 225000 = 60000$$

$$15$$

$$3^{rd} = 3 x 225000 = 45000$$

$$15$$

$$4^{th} = 2 x 225000 = 30000$$

$$15$$

$$5^{th} = 1 x 225000 = 15000$$

$$15$$

$$225000$$

# **Depletion unit method**

This is a method mainly used in the extraction of minerals e.g. quarry, oil fields e.t.c.

Depreciation is calculated as:

Cost of the asset

x no. of units taken in the period

expected total content in units



White was one of singlicom





#### >>> Illustration

An oil field is acquired for \$1000000 and expected to produce 100000 litres of crude oil .during the first year a total of 20000 litres were extracted. Calculate the depreciation charge during the year using the depletion unit method.

Depreciation = 
$$\frac{1000000}{10000}$$
 x 20000 = \$200000

# Units of output method

Under this method, depreciation is measured in terms of expected output of an asset during its lifetime compared to the output during a particular accounting period.

Depreciation = No. of units during a particular period x depreciable amount total no. of units expected during life time

# >>>Illustration

A machine is expected to produce 100,000 toys. During a particular accounting Period ended 31<sup>st</sup> December 2007, a total of 10000 units were produced. The machine had cost Sh180000 and was expected to have a salvage value of Sh 30000

Calculate depreciation as at 31 st December 2007

depreciation = 
$$\frac{10,000}{(180,000-30,000)}$$
 shs15,000

# **Revaluation method**

This is a method used to calculate depreciation on small parts of equipment and tools in an organization. An organization will find it appropriate to group the tools together and have a single figure and then revalue them at the end of the accounting period. For example, in the construction industry, one would group together screw drivers, hammers mattocks, spades and all other small equipments and then revalue after a certain period of time to arrive at the depreciation during a specific accounting period.

# Depreciation will be

Cost/valuation as at the beginning of the year xxx

Add

Purchases during the year xxx

Less

Valuation as at the end of the year (xxx)

Depreciation for the year xxxx

# 3.5 ACCOUNTING FOR DEPRECIATION

So far we have looked at ways of calculating depreciation for assets. Of more importance is to know how to account for this depreciation so as to give a figure that reflects the true and fair view of the state of affairs of a given company as to its P&L and balance sheet.

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As earlier mentioned, depreciation is a business expense, and it's accounted for in the same way as all the expenses.

The two most commonly used methods of depreciation are straight line method (also known as the cost approach) and the reducing balance method.

Once we have computed he depreciation amount, we account for it as follows in the books of account:

Dr. Deprecation expense account xxxx

Cr. Provision for/accumulated depreciation account

We could also directly debit the P&L account while the credit is made in the provisions/accumulated depreciation account.

Depreciation can be calculated pro-rata. This means with regard to the time of acquisition. However it's upon an enterprise to setup a policy that best fits them e.g. charge a depreciation pro-rata to time charge a full depreciation for the year on the year of acquisition, charge no depreciation during the year of disposal.

# >>> Example

XYZ Company bought equipment for Sh500000 on 1<sup>st</sup> April 2002. The company's policy is to charge depreciation using the straight line method pro-rata to time, what would be the depreciation charged for the three consecutive years ending 31<sup>st</sup> December. Enter the above in the books of accounts.





(Depreciation rate 20, nil residue value)

$$1^{\text{st}}$$
 year  $31^{\text{st}}$  Dec  $2002 = \frac{9}{12} \cdot 500000 \cdot \frac{20}{100} = 75000$ 

$$2^{\text{nd}}$$
 year 31<sup>st</sup> Dec 2003 =  $\frac{20}{100} \cdot 500000 = 100000$ 

$$3^{\text{rd}} \text{ year } 31^{\text{st}} \text{ Dec } 2004 = \frac{20}{100} \cdot 500000 = 1000000$$

2002: Dr. Equipment depreciation account 75000

Cr. Accumulated depreciation account

75000 2003: Dr. Equipment depreciation account 100000

Cr. Accumulated depreciation account 100000

2004: Dr. Equipment depreciation account 100000

Cr. Accumulated depreciation account 100000

# Depreciation expense a/c

2002		Sh	2002		Sh
	Accumulated	75000		P &L account	75000
	depreciation				
2003			2003		
	Accumulated	100000		P &L account	100000
	depreciation				
2004			2004		
	Accumulated	100000		P &L account	100000
	depreciation				

# Accumulated depreciation a/c

FIN	A N C I A L A C C O U N T I N	G						onsingly.com
							25010	<b>5</b>
	Ac	ccumulated d	deprecia	ation a/c			"M'W"	
2002		Sh	2002			7	√Sh	
	Balance c/d	75000		Depreciation	for		75000	
				year				
2003			2003					
	Balance c/d	175000		Balance b/d			75000	
				Depreciation	for	the	100000	
				year				
		175000					175000	
2004			2004					
	Balance c/d	275000		Balance b/d			175000	
					for	the	100000	
				year				
		275000		<b>)</b> '			275000	

Assuming the depreciation rate is reducing balance at rate of 2005

$$1^{st}$$
 year  $31^{st}$  Dec  $2002 = 9 \times 500000 \times 20 = 75000$   
12 100

$$2^{\text{nd}}$$
 year  $31^{\text{st}}$  Dec  $2003 = 20 \text{ x}$  (500000 - 75000) = 85000

$$3^{rd}$$
 year  $31^{st}$  Dec  $2004 = 20$ x (425000 - 85000) = 68000

#### **Entries:**

2002: Dr. Equipment depreciation account 75000

Cr. Accumulated depreciation account

75000 2003: Dr. Equipment depreciation account 85000

Cr. Accumulated depreciation account 85000

2004: Dr. Equipment depreciation account 68000

Cr. Accumulated depreciation account 68000







# Depreciation expense a/c

2002		Sh	2002		white Sh
	Accumulated depreciation	75000		P &L account	75000
2003			2003		
	Accumulated depreciation	85000		P &L account	85000
2004			2004		
	Accumulated depreciation	68000		P &L account	68000
			1		

# Accumulated depreciation a/c

	Sh	2002		Sh
Balance c/d	75000		Depreciation for the year	75000
		2003		
Balance c/d	160000		Balance b/d	75000
			Depreciation for the year	85000
	160000	1		160000
		2004		
Balance c/d	228000		Balance b/d	160000
			Depreciation for the year	68000
	228000			228000
	Balance c/d	Balance c/d       75000         Balance c/d       160000         160000       228000	Balance c/d 75000 2003  Balance c/d 160000  160000  2004  Balance c/d 228000	Balance c/d  Balance c/d  Balance c/d  160000  Balance b/d Depreciation for the year  160000  2004  Balance b/d Depreciation for the year  2004  Balance b/d Depreciation for the year

At the end of the period, the amount of the equipment to be shown in the balance sheet net of accumulated depreciation as at that time.

# The extracts would be as follows:

# 2002 (straight line)

Equipment at cost	500000		
Less: accumulated depreciation	75000	425000	
2003			
Equipment at cost	500000		
Less: accumulated depreciation	175000	325000	
2004			1
Equipment at cost	500000		0,
Less: accumulated depreciation	275000	225000	

# Using Reducing balance method

#### 2002

Equipment at cost 500000

Less: accumulated depreciation 75000 425000

2003

Equipment at cost 500000

Less: accumulated depreciation 160000 340000

2004

Equipment at cost 500000

Less: accumulated depreciation 228000 272000

For each asset bought by a business enterprise, an account for depreciation is opened. This is because different assets are depreciated with different accounting policies as well as different rates.

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# 3.6 ACQUISITION OF AN ASSET

When we acquire a new asset in the business, there are various entries to be recorded. We first open an asset account by the following entry:

Dr. Assets account

Cr. cash/bank/creditor depending on purchases xxxx

At the end of an accounting period we will need to account for the deprecation so that we match revenues against expenditure. We therefore open a depreciation account for the assets as follows:

Dr. Asset depreciation account xxx

Cr. Accumulated depreciation account xxxx

If an assets is to be depreciated pro-rata to time, then we take the proportion of time the asset was in existence and calculate depreciation with the predetermined policy (straight line/reducing balance e.t.c) and at the pre determined rate.







Disposal of assets in a business is a common occurrence. Assets could be disposed by a business due to any of the following reasons:

- i) The asset is no longer required
- ii) The asset has been scrapped off
- iii) The asset capacity is no longer sufficient and needs to be replaced
- iv) The asset's useful life has come to an end.

# When we dispose an asset the following will be of interest:

- i) To remove the cost of the assets from the books of accounts since its no longer an asset to the business.
- ii) Remove all the accumulated depreciation earlier provided for the asset.
- iii) Determine whether the asset was disposed at a gain or a loss.

## The following entries will be entered:

- i) Transfer the cost of the asset from the asset cost account to the asset disposal account i.e.
  - Dr. Disposal account
    - Cr. Asset cost account
- ii) Transfer the accumulated depreciation from the accumulated depreciation account to the asset disposal account
  - Dr. accumulated depreciation account
    - Cr. Asset disposal account
- iii) Record the amount of sale of the asset in the books of accounts Dr. cash/bank (if sold on cash)
  - Dr. Debtor (if sold on credit)
    - Cr. Disposal account
- iv) Transfer the balancing amount of the disposal account to the P&L account as either gainer loss

# If the disposal account has a credit balance, this is a gain on disposal.

If the asset disposal account has a debit balance then this is a loss. in other words if the "benefits" from the assets(accumulated depreciation and disposal value) exceed the initial cost of the asset being disposed then the asset is said to be disposed at a gain. The opposite of this results in a loss on disposal.

# The asset disposal account will be as follows:

# Disposal of asset a/c

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The asset disposal account w	ill be as follows:		WI Masomoti
	Disposal of asse	t a/c	
	Sh		Sh
Assets (cost value)	Xxx	Accumulated depreciation	Xxx
Gain on disposal(balance)	Xxx	Cash/debtor	Xxx
		Loss on disposal(balance)	Xxx
	xxxx		Xxxx

# >>> Example

JJ traders bought a van in Jan 2003 for Sh 200,000. The policy of the company is to depreciate motor vehicles at a rate of 25% using straight line method. The motor van was sold in March 2006 at a cash price of Sh 60,000 (full depreciation is charged on the year of acquisition and non on the year of disposal)

Show the entries of depreciation expense, accumulated depreciation since 2003 as well as the entries at the time of disposal in 2003.

#### **Solution**

# Motor vehicle depreciation a/c

2003		Sh	2003		Sh
	Accumulated depreciation	50000		P &L account	50000
2004			2004		
	Accumulated depreciation	50000		P &L account	50000
2005			2005		
	Accumulated depreciation	50000		P &L account	50000
2006			2006		
	Accumulated depreciation	0		P &L account	0





# Accumulated depreciation a/c

				. 1	
2003		Sh	2003	in	Sh
	Balance c/d	50000		Depreciation for the year	50000
2004			2004		
	Balance c/d	100000		Balance b/d	50000
				Depreciation for the year	50000
		100000			100000
2005			2005		
	Balance c/d	150000		Balance b/d	100000
				Depreciation for the year	50000
		150000			150000
2006			2006		
	Balance c/d	150000		Balance b/d	150000
				Depreciation for the year	0
		150000			150000

# Disposal of asset a/c

	Sh		Sh
Motor van (cost value)	200000	Accumulated depreciation	150000
Gain on disposal	10000	Cash	60000
	210000		210000

# A special case where accounting for depreciation change in estimate

If we change the rate at which we were charging depreciation for an asset then we'll need to adjust for depreciation as follows.:

- i) Calculate for depreciation so far provided for
- ii) Cost of asset less this provided depreciation so far
- iii) The balance be provided for uniformly at the new rate



# >>> Example

what masomerns indicom If an asset is bought for Sh 100000, expected to be depreciated at a rate of 20% with no residue value, and after being in use for 3 years the rate is changed to 10%, we would make the following adjustments:

Depreciation so far =  $100000 \times 20 \times 3 = 60000$ 

100

Balance not depreciated = 100000 - 60000 = 40000

Depreciation over the remaining useful life =  $10 \times 40000 = 4000$ 

100

#### **CHANGE IN DEPRECIATION POLICY** 3.8

When we change the depreciation policy, we need to adjust for the over/under charge previously shown in the books of account (P&L and balance sheet) supposing it was an undercharge. We calculate the correct amount of depreciation for the previous periods and then deduct the difference in the retained earnings (profits) account. The other entry is passed in the credit of the accumulated depreciation account as follows:

Dr. Retained profits (earnings)

Cr. Accumulated depreciation account

(With the amount of the under charge)

However if it was an overcharge, the entry would be:

Dr. accumulated deprecation account

Cr retained earnings account (With the

amount of the over charge)

# >>>Illustration

Mkulima processing plant has a piece of equipment bought in 2003 at a cost Sh 200000. Previously the equipment was being depreciated at a rate of 20% per annum on cost. However in 2005 the management decided to change the policy after discovering that the appropriate rate would have been reducing balance. Show the entries for adjustment that would appear in the books of Mkulima processing plant in 2005.





#### **Notes**

## There will be entries:

- i) Recognize depreciation for the year
- ii) Adjusting for the amount of the under/over charge

# Determination of the amount of under (over charge)

Year	Amount (cost)	Straight line method	Reducing balance method	Under (overcharge)
2003	2000000	400000	400000	0
2004	2000000	400000	320000	(80000)
2005	2000000	400000	256000	(148000)

However in advanced accounting levels you will realize that not all undercharge is to be deducted from the profits. An element of tax should be recognized. This is because during the year of undercharge, the company was being taxed on the "excess profits" and hence we should have a pre paid tax asset.

#### The entries would be:

Dr. retained earnings

Dr. prepaid tax

Cr. accumulated depreciation

i.e. in the case of an under charge.

# 3.9 REASONS FOR PROVIDING FOR DEPRECIATION

- Matching: depreciation is an ordinary expense resulting from use of an asset to generate revenue during a given period. Matching this expense against the revenue helps to determine the real profit.
- To determine financial position
   Depreciation should be deducted to present the present economic value so that a fair financial position of the firm is reached at.
- iii) Asset replacement
  - Providing for depreciation helps to check cash outflows in the form of drawings, taxes, dividends, e.t.c which lead to accumulation of resources required later for replacement of the asset. This is because the expense is provided for yet the cash does not flow out of the business allowing for cash to be used later.
- iii) Reservation of equity if we do not provide for depreciation there would be a risk of distributing non-distributable funds and hence consuming our capital due to overstated profits.

# masomonsindi.com 3.10 PROPERTY, PLANT, AND EQUIPMENT SCHEDULE

This was formerly referred to as the fixed asset movement schedule. It is a tabular representation of the movement of tangible assets cost within a given accounting period the schedule also shows movement of depreciation for all tangible assets within the given accounting period IAS 16 property plant and equipment requires that the schedule be shown in the published account of companies.

# The format is as shown below:

# Property plant and equipment schedule

	Cost/valuation	Freehold	Lease	hold	Plant and	Fixture	total
		property	proper	ty	machinery	furniture	
						and	
						fittings	
			Long	Short			
			lease	lease			
		Sh	Sh	Sh	Sh	Sh	Sh
1.	Balance as at1/1/01	Xx	Xx	Xx	Xx	Xx	Xx
2.	Additions	Xx	Xx	Xx	Xx	Xx	Xx
3.	Revaluation gains	Xx	-	-	-	-	Xx
4.	Reclassifications	-	(xx)	Xx	-	-	-
5.	Disposal	(xx)	(xx)	(xx)	(xx)	(xx)	(xx)
6.	Balance as at 31/12/01	XX	XX	Xx	xx	xx	xx
7.	Depreciation/amortization						
8.	Balance at 1/1/01	Xx	-	Xx	Xx	Xx	Xx
9.	Change for the year	Xx	-	Xx	Xx	Xx	Xx
10	Revaluation	(xx)	-	(xx)	(xx)	(xx)	(xx)
11	Eliminated on disposal	(xx)	-	(xx)	(xx)	(xx)	(xx)
12	Balance as at 31/12/01	(xx)	-	(xx)	(xx)	(xx)	(xx)
13	N.B.V as at 1/1/01(1-8)	Xx	Xx	Xx	Xx	Xx	Xx
14	N.B.V as at 31/12/01(6-12)	Xx	Хх	Xx	Xx	Xx	Xx





# >>> Example

# **KASNEB** adopted May 2000 question 3

- a) Briefly explain the nature and the purpose of accounting for depreciation (5 marks)
- b) The chief accountant of Jitegemea Ltd has encountered difficulties while accounting for fixed assets and the related depreciation in the company's draft accounts for the year ended 30<sup>th</sup> April 2000. He has decDecided to seek your professional advice and presented the following balances of fixed assets as at 1 st may1999.

	Acquisition cost	Accumulated depreciation	Depreciation rate
Furniture	900000	300000	12.5
Trucks	3525000	1470000	25
Plant and machinery	7387500	4462500	10
Land	2775000	-	Nil
Buildings	2925000	292500	2.5

# The following additional information was available:

- 1. It is the company's policy to write off costs of the assets using the above percentage on cost
- 2. Depreciation is fully charged on the year of acquisition and non in the year of disposal.
- 3. A three year old machine acquired for Sh 187500 was sold for Sh 15750.
- 4. It has been decided to adjust and charge depreciation on buildings at 4 %
- A used delivery van purchased three years ago for Sh 248250 was traded in during the year at the value of 157500 in part exchange of the new delivery truck costing Sh 450000
- 6. Land, buildings and machinery were acquired for Sh 1350000 from a company that went out of business. At the time of acquisition Sh. 90000 was paid to have the assets by a professional qualified valuer. The revaluation indicated the following market value:

Sh
Land 900000
Buildings 600000
Machinery 300000

#### Required:

Reschedule of movement of fixed assets as requested by the chief accountant for inclusion in the company's accounts for the year ended 30 April 2000. (10 marks)

## Solution:

a) Covered in the text

b)

	Cost/valuation	Land buildings and machinery	Plant and machinery	Fixture furniture and fittings	Total
		Sh	Sh	Sh	Sh
15	Balance as at1/5/99	13087500	900000	3225000	17512500
16	Additions	1350000	-	450000	1800000
17	Revaluation gains	450000	-	-	450000
18	Disposal	(187500)	-	(248250)	(435750)
19	Balance as at 30/4/2000	14700000	900000	3726750	19326750
20	Depreciation/amortization				
21	Balance at 1/5/99	4755000	300000	1470000	6525000
22	Change for the year	1066500	112500	931687.5	2110687.5
23	Eliminated on disposal	(37500)	-	(124125)	(161625)
24	Balance as at 30/4/2000	5784000	412500	2277562.5	8474062.5
25	N.B.V as at <b>1/5/99</b>	8332500	600000	2055000	10987500
26	N.B.V as at 30/4/2000	8916000	487500	1449187.5	10852687.8

# Workings:

Depreciation on furniture = 900000 x 12.5% = 112500

Motor vehicle = cost 3525000

Add 450000

3726750 x 25 % = 931 687.5

Buildings =  $(292500 + 600000) \times 4\% = 141000$ 

At 2.5 % = 2925000 x 2.5 % x 4 = 292500

 $4\% = 292500 \times 4\% \times 4 = 468000$ 

175500

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Machinery cost C/F + additions – disposals = balance x 10%

73787500 + 300000 - (187500) = 7500000x 10% = 750000



# 3.11 THE STATEMENT OF FINANCIAL POSITION

Fast forward - a statement of financial position is based on the fundamental business equationi.e. Assets = Capital + Liabilities A = C + L

So far we have covered a majority of the expense items that are typical of any business organization. We have also come across a trial balance and realized that all the entries in the trial balance are used in one of two places i.e. the statement of comprehensive income and the statement of financial position.

The statement of financial position can be defined as a statement which shows the assets of a business at a given point in time and the claim thereof against the assets .The claims can either be by the capital injected or liabilities to third parties.

If all double entry rules have been followed the statement of financial position should balance .A statement of financial position is based on the fundamental business equation i.e. Assets =capital + liabilities A=C+L

A statement of financial position is divided into two:

The debit side and the credit side .the debit side represent the business assets while the credit side represents liabilities and capital.

The main categories in balance sheet will be as follows

# 1. ASSETS

Fast forward - Assets can be classified as current, non-current or fictitious assets.

These are economic resources created by past activities and are capable of bringing economic benefits to the firm in future .assets can be identified by:

- Have economic value i.e. can be measured in money terms i)
- ii) Ability to generate income, goods and services in the future
- iii) Generated by past activities but not dependent on future activities.

# Assets can be classified as either:

# **Non-Current (Long Term) Assets**

www.masomornsindi.com These are assets expected to bring economic benefits to the firm in more than one accounting period. They can either be tangible or intangible. Tangible non-current assets include land motor vehicles, equipment, and computers e.t.c Intangible assets include goodwill, patents, copy rights, trademark. Intangible assets

have the ability to make revenues for a business. If someone owns exclusive copyrights over a given music item then the copy right ownership is an asset to such a business even though not touchable.

#### b) **Current Assets**

These are assets that are expected to be consumed by an organization within a period not exceeding one accounting period. The benefits from such assets is felt within one accounting period e.g. stock, cash at bank or cash in hand, prepayments, debtors, short-term investments e.t.c.

Current assets are also referred to as floating assets

Fictitious Assets: discounts on issue of shares, formation expense of a company. c)

# 2. LIABILITIES

These are financial obligations arising from past agreements activity which is expected to be paid or redeemed in future accounting periods

# Liabilities can either be

#### **Current Liabilities**

These are debts arising from ordinary trade activities and expected to be settled within the next accounting period out current assets. Examples would include trade creditors, accrued expenses, bank overdraft, and bills of exchange payable, unpaid

#### b) **Non-Current Liabilities**

These are financial obligations the firm has undertaken to redeem or settle over a period exceeding one accounting period. These liabilities arise from events outside the ordinary trading activities. Non-current liabilities include bank loans, debentures, long-term bonds payable, long-term leases.

#### **Contingent liabilities** c)

These are liabilities whose timing and amount depend on the occurrence of an event in the future. Examples include damages that could be suffered due to law suits in future or pending in the courts. These liabilities are not recorded in the books unless the amount and timing are clearly certain.

# 3. CAPITAL/EQUITY

This represents the amount contributed by owners of the business. Capital is usually a residue after all other claims. For different business organizations capital could be referring to the following:

- Preference share capital
- **Ordinary share capital**







# **Xyz company Ltd** Statement of financial position as at xxxxx

Statement of infancial position as at xxxxx				
Non-current assets land and buildings plant and equipment less accumulated depreciation	<b>Sh</b> Cost	Sh Accumulated Depreciation xx (xx)	Sh NBV xxx	
fixtures, furniture and fittings less accumulated depreciation		xx (xx)	XX - -	
motor vehicles less accumulated depreciation		xx (xx)	<b>XX</b>	
Total non-current assets			XXX	
Current Assets stock debtors less provision for doubtful debts	xxx (xxx)	xx — <sub>xxx</sub>		
prepayments short term investments cash at bank cash in hand total current assets		XXX XXX XXX XXX	_	
less Current Liabilities bank overdraft creditors	XXX XXX			

bank overdraft	XXX
creditors	XXX
accruals	XXX

	_(xxx)
net current assets	
total acceta	

total	assets	

Capital
Add: net profit

Less: drawings

# **Non-current liabilities**

loans



 $Xx_{\underline{}}$ XX

 $(xx)_{-}$ XXX

#### Notes:

masomonsindi.com A statement of financial position should present in an ordinary way so that users can make deductions they would want to without taking too much time. Therefore statements of financial position of similar organization are prepared in the same way so as to enhance understandability and compatibility.

Most organizations present their statements of financial position with increasing order of liquidity (also known as permanency). This means that for assets we start with those assets that are less likely to be converted into cash in the near future and ending with those that are readily convertible into cash e.g. for current assets:

- Stock
- **Debtors**
- Cash at bank
- Cash in hand

# **CHAPTER SUMMARY**

Statement of comprehensive income- formerly known as the income statement basicallyrepresents the performance of a business. It is the sales (revenue) for the business less all the expenses incurred to generate the sales. The end product is ether profit or loss.

#### The main reasons for preparing the statement of comprehensive income are:

- i) To compare the actual profit to the expected profits
- For planning purposes i.e. to identify areas that need attention in future ii)
- To obtain funds from lenders based on one's profitability iii)
- To inform prospective owners on the performance iv)
- In computation of taxes to ensure that the correct amount is remitted to the tax v) authorities.

Statement of financial position - formerly known as the balance sheet is a statement which shows the assets of a business at a given point in time and the claim thereof against the assets, the claims can either by the capital injected or liabilities to third parties





# **CHAPTER QUIZ**

- 1. What are the main reasons for preparing the statement of comprehensive income?
- 2. How is the cost of goods sold calculated?
- 3. What expense (accrual or prepayment) is charged against profit for a period even though it has not yet been paid or invoiced?
- 4. If a receivable allowance is increased, what is the effect on the income statement?
- 5. What are the causes of depreciation?
- 6. What are the two major methods of charging depreciation?

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# **ANSWERS TO CHAPTER QUIZ**

- 1. To compare the actual profit to the expected profits
  - For planning purposes i.e. to identify areas that need attention in future
  - To obtain funds from lenders based on one's profitability
  - To inform prospective owners on the performance
  - In computation of taxes to ensure that the correct amount is remitted to the tax authorities.
- 2. Opening inventory + purchases closing inventory.
- 3. Accrued expenses.
- 4. Increase in expenses.
- 5. Physical deterioration.
  - Economic factors.
  - Time.
  - Depletion.
- 6. Straight line method.
  - Reducing balance method

# **PAST PAPER ANALYSIS**

12/7, 6/07, 12/06, 6/06, 12/05, 6/05, 12/04, 6/04, 12/03, 6/03

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## **Question 1**

# Mary

Statement of financial position as at 31 December 2000

Sh. Non Current Assets Sh.

**Premises** 25,000.00

Plant 12,000.00

37,000.00

**Current Assets:** 

Stock 11,000.00

**Debtors** 10,000.00

Cash at bank 5,000.00

Cash in hand 3,000.00

29,000.00

Current liabilities:

Creditors (12,000.00) 17,000.00

54,000.00

Capital 34,000.00

Non Current Liabilities:

Loan from bank 20,000.00

54,000.00

During the year to 31 December 2001 the following total transactions occurred:

- Mary withdrew a total of Sh.10,000.00 in cash
- Stock in trade was bought, all on credit, for Sh.34,000.00 b)
- Sales were made totaling 60,000.00 of stock in trade which had cost Sh.37,000.00. Of these sales Sh.51,000.00 were on credit and Sh.9,000.00 for cash.
- A total of Sh.16,000.00 was drawn from the bank in cash to the cash till. d)
- Electricity for the year paid by cheque totaled Sh.2,000.00 e)
- f) Rates for the year paid by cheque totaled Sh.1,000.00
- Wages for the year all paid cash totaled KSh.10,000.00 g)
- Sundry expenses all paid in cash totaled Sh.2,000.00 h)
- Creditors were paid a total of Sh.36,000.00 all by cheque i)
- j) Debtors paid a total of Sh.54,000.00 all in cheques.
- The bank charged interest on the loan deducting Sh.3,000.00. k)

## Required:

Prepare a revised statement of financial position.

(20 marks)

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# **CHAPTER FOUR**

# SOLE PROPRIETORSHIP

# **OBJECTIVES**

After studying this chapter, you should be able to:

- Define a sole trader and explain the advantages and disadvantages of sole proprietorship form of business
- Prepare financial statements for sole proprietor form of business
- Understand the operation of nonprofit making organizations and operate

# **▶** INTRODUCTION

**Fast forward** - The only unique account in the statement of financial position of a sole proprietorshipwould be the drawings account.

Sole traders can be said to be business people who start their own enterprises and run them for themselves with the aim of making a profit. Sole proprietorship could be run family members or even the owner and one or two employees. They are the most common businesses that you will come across in any economic set-up. They include butcheries, kiosks, some wholesale shops and supermarkets, e.t.c the main reasons why they are so common include:

- i) They are easy to set up (e.g. you only need a trading license)
- ii) They require less capital to put up
- iii) They are easy to manage

# Advantages

- i) They is ease in Decision making since only one party makes the Decision
- ii) There is a personal touch with the customers
- iii) It is easy to manage
- iv) No sharing of profits
- v) Easy to start since minimal capital is required

# **Disadvantages**

- i) Incase of incapacitation of the sole proprietor the business can easily collapse
- ii) It is hard to raise capital

- iii) There is no limited liability i.e. the private property of the proprietor can be sold to cover the debts incurred by the business.

  iv) The sole proprietor suffers losses alone

# **▶** DEFINITION OF KEY TERMS

Drawings are either cash or goods withdrawn from the business by the sole proprietor for hisown use.

A Sole proprietorship is a business run by a single individual with an aim of making profit.

# **► EXAM CONTEXT**

This is a very important chapter bearing in mind sole proprietorships are the most common type of business in the country. Expect questions from this chapter.

# **▶ INDUSTRY CONTEXT**

Sole proprietorships are the most common types of businesses in Kenya, in the form of kiosks, farms and other family run businesses. This is a sector that that has largely gone without maintaining financial statements. Sole traders have however seen the need of maintaining financial statements with Kenya Revenue Authority (KRA) requiring them to file tax returns. This has resulted in high demand for bookkeeping.







The main objective of most business enterprises is to make profit. However, sometimes the business ends up making losses. For a sole proprietorship, most important financial statements are:

- a) The statement of comprehensive income
- The statement of financial position. b)

Refer to the general format of the Statement of comprehensive income and the statement of financial position.

# **DRAWINGS**

Fast forward - The total of the drawings account is deducted from capital to know how much isleft thereafter.

The only unique account in the statement of financial position of a sole proprietorship would be the drawings account. A drawings account is used to record both cash and goods withdrawn from the business by the sole proprietor for his/her own use. For example a shopkeeper will take consumables from his shop and if it is not accounted for properly, one would end up deducing the that the business is not making profits while us the truth is that the business is profitable only that the profits are taken away from the business in the form of the goods or cash.

#### When one makes a withdrawal of cash the entries will be:

Dr. Drawings account

Cr. Cash/bank account

The drawings account is shown in the statement of financial position on the credit side. The total of the drawings account is deducted from capital to know how much is left thereafter.

# When we make a withdrawal of goods the entries are as follows:

Dr. Drawing account

Cr. purchases account

This amount of goods should be shown at cost to avoid bringing in the element of unrealized profits in the business.

The drawings are then deducted from the net profit in the statement of financial position as shown in the statement of financial position extract shown below;

Statement of financial position Extract

Capital

	уууу
Non-current liabilities loans	xx
Less: drawings	(xx) xxx
Add. Het profit	XX (vv)
Capital Add: net profit	<u>Xx</u>
0!(-1	XX

# CHAPTER SUMMARY

The main reasons why sole proprietorships are so common include:

- They are easy to set up (e.g. you only need a trading license)
- They require less capital to put up
- They are easy to manage

# **CASE STUDY**

Most businesses in Kenya are sole proprietorships. These range from small scale farmers to jua kali trader to kiosk owners. These small businesses have been responsible for the current boom in the country of microfinance, informal banking like M-pesa and the increased attention by established banks like Equity bank to target small bankers (commonly known as the unbaked).









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# **CHAPTER QUIZ**

- 1. Why are sole traders common?
- 2. What are the advantages of sole trading?
- 3. If an owner takes goods out of inventory for his personal use, how is this dealt with?

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# **ANSWERS TO CHAPTER QUIZ**

- 1. They are easy to set up.
  - They require less capital to put up.
  - They are easy to manage.
- 2. There is ease in decision making since only one party makes the decision

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- There is a personal touch with the customers
- It is easy to manage
- No sharing of profits

- Easy to start since minimal capital is required
- 3. The amount is debited to drawings at cost.

# **PAST PAPER ANALYSIS**

12/06, 6/04, 12/03, 6/02, 6/01, 12/00, 6/00

# **EXAM TYPE QUESTIONS**

# QUESTION 1 (December, 2006 Q 1)

Mr. Hassan Baraka retired from employment on 1 October 2005 and was paid terminal benefits of Sh 3,000,000 He utilized Sh 2,500,000 in purchasing business premises and deposited the balance in a new business account at Faida Bank Ltd."

Mr. Baraka did not maintain proper books of account. However, he kept files of statements from suppliers, cheque counter foils and unpaid invoices for purchases made. He also maintained a note book in which he recorded sales to customers who had credit accounts and settled their accounts by cheque. Cash collected from sales was banked at the end of each week after payment of certain expenses. Mr. Baraka also maintained some petty cash for office use. Mr. Baraka estimates to have paid the following business expenses from his personal bank account.





	Sh '000'
Rent and rates for additional apace	100
Lighting expenses	50
Stationery and postage expenses	26

# An analysis of the bank statements for the year ended 30 September 2006 was as follows:

Receipts	Sh.'000'	Payments	Sh.'000'
Account opening	500	Petty cash withdrawn	20
Weekly bankings	3,769	Fixtures and fittings	300
Cheques from customers	382	Suppliers for goods	3,728
Cash refunded by a supplier	10	Insurance for inventory	40
		Bank charges	
	110		
Balance carried down	463		
	4,661		<u>4,661</u>

## Additional information:

Baraka estimates that during the year ended 30 September 2006, he utilized cash collected from sales for the following purposes:

	Sh.'000'
Wages payment	400
Sundry expenses payment	50
Drawings	600

- Cheques received from credit customers amounting to Sh 30, 000 had not been 2 credited by the bank as at 30 September 2006.
- Insurance paid for inventory during the year includes Sh 20,000 relating to premium for 3 the year ending 30 September 2007.
- 4 Petty cash balance as at 30 September 2006 was Sh 15,000 which included a post dated cheque of Sh 5,000 drawn by Mr. Baraka's friend in exchange for cash advanced from petty cash.
- Credit customers owed Sh 172,000 as at 30 September 2006. 5
- 6 As at 30 September 2006, the following were due on accounts payable:

S	h	6	0	n	n	,
			u	u	u	

Suppliers	403
Wages	10
Sundry expenses	6

7 Depreciation is to be provided on a straight-line basis at the following rates:

Business premises 2% Fixtures and fittings 10%

8 The value of inventory as at 30 September 2006 was Sh 360,000.

### Required:

- (a) Statement of comprehensive income for the year ended 30 September 2006. (12 Marks)
- (b) Statement of financial position as at 30 September 2006.

(8 Marks)

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(Total: 20 Marks)



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STUDY TEXT STSUTDUYD YT ETXETX T

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### **CHAPTER FIVE**

### PARTNERSHIP ACCOUNTS

### **▶** OBJECTIVES

A C1		41 . 4							
After	studvina	tne 1	tollowina	chapter.	vou	snould	рe	able	to:

- Define partnership and highlight the advantages and disadvantages of partnership form of business
- Prepare current account and capital accounts for partnership form of business and distribute profits to partners through the preparation of appropriation account
- ☐ Account for change in partnership agreement
- Understand the concept of goodwill; characteristics and Calculation of goodwill
- ☐ Account for goodwill and revaluation profit or loss
- Account for asset revaluation for assets taken over by a retiring partner

### **▶** INTRODUCTION

A partnership is defined as the relationship which exists between persons carrying on a business in common with a view of making profits.

### Advantages of partnerships

### Advantages over sole traders

- i. Risks are distributed over a larger number of people
- ii. There is access to addition capital
- iii. Expertise; partners bring in experience from individual fields
- iv. Easier to raise funds from external sources

### Advantages over limited liability companies

 Easier to establish and manage because there is no compliance to the Companies Act Rules

### Disadvantages

### Against sole traders

- i. Possibility of dispute among partners
- ii. Less control in the management as many people are involved
- iii. Less amount of profits distributed

### Against limited liability companies

- i. Liability of partners is unlimited. They can be called to contribute personal assets incase the business cannot meet its obligations
- ii. Comparatively difficult to raise capital
- iii. Retirement or death of a partner leads to dissolution and reformation of the firm

### **▶ DEFINITION OF KEY TERMS**

**Relationship** - a partnership has more than one person, a differentiating factor from soleproprietorship.

**Business in common** - all members to a partnership have a common purpose. This means they cannot run parallel businesses.

Profits - key to every business undertaking, partnerships aim to make profits.

### **► EXAM CONTEXT**

As emphasized in every chapter, all chapters equally important. This chapter has been frequently examined as seen in the past paper analysis the latest being June and December sitting for 2006 and 2007.

### **▶ INDUSTRY CONTEXT**

Unlike sole proprietorships where most traders don't maintain proper or any accounts in partnerships this is very crucial. Not all partner may be part of the day to day running of the business, they will for this reason require true and fair financial statements prepared and audited for the purposes of profit sharing.





### 5.1 PARTNERSHIP AGREEMENTS

Fast forward – In the absence of the partners' agreement, it is presumed that:
<ul> <li>□ Profits will be shared equally</li> <li>□ There are no partners' salaries</li> <li>□ No interest on capital is paid</li> <li>□ Partners are entitled to interest of 4% per annum on any loans advanced to the firm</li> </ul>
A partnership is usually established through a partnership agreement in which the terms of the partnership are set out. The agreement covers the following items:
<ul> <li>Amount of capital invested by each partner in the business</li> <li>The profit sharing ratio</li> <li>The interest on capital</li> <li>Salaries to partners</li> <li>Limits to drawings</li> <li>Interest on drawings, etc.</li> <li>Some partnership agreements may also guarantee minimum share of profits for on or more partners. What this means is that if the amount allocated by the profit sharin ratio is lower than that stipulated, the partner would receive the guaranteed minimum share and the remainder of the profits would be share by the other partners according to the agreement.</li> </ul>
In the absence of the partners' agreement, it is presumed that:
<ul> <li>□ Profits will be shared equally</li> <li>□ There are no partners' salaries</li> <li>□ No interest on capital is paid</li> <li>□ Partners are entitled to interest of 4% per annum on any loans advanced to the firm</li> </ul>
5.2 ACCOUNTING FOR PARTNERSHIPS

Fast forward – There are two very important accounts used in partnership accounting

- a) Partners current account
- b) Capital accounts

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.asomonsindi.com Four main transactions are recorded in these important accounts. They are; division of profits, capital investments by partners, drawings, interest on capital and interest on drawings.

### CAPITAL ACCOUNT

Partners' capital account records the initial and additional investments made by the partners into the business. In other words it records items of long-term nature. Each partner's contribution is shown separately i.e. each partner has a capital account.

Capital accounts have credit balances normally

Let's take an initial example of two partners; Abdi and Jillo, the format of capital account would be as follows:

### Capital account

	Abdi	Jillo		Abdi	Jillo
Goodwill written off	XX	XX	Balance b/f	XX	XX
Revaluation Loss	XX	XX	Additional capital	XX	XX
			Gains on Revaluation	XX	XX
Balance c/d	XX	XX	Goodwill	XX	XX

This is called a fixed capital account

### >>> Example

Abdi and Jillo intend to start a business of selling cattle. Abdi contributes Sh 100,000 and Jillo Sh 150,000. Record these initial investments in the relevant accounts.

#### Solution

Just like sole proprietorship, capital contribution is recorded thus;

Dr. Cash

Cr. Capital account (with each partner's contribution)

Capital, Abdi	Cash account			
Cash 100,000	Capital; Abdi 100,000 Capital; Jillo 150,000			
Capital, Jillo	^			
Cash 150,000	27637			



### **CURRENT ACCOUNTS**

The current accounts records movements in partners' earnings. Items that increase earnings to the partners are credited and those that decrease are debited.

They normally have a credit balance, just like the capital accounts.

The format of Current accounts is as follows

### **Current Account**

	Abdi	Jillo		Abdi	Jillo
Balance b/d	xx		Balance b/d		xx
interest on drawings	xx	xx	Interest on Capital	xx	xx
Drawings	xx		Salaries	XX	XX
			Profit share	XX	XX
Balance c/d		XX	Loan Interest	XX	XX
			Balance c/d	XX	

Note that the opening and closing balances are both on the credit and debit sides. The normal balances should be on the credit side. It is therefore not normal to have debit balances on the partners' current account. It may arise when a partner has overdrawn in his/her account.

### Salaries

Some partners could render services to the partnership in areas that they are competently qualified. For example accountancy services, legal etc. They are thus remunerated for those services in the form of salaries.

Salaries paid to partners increase their accounts. Therefore to record salaries paid to a partner, we:

Dr. Salary account

Cr. Partner current account

### ■ Interest on capital

This is a form of 'reward' to the partners for contributing capital to the business. It therefore increases partners' incomes.

### The entry is therefore as follows:

Dr. Profit and loss appropriation account

Cr. Current account.

### Drawings

White Masomons Indicom Drawings are goods meant for the business that owners take for personal use. They are therefore not sold nor are they reflected in the closing stock. They are normally removed at cost from the trading account into a drawings account. At the end of the year, they are transferred into the current account by the following entry;

Dr. Current account

Cr. Drawings account

### Interest on drawings

### Fast forward – Drawings are like advancement to the partners in form of goods.

Interest is normally charged on Drawings. This reflects an amount over and above the value of the goods called the interest on drawings recorded thus:

Dr. Current account

Cr. Profit and loss appropriation account

### Division on partnership profit

Profit from a partnership is divided among the partners in accordance with the partnership deed. In case of no such deed, profits are shared equally as noted above.

To record partnership profits, we need to introduce a profit and loss appropriation account or simply appropriation account.

### To record profit share:

Dr. Profit and loss appropriation account

Cr. current account

#### Note

The capital account could either be fixed or fluctuating. A fixed capital account is one that records the long-term items alone. As the name suggests, the amounts do not change unless additional capital is introduced by partners.

Fluctuating capital account is one where both the long-term and short-term (current account items) items are recorded on the same account. Where fluctuating capital accounts are kept, current accounts do not exist; their items are passed onto the capital account.

The amount of the ending balance keeps on changing due to the inclusion of short-term items hence the name fluctuating account.





Note that the fixed format is highly preferred by examiners and unless told to use the fluctuating capital account, stick to the fixed capital account(s i.e. separate capital and current accounts).

### The format of the fluctuating capital account is as follows:

### **Fluctuating Capital Account**

	Abdi	Jillo		Abdi	Jillo
Drawings	XX	xx	Balance b/d	XX	XX
interest on drawings	xx	xx	Additional capital	XX	XX
			interest on Capital	XX	XX
			salaries	XX	XX
			loan interest	XX	XX
Balance c/d	xx	xx	profit share	xx	xx

The end balances in a fluctuating capital account keep changing even without injection of additional capital due to the inclusion of current account items.

In fluctuating capital account, the current account does not exist.

### 5.3 FINAL ACCOUNTS

In sole proprietorship, we learnt the two conventional final accounts i.e. trading, statement of comprehensive income and the balance sheet. The financed by side of the statement of financial position records the partners' capital and current accounts separately. We normally introduce the profit and loss appropriation account or simply the appropriation account. The rest does not change in partnerships.

### APPROPRIATION ACCOUNT

Appropriation account is an extension of the statement of comprehensive income showing how the partnership profit was shared. In arriving at the amount to be shared among the partners, we include the four basic items discussed above; salaries to partners, interest on drawings and interest on capital, the fourth item being the profit share.

The basic format of an appropriation account is as

follows: Let us use Abdi and Jillo again;

# Abdi and Jillo Partnership Profit and Loss Appropriation Account For the period ended...

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	·	
	Sh.	Sh.
Net Profit for the year		XX
Add; Interest on Drawings; Abdi	XX	
Jillo	XX	
		XX
		XX
Less; Interest on Capital; Abdi	XX	
Jillo	XX	
		(XX)
Less; Salaries; Abdi	XX	
Jillo	XX	
		(XX)
Balance to be shared in ratio;		XX
Abdi	XX	
Jillo	XX	
		(XX)
		NIL

Note: The final figure should be zero because the balance is fully shared among/between the partners.

### >>> Worked examples

You now know all you need to about partnership accounting.

Let us now look at some short examples:

### >>> **Example 1**

Mogire, Waituka and Kipkorir are in partnership. Mogire does the accounting work while Waituka offers legal services and for each earns a salary of Sh 10,000 per month. The profit or loss is shared equally. The profit for the month was Sh 110,000.

### Show the relevant accounts for the partnership:







	Mogire	Waituka	Kipkorir		Mogire	Waituka	Kipkorir
				Salary	10,000	10,000	
Balance c/d	40,000	40,000	30,000	Profit Share	30,000	30,000	30,000
	40,000	40,000	30,000		40,000	40,000	30,000
				balance b/d	40,000	40,000	30,000

### The appropriation account will be

### MOGIRE, WAITUKA AND KIPKORIR PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT

FOR THE MONTH ENDED...

Net profit for the month			110,000
less salaries	Mogire	10,000	
	Waituka	10,000	
			(20,000)
profit to be shared			90,000
Profit share	Mogire	30,000	
	Waituka	30,000	
	Kipkorir	30,000	
			(90,000)
		_	NIL

### >>> Example 2

Assume in the above example that a clause in the partnership deed guaranteed a minimum profit to Mogire of Sh 35,000, show the new set of accounts.

### Solution

In our discussion above, we noted that some partnership agreements could guarantee one or more of the partners a minimum profit share beyond which his/hers share can't fall. In this example, Mogire's share can't go below Sh 35,000. The remaining will be shared equally between Waituka and Kipkorir as follows:

### **Current Account**

							77/2
	Mogire	Waituka	Kipkorir		Mogire	Waituka	Ripkorir
				Salary	10,000	10,000	
Balance c/d	45,000	37,500	27,500	Profit Share	35,000	27,500	27,500
	45,000	37,500	27,500		45,000	37,500	27,500
				balance b/d	45,000	37,500	27,500

### MOGIRE, WAITUKA AND KIPKORIR PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE MONTH ENDED...

		•		
Net profit for the mo	nth		110,000	
less salaries	Mogire	10,000		
	Waituka	10,000		
			(20,000)	
profit to be shared			90,000	
Profit share	Mogire	35,000		
	Waituka	27,500		
	Kipkorir	27,500		
			(90,000)	
			NIL	

Let us now have a comprehensive example capturing all aspects up to final accounts

### >>> Example 3

Ochieng and Otieno are in partnership sharing profits and losses equally. The following is their trial balance as at 30<sup>th</sup> June 2006:

Puildings (soot Sh. 90 000)	Dr, Sh.	Cr. Sh	
Buildings (cost Sh. 80,000) Fixture at	55,000 16,000		
Provision for depreciation on fixtures	10,000	8,300	
Debtors	21,243	0,500	
Creditors	21,240	16,150	
Cash at bank	5,677	10,100	
Stock at 30" June 2005	46,979		
Sales	,	128,650	
Purchases	90,416	-,	
Carriage outwards	6,288		
Discounts allowed	5,115		
Loan from Oloo		129,100	
Office expenses	7,416		
Salaries	23,917		^
Bad debts	5,503	F 400	
Provision for bad debts	0.000	5,400	(2)
Loan interest – Oloo	9,000	45,000	2716371
Capital – Ochieng Capital – Otieno		39,500	
Current account – Ochieng		13,106	20
Current account – Othleng		9,298	\ \ \
Drawings by Ochieng	12,400	3,230	
Drawings by Otieno	8,650		
Diamings by Ottorio	· · · · · · · · · · · · · · · · · · ·		
TOTAL	394604	394604	
IOIAL			



Prepare a trading, profit and loss and appropriation account for the year ended 30<sup>th</sup> June 2006 and a statement of financial position as at that date incorporating the following information:

- a. Stock at 30<sup>th</sup> June 2006 was Sh 61,341
- b. Office expenses and Wages of Sh 2596 and Sh 5717 respectively are for next year.
- c. Depreciation is to be charged at 10% on reducing balance method on fixtures and Sh 750 on buildings.
- d. Provision for bad debts is to be reduced to Sh 4000
- e. Not yet entered in the books is salary of Sh 1,000 to Ochieng
- f. Interest on drawings: Ochieng, Sh 5,180 and Otieno Sh 5,120
- g. Interest on capital account balances is at 10%
- h. Freehold land was purchased during the year at Sh 80,900 vide a cheque. While the entry was passed in the cash at bank account, no other entry was made.

### Solution

### **Workings:**

### Salaries and wages

				Balance			
Balance b/d	7,416	Profit and loss	4,820	b/d	23917	Profit and loss	18200
		Balance c/d	2,596			Balance c/d	5717
	7,416		7,416		23917		23917
				Balance			
Balance b/d	2,596			b/d	5717		

### Provision for bad debts

### Freehold land account

Profit & loss	1,400	Balance b/d	5,400	Bank	80900	Balance c/d	80900
				Balance			
Balance c/d	4,000			b/d	80900		
	5,400		5,400				
		Balance b/d	4,000			ı	

From your previous chapters, prepayments and accruals are treated as balance carry downs

So that they appear in balance sheet. Note that the figure to the statement of comprehensive income is the balancing figure.

Depreciation on fixtures= 10% of NBV

NBV= Cost - Accumulated depreciation

Depreciation on fixtures = 10% (16000 - 8300)

= 770

Interest on capital; Ochieng, 10%X 45,000 = 4,500

Otieno, 10%X 39500 = 3950

Note that the statement of financial performance includes the appropriation account. The title should use the correct wording because we are presenting three accounts in continuation.

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# OCHIENG AND OTIENO PARTNERSHIP STATEMENT OF FINANCIAL PERFORMANCE AND APPROPRIATION ACCOUNT FOR THE YEAR ENDED 30TH JUNE 2006

	Sh		Sh.
Opening stock	46,979	Sales	128,650
add purchases	90,416		
cost of goods available	137,395	]	
less closing stock	61,341		
Cost of goods sold	76,054		
Gross profit c/d	52,596		
	128,650		128,650
Office expenses	4,820	Gross profit b/d	52,596
Wages and salaries	18,200	Provision for bad debts	1,400
Depreciation on fixtures	770		
Depreciation on Buildings	750		
Carriage outwards	6,288		
Discount allowed	5,115		
Loan interest; Oloo	9,000		
Bad debts	5,503		
Net profit c/d	3,550		
	53,996		53,996
interest on Capital		Net profit b/d	3,550
Ochieng	4,500	Interest on Drawings;	^
Otieno	3,950	Ochieng	3 5,180
Salary; Ochieng	1,000	Otieno	5,120
Profit share		28	
Ochieng	2,200		
Otieno	2,200		
	13,850		13,850





Note that in partnership final accounts, even when not asked to draw the capital and respecially the) current account, they are almost being asked indirectly because you will need them to draw your balance sheet.

### **Partnership Current account**

	Ochieng	Otieno		Ochieng	Otieno
Drawings	12,400	8,650	Balance b/d	13,106	9,298
Interest on Drawings	5,180	5,120	Salary	1,000	
			Interest on Capital	4,500	3,950
Balance c/d	3,226	1,678	Profit share	2,200	2,200
	20,806	15,448		20,806	15,448
			Balance b/d	3,226	1,678

### **OCHIENG AND OTIENO PARTNERSHIP** STATEMENT OF FINANCIAL POSITION **AS AT 30TH JUNE 2006**

Non Current assets					
	Cost	Dep.	Net	Capital	Sh
	Sh	Sh	Sh	Ochieng	 45,000
Freehold land	80,900		80,900	Otieno	39,500
Buildings	80,000	25,750	54,250	add current accounts;	
Fixtures	16,000	9,070	6,930	Ochieng	3,226
			142,080	Otieno	1,678
Current Assets				Long term liabilities	
Debtors	21,243			Loan from Oloo	129,100
less provision for BD	(4,000)			Current liabilities	
Net debtors		17,243		Creditors	 16,150
Bank		5,677			
Stock		61,341			2
Prepaid office expense	es	2,596		1	0
Prepaid wages		5,717	_	100	
			92,574	012871	
			234,654		234,654

### 5.4 ACCOUNTING FOR CHANGE IN PARTNERSHIP AGREEMENT

**Fast forward** – Changes in the partnership agreement will affect both the statement ofcomprehensive income/statement of financial performance and the statement of financial position.

Change they say is inescapable. Partners being as they can be may effect changes in their partnership deed. A change may occur in three areas:

- a) Profit and loss sharing ratio
- b) Entry of a new partner
- c) Exit of an existing partner either through death or retirement

In any case a change will affect both the statement of comprehensive income and the statement of financial position.

### ■ Statement of Comprehensive Income

The statement of comprehensive income is separated up to the point of change and after the point of change. Profits are then distributed according to the agreements before the change and after the change.

### ■ The statement of financial position

The capital accounts will have to be adjusted for goodwill and effects of revaluation.

### >>> Example 1

Jane and John are in partnership sharing profits and losses equally. The partnership agreement charges Sh 2000 per month to Jane.

In mid year, they agree to change the partnership deed to charge a higher salary of Sh 6000 to Jane and also change the profit and loss sharing ratio into 3:2.

You are required to show the relevant accounts at the year end if the profit amounted to Sh. 120,000.





The distribution of profits before change was as follows:

# JANE AND JOHN PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE PERIOD SIX MONTHS BEFORE CHANGE

Net Profit	(120,000/2)		60,000
Less salary to Jane	(2,000X6)		(12,000)
Balance to be shared			48,000
Profit Share	Jane	24,000	
	John	24,000	
			(48,000)
			NIL

### Distribution of profits after change

# JANE AND JOHN PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE PERIOD SIX MONTHS AFTER CHANGE

Net Profit			60,000
Less salary to Jane	(6000X6)		(36,000)
Balance to be shared			24000
Profit Share	Jane (3/5X24,000)	14,400	
	John (2/5X24,000)	9,600	
			(24,000)
			NIL

### >>> Example 2

Wanyika and Wathara are in partnership sharing profits and losses equally. Their year ends on 31<sup>st</sup> December. On September 30<sup>th</sup> 2007, Wawinja joined the partnership. Henceforth, the profit and loss sharing ratio became 3:2:1 in Wanyika, Wathara and Wawinja respectively. No salaries were payable to any partner. The profit as at 31<sup>st</sup> December 2007 was \$h 360,000.

Assuming that the profit accrues evenly over the year, show the appropriation account and the partners' current accounts.

### Profit distribution before change will be:

# WANYIKA AND WATHARA PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE NINE MONTHS ENDED SEPTEMBER 30TH 2007

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Net profit ( 360,000x9/12)			270,000
profit share	Wanyika	135,000	
	Wathara	135,000	
	•		(270,000)
			NIL

### Distribution after change will be:

# WANYIKA AND WATHARA PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE THREE MONTHS ENDED DECEMBER 31ST 2007

Net profit ( 360,000x3/12)			90,000
profit share	Wanyika (90,000X3/9)	30,000	
	Wathara (2/9X90,000)	20,000	
	Wawinja (1/9X90,000)	10,000	
			(90,000)
			NIL

Let us now have a typical exam question on what we have already learnt.

### >>> Example 3 (KASNEB Adapted)

Aloo and Bara are partners in the business of selling motor vehicle spare parts and accessories. The trial balance given below was extracted from the books of the partnership on 30<sup>th</sup> June 1996.



	Dr., Sh '000	Cr., Sh 000
Capital – Aloo		1,500
Capital – Bara (admitted as partner on 1.4.1996		200
Sales		6,000
Creditors		800
Drawings – Aloo	600	
Furniture and fittings at cost	800	
Land and buildings at cost	1,500	
Provision for depreciation – furniture and fittings		100
Provision for depreciation – land and buildings		200
Debtors	480	
Provision for bad and doubtful debts(1.7.1995)		35
Purchases	3,390	
Returns inwards	120	
Returns outwards		90
Stock as at 1.7.1995	450	
Salaries and wages – selling	640	
Salaries and wages – administrative	650	
Salesmen commission	50	
Cash at bank	100	
Insurance	45	
Rent and rates	20	
General administrative expenses	80	
TOTALS	8,925	8,925

Prior to his admission as a partner on 1<sup>st</sup> April 1996, Bara was the general manager of the firm and was earning a salary of Sh 31250 per month. This salary has not been included in the accounts. He brought in capital of Sh 200000 in cash and was thereafter entitled to one-fifth of the firm's profits. The partnership agreement provides for interest to be charged on drawings made after the commencing of partnership at the rate of 10% per annum.

### The following additional information is provided:

1. The sales for the 9 months to 31stmarch 1996, including returns of Sh 96000 were Sh 4,800,000 whereas the purchases over the same period amounted to Sh 2,690,000. there were no purchase returns the last three months of the period

- asomon sindi.com Depreciation is to be provided on written down value of the building at 5% perannum 2. and on furniture at 20% per annum. Although the cost of the land on 30<sup>th</sup> June 1996 was Sh 700,000 no depreciation is to be provided.
- A debt of Sh 20,000 is to be written off, and the provision for bad and doubtful debts is 3. to be maintained at 5% of the remaining debtors.
- The drawings by Aloo after the formation of the partnership are Sh 200,000 made on 1<sup>st</sup> 4. April 1996.
- Expenses are to be apportioned between the two periods as follows; 5.

#### **Base**

Selling expenses net sales value Administrative expenses time basis Depreciation time basis Other expenses time basis

- Insurance paid in advance and rates outstanding at 30<sup>th</sup>June 1996 are Sh 5,000 and 6. Sh 10,000 respectively
- Stock in trade was Sh 600,000 at 31<sup>st</sup> March 1996 and Sh 750,000at 30<sup>th</sup> June 1996 7.

### Required:

Prepare the statement of comprehensive income for the 9 months ended 31 st March 1996 and for the 3 months ended 30th June 1996, and a statement of financial position as at that date.

### Solution

Does it look like rocket science, may be yes, but wait till we are through, just follow the steps we have been using.

You should never forget your workings, they always start.

Look at what you are given in the additional information.

- The fact that those differentiations are given makes it easy for us, just post them. 1.
- 2. Depreciation
  - a). Buildings; 5% of written down value Buildings at cost = 1500,000 - 700,000= 800,000Written down value = cost – accumulated dep. = 800,000 - 200,000=600,000Therefore,  $dep = 5\% \times 600,000$ = 30,000





We can do this without drawing the T accounts now, We write off a bad debt by, Dr. Bad debts Sh 20,000 Cr. Trade debtors Sh 20,000 Provision for bad debts; 5 %( 480,000 – 20,000) = 23,000

The difference (this time a decrease) goes to the statement of comprehensive income = 35,000 - 23,000

= 12,000

4. Apportioning of expenses;

Selling expenses are on basis of net sales value Net sales = 5,880,000

For nine months, 4707, 000/5880,000 X 640,000 = 512,000 For 3 months, 1176, 000/5880,000 X 640,000 = 128,000

### **Insurance account**

### Rent and rates account

Balance		Profit and		Balance		Profit a	and
b/d	45,000	loss	40,000	b/d	20,000	loss	30,000
				Balance			
		balance c/d	5,000	c/d	10,000		
					-		
	45,000		45,000		30,000		30,000
Balance							
b/d	5,000					Balance b/	′d 10,000

TUDY TEXT

### **ALOO AND BARA PARTNERSHIP** STATEMENT OF COMPREHENSIVE INCOME FOR

FINANCIALACCOUNT	'ING			u.masomonsinoj.com							
		PARTNERSHII		2850mon							
<u>STATEMENT (</u>	9 Months to 01.04.2006 3 Months to 30.06.2006										
-	Sh.	Sh.	Sh.	Sh.							
Sales		4,800,000		1,200,000							
less returns inwards	_	96,000	-	24,000							
Net sales		4,704,000		1,176,000							
less cost of sales		•									
Opening stock	450,000		600,000								
add purchases	2,690,000		700,000								
less returns outwards	(90,000)										
cost of goods available	3,050,000		1,300,000								
less closing stock	(600,000)		(750,000)								
cost of sales		(2,450,000)		(550,000)							
Gross profit		2,254,000		626,000							
add Decrease in provision for BD less expenses		9,000		3,000							
Depreciation on furniture	105,000		35,000								
Depreciation on buildings	22,500		7,500								
Bad debts	15,000		5,000								
Salaries – Selling	512,000		128,000								
Salaries- Administrative expenses	487,500		162,500								
Salesmen commission	40,000		10,000								
Insurance	30,000		10,000								
Rates	22,500		7,500								
General administrative expenses	60,000		20,000								
Salary to Bara	281,250										
Total expenses		1,575,750		385,500							
Net Profit		687,250	<del>-</del>	243,500							
add interest on drawings; Aloo Profit to be shared Profit share Aloo Bara	_	001,200	198,800 49,700	5,000 248,500 (248,500) NIL							

2,030,750





### Notes:

- Bara will not get salary in the last three months because he is now a partner. If he was still a. entitled to the same amount of salary even after becoming a partner, the amount would appear in his current account but not the statement of comprehensive income
- The appropriation account will only be for the last three months; the effective period of partnership.

### Partners' Current account

	Aloo	Bara		Aloo	Bara
Interest on drawings	5,000		Profit for 9 months	687,250	
Drawings	600,000		Profit for 3 months	198,800	49,700
Balance c/d	281,050	49,700			
	886,050	49,700		886,050	49,700

### **ALOO AND BARA PARTNERSHIP** STATEMENT OF FINANCIAL POSITION **AS AT 30TH JUNE 1996**

AS	AT SUIT SUNE I	<del>330</del>	
Non-Current Assets	Cost	Dep.	Net
<del>-</del>	Sh.	Sh.	Sh.
Furniture	800,000	240,000	560,000
Land and Buildings	1,500,000	230,000	1,270,000
	, ,		1,830,000
Add working Capital			
Current Assets			
Debtors	460,000		
Less provision for bad debts	(23,000)		
Net debtors		437,000	
Bank		100,000	
Stock		750,000	
Prepaid insurance		5,000	
		1,292,000	
less current liabilities			
Creditors	800,000		
Accrued rates	10,000		
Accrued salary to Bara	281,250		
		(1,091,250)	
Working capital			200,750
			2,030,750
Financed by;			<u> </u>
Capital Aloo		1,500,000	
Bara		200,000	4 700
Current Accounts Alex		204.050	1,700,000
Current Accounts Aloo		281,050	
Bara		49,700	220.750
			330,750

## 5.5 ADJUSTMENTS FOR GOODWILL, AND REVALUATION PROFIT OR LOSS

Fast forward – Purchased goodwill is the amount paid for a business in excess of its netassets

Goodwill could be defined as any excess of the cost of acquisition over the acquirer's interest in the fair value of the identifiable assets and liabilities acquired as at the date of the exchange transaction.

In layman terms, goodwill can be viewed as that amount over and above the value of assets being purchased.

Goodwill should not be recognized in the books because it has no objective value and it keeps on changing in value constantly.

Goodwill could either be purchased or non-purchased, purchased goodwill is recognized in the books while non-purchased is not.

**Purchased goodwill** is the amount paid for a business in excess of its net assets. It arises whena business is sold as a going concern.

**Non purchased** goodwill could be termed as the goodwill inherent in a business. It may not beobjectively measures. Some of its measures include:

ш	Good reputation
	Hospitable reception and staff attitude
	High profitability
	Good management
_	0

Strategic location

Good reputation

Promptness in response

It therefore becomes difficult to value.

In accounting for goodwill, we deal more with the purchased goodwill because of its ease to value numerically (remember accounting is the science of numbers).

If a business K has net assets worth Sh 900, 000 and it is purchased at one million shillings, then goodwill could be calculated as:

Goodwill = Sh 1,000,000 - 900,000=Sh 100,000. This captures our definition of goodwill given above.



### **METHODS OF CALCULATING GOODWILL**

In calculating goodwill, the method varies according to the type of business whose goodwill is being measured.

For retail businesses for instance, goodwill is customarily calculated at average weekly sales for the previous year multiplied by a given figure.

For professional firms, the custom is to value goodwill at the gross annual fees multiplied by a given figure.

It can also be valued by getting the average net annual profit for a specified past number of years multiplied by a given number.

In case of sole traders, goodwill is valued based on the super profits method. The net profit figure is adjusted for a normal salary figure given to the proprietor and notional interest for capital.

### CHARACTERISTICS OF GOODWILL

- i. It is incapable of realization separately from the business as a whole
- ii. Its value has no reliable or predictable relationship to any costs which may have been incurred
- iii. Its value arises from various intangible factors which cannot be valued
- iv. Its value can fluctuate widely according to internal and external circumstances over relatively short periods of time.
- v. The assessment of the value of goodwill is highly subjective.

### Accounting entries

As we have mentioned above, only purchased goodwill is passed into the accounts. Specific to partnerships, adjustments for goodwill in the accounts of the partners whenever a change inthe partnership takes place:-

- a. Change in profit and loss sharing ratios
- b. Admission of a new partner
- c. Retirement or death of a partner

The change may involve cash being paid by one partner to another, or an adjustment in the books is made so that the changes in the partnership does not lead to partner losing his/her ownership share without being compensated adequately.

### While accounting for goodwill,

- a) It could be shown in the books; or
- b) It could be written off i.e. not shown the books

### a) Where goodwill is shown in the books, the double entry is:

Dr. Goodwill

Cr. partners capital account (using the old profit sharing ratio)

### >>> Example 1

Mutie, Mutua and Mutinda have always shared profits in the ratio of 4:2:2 respectively. They now decide to alter that ratio to 5:2:1. Accompanying the change is a Sh 80,000 goodwill. The net assets without the goodwill are Sh 100,000. The capital accounts are as follows:

	Sh
Mutie	50,000
Mutua	30,000
Mutinda	20,000

If the partners decide to show goodwill in the accounts, show the statement of financial position as at 31<sup>st</sup> December 2006.

Old ratio 4:2:2

New Ratio 5:1:1

Share goodwill in the old ratio of Sh 80,000

Dr. Goodwill 80,000

Cr. Capital accounts; Mutie (4/8X80,000) 40,000

Mutua (2/8X80,000) 20,000 Mutinda (2/8X80,000) 20,000

Mutie, Mutua and Mutinda Partnership

Statement of financial position as at 31st December 2006

Assets	100,000	Capital;	Mutie	90,000
Goodwill	80,000		Mutua	50,000
			Mutinda	40,000
	180,000	]	•	180,000

### >>> Example 1b

Suppose that after some days they decide to sell the business and receive Sh 180,000 in cash show how the cash would be shared.





### **Solution**

Each partner will receive an amount equal to their statement of financial position balances above:

Dr. Capital Accounts; Mutie 90,000

> Mutua 50,000

Mutinda 40,000

180,000 Cr. Cash

- b) If goodwill is to be written off or is not to be shown in the accounts, the entries are made in two steps:
- b1) Dr. goodwill

Cr. partners' Capital accounts

Using the old profit sharing ratio

b2) Dr. Partners' capital accounts using the new ratio

Cr. goodwill

To write off goodwill from the books, you will note that goodwill will appear nowhere in the books of account.

### >>> Example 2

Using the example 1 above, show the partners' capital accounts and the statement of financial position if they decide to write off the goodwill account.

### **Solution**

Step 1; use the old sharing ratio

Dr. Goodwill 80000

Cr. Capital accounts; Mutie(4/8X80,000) 40,000

> Mutua(2/8X80,000) 20.000

Mutinda(2/8X80,000) 20,000

Step 2; write off goodwill using the new sharing ratio

Dr. Capital accounts: Mutie (5/8) 50,000

> Mutua (2/8) 20,000

> > Mutinda (1/8) 10,000

Cr. Goodwill 80,000

### **Goodwill account**

FINANCIA	LACCOUI	NTING			ansingl.com
		Goodw	rill account		I masomo.
Capital accounts( in	Mutie	40,000	Capital accounts(in new sharing	Mutie	50,000
old sharing ratio)	Mutua Mutinda	20,000 20,000 80,000	ratio)	Mutua Mutinda	20,000 10,000 80,000

### **Capital accounts**

	Mutie	Mutua	Mutinda		Mutie	Mutua	Mutinda
Goodwill(new <sup>-</sup> ratio)	50,000	20,000	10,000	Balance b/d	50,000	30,000	20,000
Balance c/d	40,000	30,000	30,000	Goodwill(old ratio)	40,000	20,000	20,000
	90,000	50,000	40,000		90,000	50,000	40,000
_				Balance b/d	40,000	30,000	30,000

### **MUTIE, MUTUA AND MUTINDA PARTNERSHIP**

### STATEMENT OF FINANCIAL POSITIONAT 31 ST DECDECEMBER 2006

Assets	100,000	Capital		
		Mutie	40,000	
		Mutua	30,000	
		Mutinda	30,000	
	100,000		100,000	

### >>> Example 2b

If the business is sold on  $1^{st}$  January 2007 for Sh 100,000 cash show how the proceedings would be shared among the partners.

### Solution

	Sh.
Mutie	40,000
Mutua	30,000
Mutinda	<u>30,000</u>
	100,000







### 5.6

REVALUATION OF PARTNERSHIP ASSETS WINN, FRASCIFIC Like goodwill, revaluation of partnership assets takes place under the similar conditions of:

- i. A change in the profit and loss sharing ratio
- Admission of a new partner ii.
- iii. Exit of an existing partner

It is necessary to revalue partnership assets to ensure fairness. For instance when a new partner is and the assets are not revalued, he/she may end up gaining unfairly from efforts of the other existing partners. Similarly, when a partner exits the partnership and no revaluation is done, he may forego benefits he helped plough into the partnership which is not fair.

Revaluation therefore becomes necessary in order to compensate the old partners for their efforts.

Adjustments are then made to the old partners' capital accounts in their old profit and loss sharing ratio.

When revalued, asset values may increase or Decrease.

### **Accounting entries**

- a. when asset values increase.
  - dr. Asset account
  - ii. Cr Revaluation account (with the amount of increase)
- when asset value Decreases, b.
  - Dr, Revaluation account
  - ii. Cr. Asset account (with the amount of Decrease)
- After all the entries are made, revaluation account is balanced. The balance could either be a gain or a loss which is then passed o to the partners' capital accounts in the existing/old profit and loss sharing ratio. A profit is credited to the partners' capital account while a loss is debited.

### >>> Example 1

Victor and Mary are in partnership sharing profits and losses in the ratio 2:1. Their statement of financial position as at 31<sup>st</sup> December 2005 was as follows:

Plant at cost	12,000	Capitals;	3
Fixtures	8,460	Victor	19,820
Stock	5,500	Mary	9,920
Debtors	1,530		0,
Bank	2,250		
	29,740		29740

From January 1<sup>st</sup>, they decided to change their profit and loss into the ratio of their capitals. Accompanying the change was a revaluation on the partnership assets as follows: Plant Sh18,000, fixtures Sh. 8,000 and stock Sh. 5,000.

You are required to show the revaluation account and the statement of financial position as at January 1<sup>st</sup> 2006.

### Solution

Plant account				Fixtures account			
Balance b/d	12,000			Balance b/d	8,460	Revaluation	460
Revaluation	6,000	Balance c/d	18,000		-,	Balance c/d	8,000
	18,000		18,000	<u>-</u>	8,640		8,460
	Stock a	ccount					

Stock account					
Balance b/d	5,500	Revaluation	500		
		Balance c/d	5,000		
	5,500		5,500		

Note that the being revalued is taken down as the closing balance. Revaluation gain or loss is the difference between the book value and the revalued amount.

Let us now prepare the Revaluation account. We only take the gains or the losses to this account in order to get the net revaluation gain or loss.

Revaluation account				
Fixtures	460	Plant	6,000	
Stock	500		0,000	
(Rev. Gain = 5040)				
Capital a/c Victor	3,360			
Capital a/c Mary	1,680			
	·		· · · · · · · · · · · · · · · · · · ·	

6,000

The gain (or loss) on revaluation is never shown on the face of the revaluation account. It is shared directly between/among the partners in their OLD profit sharing ratio. In this example, it is shown in parentheses just to emphasize on its calculation.

6,000







	Victor	Mary		Victor	Mary
			Balance b/d	19,820	9,920
Balance b/d	23,180	11,600	Revaluation gain	3,360	1,680
	23,180	11,600		23,180	11,600

### Victor and Mary Partnership

### Statement of financial position as at 1st January 2006

<b>Asset</b> s		Capitals	
Plant	18,000	Victor	23,180
Fixture	8,000	Mary	11,600
Stock	5,000		
Debtors	1,530		
Bank	2,250		
	34,780		34,780
		1	

We now know almost everything we need to know about partnership accounting. Let us work out a typical full examination question covering all we have learnt so far.

### 5.7 REVALUATION OF ASSETS TAKEN OVER BY A RETIRING PARTNER

On retirement of a partner, his/her investment in the partnership is given back to him/her together with balances due to him from his current account and any loan payable to him by the partnership.

The payment is normally effected in cash. Sometimes the retiring partner may have so much to be paid that a full settlement may not be possible or it could plunge the partnership into financial difficulties thereafter. In such a case, the partnership pays part of all the dues and the remainder is held in the partnership as a loan to the partnership.

Some of this part payment may be in the form of the retiring partner taking over an asset or assets from the partnership. Any such assets are deducted from the retiring partner's amount payable to him.

### **Accounting entries**

www.masomonsindi.com The asset being taken over is first revalued and any revaluation gain or loss accounted for. Then:

Dr. Capital account of the retiring partner (with the revalued amount) Cr. Asset account

### **EXAMPLE 1 (KASNEB ADAPTED)**

Kyamba, Onyango and Wakil were partners in a manufacturing and retail business sharing profits and losses in the ratio of 2:2:1 respectively

Given below is the statement of financial position of the partnership as at 31 st March 2001.

Statement of financial position as at 31st March 2001				
Assets				
Non-current assets				
Fixed assets		465,000		
Current assets				
Stocks	294,000			
Debtors	209,000			
		503,000		
	_	968,000		
Capital and liabilities	_			
Capital accounts				
Kyamba	160,000			
Onyango	140,000			
Wakil	200,000			
		500,000		
Current accounts				
Kyamba	65,300			
Onyango	49,000			
Wakil	53,000			
		167,300		
	_	667,300		
Current liabilities				
Bank overdraft	48,700			
Trade creditors	252,000			
		300,700		
	_	968,000		
	_			





### Additional information:

- On April 1<sup>st</sup>, Wakil retired from the partnership and was to start a business as a sole trader while Kyamba and Onyango continued with the partnership.

  On retirement of Wakil, the manufacturing business was transferred to Kyamba and Otieno continued with the retail hours.
- 2. The assets and liabilities transferred to Wakil were as follows:

	Net book value	Transfer Value		
	Sh	Sh		
Fixed Assets	260,000	306,000		
Stocks	166,000	157,000		
Debtors	172,000	165,000		
Creditors	156,000	156,000		

Wakil obtained a loan from a commercial bank and paid into the partnership the net due to him.

Fixed assets ac					
Balance b/d	465,000	Wakil	306,000		
Revaluation acc.	46,000	Balance c/d	205,000		
	511,000		511,000		
	Stock	account			
Balance b/d	294,000	Revaluation	9,000		
		Wakil	157,000		
		Balance c/d	128,000		
	294,000		294,000		
	Debtors	account			
Balance b/d	209,000	Revaluation	7,000		
		Wakil	165,000		
		Balance c/d	37,000		
	209,000		209,000		
		ditors			
Wakil	156,000		252,000		
Balance c/d	96,000				
	252,000		252,000		
	Revaluat	ion account			
Stock	9,000	Fixed assets	46,000		
Debtors	7,000				
Capital,			40.5		
Kyamba	12,000		1/0		
Onyango	12,000		0128176371		
Wakil	6,000		6/1		
_	46,000		46,000		

- 3. O3. On retirement of Wakil from the partnership, goodwill was valued at Sh. 200,000 but was not to be maintained in the books of partnership of Kyamba and Chyango
- **4.** After retirement of Wakil on 1<sup>st</sup>April 2001, Kyamba and Onyango agreed on the following terms and details of the new partnership:
  - □ Kyamba and Onyango to introduce additional capital of Sh 48,000 and Sh 68,000 respectively
  - □ Each partner was entitled to interest on capital at10% per annum w.e.f 1<sup>st</sup> April 2001 and the balance of the profits was to be shared equally after allowing for annual salaries of Sh 72,000 to Kyamba and Sh 60,000 to Onyango.
- **5.** The profit of the new partnership before interest on capitals and partners' salaries was Sh 240,000 at the year ended 31<sup>st</sup> March 2002.
- **6.** The profits made by the new partnership increased stocks by Sh 100,000. Debtors by Sh 90,000 and bank balance by Sh 50,000.
- **7.** Drawings by the partners in the year were Kyamba Sh 85,000 and Onyango Sh 70,000.

### Required:

- a. Profit and loss appropriation account for the year ended 31<sup>st</sup> March 2002
- b. Capital accounts for the year ended 31<sup>st</sup> March 2002
- c. Current accounts for the year ended 31<sup>st</sup> March 2002
- d. Statement of financial position of the new partnership as at 31 st March 2002

### Solution

Never forget your workings, however complicated the question might seem.

Before we prepare the current final accounts, we need to close the books unto the point of Wakil's retirement. So, we close the current account of Wakil into his capital account

### Wakil, Current account

	•			
Capital account	53,000	Balance b/d	53,000	

Capital accounts

	Kyamba	Onyango	Wakil		Kyamba	Onyango	Wakil
Goodwill	100,000	100,000		Balance b/d	160,000	140,000	200,000
Fixed assets			306,000	Revaluation	12,000	12,000	6,000
Stock Debtors			•	Goodwill Wakil's Current acc.	80,000	80,000	40,000 53,000
Balance c/d	152,000	132,000		Liabilities	120		156,000
6/ G				Bank (balancing figu	ıre)		173,000
	252,000	232,000	628,000	_	252,000	232,000	628,000



The balancing figure of represents the amount Wakil will have to pay the partnership because he's got more than he should have gotten. It could be looked at this way:

Capital acc

402,000

Current acc

455,000

Wakil should have got Sh 455,000, but from his capital account, he is to get Sh 628,000. The balance therefore represents the amount he will have to pay the partnership of Sh 173,000.

We can now prepare the statement of financial position immediately after the retirement of Wakil using the capital accounts above.

### KYAMBA AND ONYANGO PARTNERSHIP STATEMENT OF FINANCIAL POSITION AS AT 1ST APRIL 2001

Fixed assets		205,000
Current assets		200,000
Stock	128,000	
Debtors	37,000	
Bank(173000 - 48700)	124,300	_
	289,300	
Less current liabilities		
Creditors	96,000	<u>-</u>
		193,300
		393,300
Capital accounts(from Capital acc. Above)		
Kyamba	152,000	
Onyango	132,000	_
Current accounts		284,000
Kyamba	65,300	
Onyango	49,000	^
		114,300 393,300 on account.
We could now go ahead with the profit and los	s appropriati	on account.

# KYAMBA AND ONYANGO PARTNERSHIP PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31ST MARCH 2002.

Net profit 240,000 less salaries Kyamba 72,000 Onyango 60,000 (132,000)108,000 less interest on capital Kyamba 20,000 Onyango 20,000 (40,000)Balance to be shared 68,000 Kyamba 34,000 Onyango 34,000 (68,000)

At the end of the year, the capital accounts will be similar to those drawn above but with the exclusion of Wakil's column because he has since left and then the additional contributions of capital by the remaining partners.

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### **Capital accounts**

NIL

	Kyamba	Onyango		Kyamba	Onyango
Goodwill	100,000	100,000	Balance b/d	160,000	140,000
			Revaluation	12,000	12,000
			Goodwill	80,000	80,000
Balance c/d	200,000	200,000	Cash(more capital)	48,000	68,000
	300,000	300,000		300,000	300,000

### **Current accounts**

	Kyamba	Onyango		Kyamba	Onyango
Drawings	85,000	70,000	Balance b/d	65,300	49,000
			Salary	72,000	60,000
			Interest on capital	20,000	20,000
Balance c/d	106,300	93,000	Profit share	34,000	34,000
	191,300	163,000	]	191,300	163,000





# KYAMBA AND ONYANGO PARTNERSHIP STATEMENT OF FINANCIAL POSITION AS AT 31ST MARCH 2002

STATEMENT	OF FINANCIAL F	USITION AS AT 313	I WARCH 2002
Fixed assets			205,000
<b>Current assets</b>			
Stock		228,000	
Debtors		127,000	
Bank		135,300	
		490,300	
Less current lia	bilities		
Creditors		96,000	
			393,300
		·	599,300
Capital accounts	<b>;</b>	- -	
	Kyamba	200,000	
	Onyango	200,000	
			400,000
Current accounts	5		
	Kyamba	106,300	
	Onyango	93,000	
			199,300
		-	599,300

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### **Chapter summary**

A partnership is usually established through a partnership agreement in which the terms of the partnership are set out. The agreement covers the following items:

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	Amount of capital invested by each partner in the business
П	The profit sharing ratio

- The interest on capital
- Salaries to partners
- Limits to drawings

Interest on drawings

### In the absence of the partners' agreement, it is presumed that,

- Profits will be shared equally
- There are no partners' salaries
- No interest on capital is paid
- Partners are entitled to interest of 4% per annum on any loans advanced to the firm

### **CASE STUDY**

The most prominent forms of partnerships in the country are service based. These include audit firms and law firms.

Examples of the big audit firms include Price water house Coopers (PWC), Deloitte, Ernst and Young and KPMG in Kenya.

With the growing partnership between indigenous mid-level firms and leading global networks, a shift in market structure is unfolding as the smaller companies continue to win contracts from the top four. Though the top four multinationals control about 85 per cent of the market in terms of deal value, the mid tier firms that have sought international affiliation have been growing their client base at a faster rate than the multinationals.

Estimates from the Institute of Certified Public Accountants of Kenya (ICPAK) show that the mid-tier firms now control between 60-70 per cent of the industry's client base up from about 40 per cent in 2000. In recent years, seven of the top 15 firms, excluding the big four, have formed partnerships with local accounting firms as they seek to spread their foothold across the globe with the emerging markets like Kenya being their focus. (Source, *The Business Daily, 2008*).





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### **CHAPTER QUIZ**

- 1. What is a partnership?
- 2. What is a partner's salary, an expense or an appropriation of profit?
- 3. How is profit shared between partners?
- 4. How is profit shared in the absence of the partnership agreement?

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### **ANSWER TO CHAPTER QUIZ**

- 1. An agreement between two or more individuals to carry on the risk and rewards of a business together.
- 2. An appropriation of profit.
- 3. According to the terms of the partnership agreement.
- 4. It is presumed that:-

- Profits will be shared equally
- There are no partners' salaries.
- No interest on capital is paid.
- Partners are entitled to interest of 4% per annum on any loans advanced to the firm.

### PAST PAPER ANALYSIS

12/07, 6/07, 12/06, 6/06, 12/05, 6/05, 6/04, 6/03

### exam type questions

### ■ Question 1 (June 2006 Question 4)

- (a) Briefly explain why goodwill should be paid under the following circumstances:
  - i. By a partner on admission to a partnership.
  - ii. To a partner on retirement from a partnership.

(2 marks)

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(2 marks)



(b) Akili, Busara and Chema are in partnership sharing profits sharing profits and losses equally after allowing for interest on capital at 5% per annum to the partners and a salary to Busara of Sh 20,000 per month.

The trial balance of the partnership as at 30 April 2006 was as follows:

			Sh.'000'	Sh.'000'
Capital accounts:		Akili		2,500
		Busara		2,000
		Chema		1,000
Current acco	unts:	Akili		200
		Busara		300
		Chema		200
Drawings:	Akili		300	
	Busar	a	400	
	Chem	a	200	
Sales				20,000
Inventory as	at 1 Ma	y 2005	3,000	
Purchases		10,300		
Operating expenses		6,400		
Loan: Busar	a (Inter	est at 10% per annum	)	1,000
Cher	na (Inte	rest at 10% per annun	n)	2,000
Land			1,000	
Buildings			5,000	
Plant and ma	achinery	r: Cost	7,000	
		Accumulated deprecia	ation	4,000
		(30 April 2006)		
Accounts rec	eivable	/accounts payable	4,000	3,300
Cash at Banl	<			1,100
			37,600	<u>37,600</u>

### **Additional Information**

- 1. Closing inventory as at 30 April was valued at Sh 2,400,000.
- 2. Interest on loans had not been paid.
- 3. Sales include credit sales of Sh 600,000 in respect of two items sold on the basis of confirmation by the customers. The items had cost Sh 100,000 each. As at 30 April 2006, the customers had not confirmed whether they would buy the goods.

- On 1 November 2005, the terms of the partnership agreement were changed. The 4. Profit sharing ratio of 5:3:2 for Akili, Busara and Chema respectively. new terms provided for:

  - Interest on capital at 5% per annum.
  - Salaries of Sh 10,000 per month to Busara and Chema.

For the purpose of the change, goodwill was valued at Sh 1,200,000 and was to be written off immediately while the land buildings were valued at Sh 2,000,000 and Sh 6,400,000 respectively.

### Required:

Trading, Profit and loss and appropriation accounts for the year ended 30 April 2006

(6 marks)

b) Partners' capital and current accounts (6 marks)

c) Statement of financial position as at 30 April 2006 (4 marks)

(Total: 20 marks)

### Question 2 (December 2006 Question 3)

Grace and Beatrice were operating a retail business sharing profits and losses in the ratio of 2:1 respectively up to 31 March 2006 when they admitted Catherine to the partnership. The partners allowed payment of interest on partners' fixed capital accounts but did not allow for interest on partners' current accounts.

The following balances on the opposite page were extracted from the partnership's book of account as at 30 September 2006:





		Sh.'000'	Sh.'000'
Leasehold premises	(purchased 1 October 2005)		6,000
Purchases		16,400	
Sales (Sh 14,000,00	0 to 31 March 2006)"		35,000
Motor vehicles at cos	st		3,400
Salaries		5,200	
Provision for deprec	iation as at 1 October 2005:		
Motor vehicles		1,200	
Shop fittings		400	1,600
Stocks (1 October 20	005)		4,800
Shop fitting at cost a	t cost		1,200
Accounts receivable			900
Balance at bank			9,280
Fixed capital accoun	ts: Grace		3,000
	Beatrice		2,000
	Catherine	1,500	6,500
Current accounts:	Grace	1,600	
	Beatrice		1,200
	Catherine	3,500	6,300
Professional charges	S		420
Rent, rates and elec	1,240		
General expenses (S	31 March 2006)"	2,640	
Accounts payable			4,280
Shop wages	2,200		

### Additional information:

- On 31 March 2006 when Catherine was admitted as a partner, the profit sharing ratio changed to Grace 2/5, Beatrice 2/5 and Catherine 1/5. For the purpose of admission, goodwill was valued at Sh 12,000,000 and was written off the books immediately. On 1 April 2006, Catherine paid Sh 5,000,000 which comprised her fixed capital of Sh 1,500,000 and her current account contribution of Sh 3,500,000."
- The partners also agreed that any apportionment of gross profit was to be made on the basis of sales. The apportionment of expenses, unless otherwise indicated, was to be on time basis.

- 3 On 30September 2006, stock was valued at Sh 5,100,000.
- www.masomornsindi.com Provision was to be made for depreciation on motor vehicles and shop fittings at the 4 rate of 20% and 5% per annum respectively, based on cost.
- 5 Salaries included the following partner's drawings during the year:

Grace Sh 600,000 Beatrice Sh 480,000 Catherine Sh 250,000"

- At 30 September 2006, rates paid in advance amounted to Sh 260,000 while electricity accrued amounted to Sh 60,000.
- 7 A difference in the books of Sh 120,000 that had been written off to general expenses as at 30 September 2006 was later found to have been due to the following errors:
  - □ Sales returns of Sh 180.000 had been debited to sales but were omitted from the customers account.
  - ☐ The purchase journal had been under cast by Sh 200,000.
- Doubtful debts (for which full provision was required) as at 31 March 2006 amounted to Sh120,000 and Sh 160,000 as at 30 September 2006.
- Professional charges included Sh 200,000 paid in respect to the acquisition of leasehold premises. These fees are to be capitalized as part of the lease, the total cost of which was to be depreciated in 25 equal annual installments. Other premises owned by Beatrice were leased to the partnership at Sh 600,000 per annum but no rent had been paid or credited to her for the year to 30 September 2006.

### Required:

(a) Statement of comprehensive income for the year ended 30 September 2006.

(10 Marks)

(b) Statement of financial position as at 30 September 2006.

(6 Marks)

(c) Partners' current accounts.

(4 Marks)

(Total: 20 marks)

### Question 3 (June 2007 Question 2)

Ali and Bakari were in partnership sharing profits and losses in the ratio of 3:2 respectively. The terms of the partnership entitled to the partners to interest on their capital balances at 5% per annum. Bakari was also entitle to an annual salary of Sh,4 million.

The statement of financial position extracted from the books of account of the partnership as at 1 January 2006 was as follows.



		Sh. '000'	Sh. '000'
Non-current assets	:		n
Business premises			20.800
Equipment at cost		8.000	
Provision for depreci	ation-equipment	4.800	3.200
			24.000
Current assets:			
Inventory		5.600	
Accounts receivable		2.200	
Cash at bank		400	<u>8.200</u>
Total assets			32.200
Capital and liabilitie	es:		
Capital accounts:	Ali	16.000	
	Bakari	<u>10.000</u>	26.000
Current accounts:	Ali	3.200	
	Bakari	(300)	2.900
Current liabilities:			
Accounts payable		3.000	
Accounts payable Accruals		3.000	
Acciuais		3.300	
Total capital and liab	ilities		32.200

On 1 April 2006 Chando was admitted as a partner. He has been a salaried employee of the partnership and earned Sh 8 million per year. The terms of Chando's admission were as follows:

□ Chando was to pay Sh 12 million to the partnership as his capital contribution. Goodwill was valued at Sh 14 million and was to be written off the partners capital accounts immediately.
 □ The profit sharing ratio was to be 4/7 to Ali, 2/7 to Bakari and 1\7 to Chando. The partners' interest on capital was to be raised from 5% per annum.
 □ Bakari's salary per annum was to be raised to Sh 6 million and Chando was to receive a salary of Sh 6 million per annum.
 □ The necessary transactions to effect the admission are to be made in the capital accounts.

### Additional information:

W.Masomomsindi.com The following balances were extracted from the partnership's draft financial statements for the year ended 31 December 2006:

	Sh. '000'	Sh. '000'
Net profit for the year		55.155
Inventory		12.555
Accounts receivable		3.500
Cash at bank		8.800
Accounts payable		3.080
Accruals		400
Drawings by partners		
Ali	23.705	
Bakari	19.525	
Chando	<u>8.250</u>	15.480

- 2. The closing inventory (Sh 12,555,000) included some stock items which had cost Sh 750,000 but could only realize Sh 280.000.
- 3. A provision for doubtful debts is to be made at 3% of the accounts receivable
- 4. During the year depreciation on equipment was wrongly computed at the rate of 10% based on cost instead of correct rate of 15% using the reducing balance method. I addition, depreciation amounting to Sh 200.000 had not been provided on business premises.
- 5. The partners had taken goods for personal use as follows:

	Sh. '000'
Ali	1.000
Bakari	900
Chando	600

Accrued electricity as at 31 December 2006 amounted to Sh 120.000. This amount 6. had not been provided in the accounts.

### Required:

A schedule showing the corrected net profit and appropriation account for the year ended 31 December 2006.

Hint: Start with the net profit of Sh 55,155,000 as per draft accounts to compute the corrected net profit) (8 marks)

- Partners' current accounts. (4 marks) b)
- Partners capital accounts (2 marks) c)
- Statement of financial position as at 31 December 2006 d) (6 marks)

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**5** 

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# **CHAPTER SIX**

### NON PROFIT MAKING ORGANIZATIONS

### **▶** OBJECTIVES

After studying this chapter, you should be able to:

Prepare financial statements for nonprofit making organizations
Understand and explain the terminologies used in the financial statements of nonprofit making organizations different from sole proprietorship
Understand the format of the financial statement for a nonprofit making organization
Understand the operation of nonprofit making organizations such as clubs and explain the sources of revenue to these form of business organizations

### **▶** INTRODUCTION

**Fast forward** - Since the non profit making organizations are not owned by a group of people, they do not maintain a capital account.

These are some form of business organization that is set up to promote or to cater for the welfare of the members involved and not to make profit. They include clubs, e.g. sports clubs, welfare associations and charitable institutions e.t.c.

Since these organizations are not formed for purposes of trade they maintain different types of accounts from the trading organizations.

Instead of preparing cash book the non profit making organizations prepare a receipts and payments account whose entries however are similar to those made in the cash book.

The excess of income over expenditure is referred to as a surplus; the equivalent of a profit in the P & L account. If expenditure exceeds income then a deficit results; the equivalent of a loss in the P & L account.

Since the non profit making organizations are not owned by a group of people, they do not maintain a capital account. Instead the member's contributions, donations, investments e.t.c are maintained as accumulated fund instead of capital.

Jasomon Sindi.com The non profit making activities may however carry some trading activities in small scale to finance some of the clubs activities e.g. a golf club may also be operating a bar. In such cases then, in addition to the statement of comprehensive income the organization may also maintain a trading account for such trading activities e.g. a bar's trading account which will be similar to the trading account of profit-making organizations.

### **▶** DEFINITION OF KEY TERMS

Non profit making organizations are some form of business organization that is set up topromote or to cater for the welfare of the members involved and not to make profit.

### **► EXAM CONTEXT**

As you can see in the past paper analysis at the end of this chapter, this is a frequently examined chapter. Clear understanding of its content will be an obvious edge.

### **► INDUSTRY CONTEXT**

Examples of non-profit making organizations are the Kenya Red Cross, Strathmore University, Muthaiga Country Club and many other entities that do not exists to make a profit and distribute to share holders. Nonprofit corporations exist solely to provide programs and services that are of public benefit. While they are able to earn a profit, more accurately called a surplus; such earnings must be retained by the organization for its future provision of programs and services. Earnings may not benefit individuals or stake-holders.



# asomon singly com THE FORMAT OF THE STATEMENT OF COMPREHENSIVE INCOME

### <NAME OF ORGANISATION> STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED <DATE>

Incomes	Sh	Sh
Profit from trading activities		Xx
Subscriptions		Xx
Income from investments		Xx
Donations Income from other activities(e.g. dinner dance, raffles e.t.c)		Xx <u>Xx</u> xxx
Expenditure		
Depreciation	Xx	
Salaries and wages	Xx	
Expenses on other activities e.g. prizes	Xx	
Loss from trading activities	Xx	
All other expenses	<u>xx</u>	
		(xxx)
SURPLUS/ (DEFICIT)		XXXX

### FORMAT OF THE STATEMENT OF FINANCIAL POSITION

# XYZ COMPANY LTD STATEMENT OF FINANCIAL POSITION AS AT XXXXX

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	Sh	<b>Sh</b> Accumulated	Sh
Non-current assets land and buildings	Cost	Depreciation	NBV xxx
plant and equipment	XX	(xx)	XX
fixtures, furniture and fittings	xx	(xx)	XX
motor vehicles	xx	(xx)	xx
total non-current assets	Xx	Xx	XXX
Current Assets			
stock Debtors	XXX		XX
less provision for doubtful debts	(xxx)	_	
			XXX
Prepayments		Xxx	
short term investments cash in hand(receipts and payments)		Xxx xxx	
total current assets			•
total current assets		XXX	
less Current Liabilities			
bank overdraft	XXX		
Creditors	XXX		
Accruals	XXX	(xxx)	
net current assets		(XXX)	XXX
total assets			ууууу
Accumulated fund b/f			
Add/(less):surplus(deficit)			Xx
			Xx
Less: drawings			XX
•			(xx)
Other funds			XXX
Life membership fund		Xx	
Building education fund		Xx	XX
		S	уууу





### NOTES TO THE FORMAT ON THE OPPOSITE PAGE

# ☐ 1 SUBSCRIPTION

**Fast forward** - Any subscriptions prepaid are shown as creditors since the club is the one left witha liability of providing the service already paid for.

These are the amounts received by the club from the members to renew their membership. It is often paid on an annual basis. Usually this is income for the club and is therefore reported in the statement of comprehensive income. Depending on the policy of a club, any subscriptions due but not received are shown as accrued income (debtors for subscriptions) in the balance sheet.

Any subscriptions prepaid are shown as creditors since the club is the one left with a liability of providing the service already paid for. Some clubs however will not report subscriptions as income until it is received in form of cash.

### 2. INCOME FROM INVESTMENT

**Fast forward** – If investment income is for a specific purpose and relates to a specific fund it willnot be reported in the statement of comprehensive income, but credited directly to the fund.

Some clubs invest excess cash in the bank (fixed deposit account), shares of limited companies, treasury bills and any other investment that may be available.

If the club is investing with no specific intention (i.e. a general investment) then the income from this investment should be reported in the statement of comprehensive income. However if the investment is for a specific purposed and relates to a specific fund (e.g. building fund) it will not be reported in the statement of comprehensive income but credited directly to the fund.

### 3. OTHER FUNDS

These are fund set up for a specific purpose. They will be shown together with the accumulated fund. Any incomes relating to these funds will be credited directly to the funds net of any expenses incurred in generating the funds. Such funds include building funds, educational funds e.t.c

### LIFE MEMBERSHIP FUND

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Some members may pay some amount to become full life members of the club and if this happens, there may be a need to spread out these amounts over the expected life of the members in the club. Depending on the policy of the club, the following accounting treatment may be allowed:

- i) The full amount is reported in the statement of comprehensive income in the year it is receive and therefore no balance is retained in the life membership account.
- ii) The amount is shown separately in the life membership fund with no transfer in the statement of comprehensive income and hence no balance in the life membership account.
- iii) Some amount is transferred to the income and expenditure from the life membership fund over the expected life of the members in the club.

### **CHAPTER SUMMARY**

**Non profit making organizations** are organizations which do not exist primarily to make profitbut to fulfil some other purpose such as the general welfare of society, or to promote sports, religion or some other lawful activity.

They may carry out some trading activity, but this would be strictly to assist them in achieving their objectives.

They maintain two main accounts: the receipts and payments account and the income and expenditure account.

### **CASE STUDY**

The K-Rep Company is a holding company, whose primary function is to own the K-Rep NGO and hold majority shares in the K-Rep Bank. It is a non-profit company registered as a company limited by guarantee. Its income mostly constitutes dividends and income on fee notes from the K-Rep Bank. This income is channeled to the NGO for product development and experimentation in keeping with the mission of K-Rep.





### CHAPTER QUIZ

- 1. Why do non- profit making organizations exist?
- 2. Why don't non- profit making organizations maintain a capital account?

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### ANSWERS TO CHAPTER QUIZ

- 1. To promote or to carter for the welfare of the members involved and not to make profit.
- 2. They are not owned by individuals or groups for profit generation. They instead have accumulated funds from members.

### **PAST PAPER ANALYSIS**

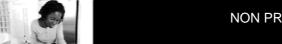
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### **Question 1 (June 2006 Question2)**

Umoja Women's Welfare Society sells water tanks at subsidized prices to its members and the general public. The members' contributions are used to meet the cost of manufacturing the water tanks.

The trial balance extracted from the books of account of the society as at 30 April 2006 was as follows:

	Sh.'000' DR	Sh.'000' CR
Accumulated fund as at 1 may 2005		25,000
Annual subscriptions received		10,000
Stock of raw materials as at 30 April 2006	20,000	
Motor vehicle: Cost	10,000	
Accumulated depreciation		4,000
Machinery: Cost	22,000	
Accumulated depreciation		5,000
Donations from members		2,500
Raw materials used in production of water tanks	35,000	
Sale of water tanks		45,000
Selling expenses	2,000	
Factory wages	600	
Factory overheads	1,000	
Creditors for raw materials		2,800
Cash at bank and in hand	500	
Society's office expenses	4,100	
Membership fees fund		7,500
Sale of Raffle tickets		2,800
Raffle prizes paid	1,200	2,800
Cost of raffle tickets	300	100
Suspense account	7,900	0/1
	104,600	104,600

### Additional information:

F I N A N C I A L A C C O U N T I N G	osinoj. Om
onal information:  An investigation carried out on the suspense accou	www.thasomot.
Subscriptions in arrears as at 30 April 2005 Bonus paid to factory staff during the year Rent for factory building Rent for the society's offices Subscriptions in advance as at 30 April 2005	Sh.'000' 3,500 1,500 1,000 4,000 2,100 7,900

- 2 Annual subscriptions in arrears as at 30 April 2006 amounted to Sh 2,000,000 while subscriptions received in advance as at 30 April 2006 amounted to Sh 1,500,000.
- 3 The membership fee is levied every ten years. The membership fees attributable to the year ended 30 April 2006 amounted to Sh 800,000
- Accrued society's office expenses as at 30 April 2006 amounted to Sh 400,000. 4
- 5 The motor vehicle usage should be apportioned to the factory and society's offices at 80% and 20% respectively. Depreciation should be provided on cost at 5% per annum on machinery and 10% per annum on motor vehicles.

### Required:

- Water tanks trading and statement of comprehensive income for the year ended 30 (a) April 2006 (6 marks)
- (b) Income and expenditure account for the year ended 30 April 2006 (8 marks)
- (c) Statement of financial position as at 30 April 2006. (6 marks)

(Total: 20 marks)

### **Question 2 (June 2007 Question 3)**

Bahari Sailors Club is an association for sailors. It provides the following services to the members and the public:

A club house with a bar for drinks and other social functions	
Yacht racing competitions	40
Hire of boats	
A sailing training school for all age groups.	120





### The following financial information relates to the club as at 1 June 2006:

	Sh '000'
Fixed assets (Net book value):	
Repairs workshop	5000
Freehold premises	40000
Boatyard and launch facilities	8000
Fixtures and fittings	3000
Club-owned boats and yachts	35000
Current assets and liabilities:	
Members' subscriptions:	
Outstanding	400
Prepaid	560
Bank balance	11.070
Bar stocks	3.100
Creditors for bar purchases	500

The club's receipts and payments for the year ended 31 May 2007 were as follows:

	Sh '000'	Payments	Sh '000'
Receipts			
Receipt from training school	2.050	Purchase of two new club yacht	s 5.000
Boat hire charges:		Repairs to yachts and boats	1.920
For members 5.010	900	Purchase of bar stocks	
For non-members	1.960	Prizes paid on yacht racing	
Members' subscriptions	20.090	competitions	1.870
Bar and social functions' takings		Wages to barmen	1.260
(Cash collections)	8.000	salary to training school staff an	d
Fees and charges from yacht racing		bar attendants	1.500
Competitions	3.080	General expenses	2.200
Salvage proceeds from sunk boat	200		

### Additional information:

1) During the year, a club boat whose net book value was Sh 2,000,000 was involved in a collision while sea. The boat sunk and the salvage was disposed of for Sh 200,000.

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<b>.</b>	voina halanaa haaia at i	the fellowing engage and
Depreciation is provided on redu	icino balance basis at i	the following annual rates:
Depreciation is provided on redu	icing balance basis at	the following annual rates:
Depreciation is provided on redundated Asset:	Rate	the following annual rates:
Asset: Freehold premises	Rate 5%	the following annual rates:
Asset:	Rate	the following annual rates:
Asset: Freehold premises	<b>Rate</b> 5%	the following annual rates:
Asset: Freehold premises Boatyard and launch facilities	<b>Rate</b> 5% 5%	the following annual rates:

- 3) Full years' depreciation is provided in the year of acquisition but none in the year of disposal. Bar stocks as at 31 May 2007 were valued at Sh 2850000.
- 4) Outstanding creditors as at 31 May 2007 were as follows:

	Sh. '000'
Bar purchases	610
Bar wages	35
Repairs to boats	320

- 5) Non-members are allowed to hire boats at an extra charge of 20%. During the year, 25% of the 20% extra charge received from hire of boats to non-members was donated to a local charity. This donation had not yet been paid to the local charity.
- 6) A retired club member died recently and bequeathed (left by his will) two boats to the club. The boats were valued at Sh 3000000 and were formally acquired on 1 May 2007.
- 7) As at 31 May 2007 outstanding and prepaid member's subscripts amounted to Sh 350000 and Sh 790000 respectively.

### Required:

a) Income and expenditure account for the year ended 31 May 2007.

(12 Marks)

b) Statement of financial position as at 31 May 2007.

(8 marks)

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## **CHAPTER SEVEN**

### MANUFACTURING ACCOUNTS

### **▶** OBJECTIVES

### After studying this chapter, you should be able to:

Identify the various types of costs and their classification for purposes of preparing the manufacturing account

Distinguish between production and non production costs, prime cost and overhead costs

Prepare manufacturing, trading and statement of comprehensive income for a manufacturing firm

Understand the concept of unrealized profit and pass journal entries to account for the provision

### **▶** INTRODUCTION

Earlier we dealt with sole proprietors; most sole proprietors are merchandising entities since they buy goods in a form when they are ready for sale. They resale the goods and hence a majority of them are distributive agents. Another form of business enterprise is manufacturing business. These are businesses that manufacture the goods themselves and later distribute them. Such enterprises in Kenya include Unilever (K) Ltd, Bidco Oil Refineries e.t.c. for such business enterprises an account known as a manufacturing account is prepared in addition to the statement of comprehensive income

A manufacturing enterprise will utilize a manufacturing account to determine production cost. In the trading, statement of financial performance will be used instead of a purchases account.

### **▶** DEFINITION OF KEY TERMS

**Prime cost:** These are costs that can be directly related attributed to a unit of product. The sumof direct costs is referred to as prime costs.

### **► EXAM CONTEXT**

This is a very important chapter. Though not tested very frequently, examiners have repeatedly stressed that students must know the whole syllabus. If you miss out a syllabus area, you will severely limit your chances of passing the exam.

### **► INDUSTRY CONTEXT**

www.masomomsindi.com This is a very important chapter bearing in mind the number of manufacturing industries in the country. All the concepts that will be discussed in this chapter are very important.

### **PRODUCTION COSTS** 7.1

In manufacturing enterprises the total costs of production is divided into two:

- Prime cost/ direct cost
- ii) Indirect cost

### I) DIRECT MANUFACTURING COST

Fast forward – Direct costs are costs that are easily traced into a unit of a product.

Direct costs are also known as prime costs. These are costs that can be directly related attributed to a unit of product. The sum of direct costs is referred to as prime costs. The costs are easily traced into a unit of a product.

### They include:

- a) Direct materials
- b) Direct labor
- c) Direct expenses

Other direct costs include: hire purchase of special machinery for production, carriage inwards on raw materials.



### II) INDIRECT MANUFACTURING COSTS.

These are incurred during the production process but cannot be easily traced to unit of a product made. This cost must be incurred for production to be complete. They include:

- a) Factory lighting and heating
- b) Rent of factory
- c) Deprecation on plant and equipment
- d) Factory power
- e) Wages for factory casuals
- f) Maintenance of factory forklifts

### ■ III) OTHER EXPENSES

Other expenses incurred by a manufacturing enterprise include:

### i) Administration Expense

- Salaries and wages for staff (administration staff)
- Legal expenses
- Accountancy expenses
- Depreciation of office equipment

### ■ ii) Selling and Administration Expense

- Salaries and wages for the sales and marketing team
- Depreciation for distribution vehicles
- Advertising expense
- Carriage outwards,
- Commissions paid out on sales

### ■ iii) Finance charges

- Discount allowed
- Bank charges
- Bank interest on loan
- Debenture interest

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# www.masononsindi.com MANUFACTURING STATEMENT 7.2 THE **OF COMPREHENSIVE INCOME**

Fast forward – The statement of comprehensive income will be similar to that of a soleproprietorship except for a few areas that are covered below.

The manufacturing	statement of	comprehensive	income will I	be divided	into three

- Manufacturing section
- Trading account
- Profit and loss account

These sections are clearly shown in the format below:

### Format of a manufacturing account:

### XYZ LTD **MANUFACTURING ACCOUNT** FOR THE PERIOD ENDED XX XX XX

Production cost for the period:	Sh	Sh
Direct material		XXX
Direct labor		XXX
Direct expenses		XXX
Prime costs		XXX
Indirect manufacturing costs		
Indirect labor	xxx	
Indirect materials	XXX	
Factory rent	XXX	
Depreciation for factory machinery and plant	XXX	
Salary for factory manager	XXX	
Heating and lighting expenses	XXX	
		XXX
Total cost of production during the period		XXX

XXX

XXX





Opening stock raw materials

Finished goods at transferred price

Sometimes we may have the balances of raw materials from previous year's production. These could also be Work In Progress (WIP) brought in at the beginning of the period as well as some work in progress at the end of the period. In this case the format would appear as follows:

### **XYZ LTD MANUFUCTURING ACCOUNT** FOR THE PERIOD ENDED XXXXXX

Add: purchased raw materials	XXX	
Carriage inwards (raw materials)	XXX	
Less: return outwards (raw materials)	<u>(xxx)</u>	
Cost of materials available for production		xxx
Less closing stock (R.M)		<u>(xxx)</u>
Cost of raw materials used		xxx
Add direct labor		xxx
Direct expenses		XXX
Prime costs		XXX
Indirect Expenses		
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		<u>(xxx)</u>
Total Cost of production		XXX
Manufacturing gross profit added		XXX

The statement of comprehensive income will be similar to that of a sole proprietorship except for the following:

- i) The purchases will be replaced by finished goods at transfer price. This is because finished from manufacturing are now the ones being put up for sales.
- The opening sock to be used in the statement of comprehensive income is the ii) opening stock of finished goods.

asomon sindicorr After obtaining gross profit we add the element of factory profit if we had marked up the goods before transferring them from the factory. If there was no transfer then this need not be done. This arises because once we marked them up; the costs of goods available for sale as well as cost of sales were increased by the element of profit and consequently reducing our gross profit.

### >>> Illustration I:

Given the following:

Sales = 200000

Cost of production

Opening stock of finished goods = 20000

Closing stock of finished goods = 25000

i) Determine the gross profit, assuming the goods were transferred at cost:

Sales	200000
Cost of sales	
Opening stock	20000
Add cost of production	100000
Goods available for sale	120000
Less closing stock	(25000)
Cost of sales	(95000)
Gross profit	105000

Calculate the gross profit, assuming the cost of production was marked up by 25% ii) before transfer from manufacturing.

Cost of production = 100000 Transfer mark up = 100000x 20/100 = 20000

Transfer price = 100000 + 20000 = 120000

	Sh
Sales	200000
Cost of sales	
Opening stock	20000
Add: transfer price of finished goods	120000
Cost of goods available for sale	140000
Less; closing stock	(25000)
Cost of sales	(115000)
Gross profit	85000
Add: manufacturing gross profit	20000
Total gross profit	<u>115000</u>

You will realize that if we mark up the cost of goods manufactured, we end up understating the gross profit by the amount of mark up and hence the need to mark back the manufacturing gross profit to normal sales gross profit.







**Fast forward** – a high value of closing stock will lead to a lesser value of cost of goods and consequently higher profits (overstated profits).

For firms that take up the policy of marking up goods during manufacturing, there will be an element of unrealized profit in the value of the closing stock for finished goods. This needs to be adjusted for so that we can reflect statements that are reliable and accurate. If the element of unrealized profit is not deducted from closing stock of finished goods we end up overstating closing stock which in effect overstates our gross profit. This is because a high value of closing stock will lead to a lesser value of cost of goods and consequently higher profits (overstated profits)

### The adjustment is done as follows:

Dr. P&L account xxx

Cr. Finished goods account xxx

(With amount of unrealized profit)

### >>> Illustration

ABC Co. LTD manufactures food products for the local market. The factory applies \ mark up of 25% on goods transferred to the selling department. For the year just ended, the closing stock of finished goods was found to be Sh 1000000. Calculate and show the adjustments necessary:

amount of unrealised profit=
$$\frac{25}{125}$$
 =200000

Dr. P&L account (unrealized profit) 200000

Cr. Finished goods account 200000

If during the previous year a provision for unrealized profit had been made at Sh 50000, then this year we would only require making an extra Sh 150000. The account would appear as follows:

### Unrealized profits a/c

	Sh	√ Sh
P&L account	150000	Provision for unrealized profits 150000 a/c

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	Provision for unrealize	ed profits	w.Masomor
	Sh		sh Sh
Balance c/d	200000	Profit for the year	150000
		Balance c/d	50000
	200000		200000

The statement of financial position of manufacturing enterprises is similar to that of other organizations. The only difference is that may arise is that there will be three classes of stock under current assets. These are:

- i) Closing stock of finished goods
- Closing stock of raw materials ii)
- iii) Closing stock of work in progress

### CHAPTER SUMMARY

In manufacturing enterprises the total costs of production is divided into two:

- i) Prime cost/ direct cost
- ii) Indirect cost

If the element of unrealized profit is not deducted from closing stock of finished goods we end up overstating closing stock which in effect overstates our gross profit. This is because a high value of closing stock will lead to a lesser value of cost of goods and consequently higher profits (overstated profits).







research, production, sales and marketing and finance.

The Chandaria Group of Industries is a family-owned manufacturing company (with the three key players being Maganlal and his two sons, Dinesh and Mahesh) that relies on a strong professional team being involved in every sector of specialization. A committed team of senior,

One of the main reasons why Chandaria Group of Industries is successful is its ability to account for all its investments and processes.

middle and junior managers ensure a drive of excellence in all the departments such as global

### **CHAPTER QUIZ**

- 1. How is the total cost of production divided in manufacturing enterprises?
- 2. What are prime/ direct costs?



# **ANSWERS TO CHAPTER QUIZ**

- 1. Prime/ direct costs
  - Indirect costs.
- 2. These are costs that can be directly related to a unit of production.

# **PAST PAPER ANALYSIS**

12/07, 12/06, 6/06, 6/04, 6/03

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# **Question 1 (December 2007 Question2)**

The following balances were extracted from the books of Taba Ltd., a manufacturing and trading company, as at 31 October 2007:

	Sh "000"
Business premises at cost	20.000
Plant and equipment at cost	18.000
Motor vehicles at cost	6.400
Accumulated depreciation as at 1 November 2006:	
Business premises	3.200
Plant and equipment	10.000
Motor vehicles	2.400
Ordinary shares (Sh.10 each)	15.000
Share premium	5.000
Retained earnings (1 November 2006)	28.300
Inventory as at 1 November 2006:	
Direct materials	1.200
Work in progress	800
Finished goods	1.600
Purchases of direct materials sales	16.400
Production overhead	67.100
Administration overhead	10.400
Trade receivables	4.900
Trade payables	4.600
Other payables: PAYE	1.300
VAT	2.800
Cash in hand 300	
Bank balance	32.900
Direct manufacturing wages	18.000
Selling overhead	200

### Additional information:

- On 1 November 2006, the company sold an item of plant for Sh 600.000. The item of plant had cost the company Sh 2.000.000 on 1 November 2003. The proceeds from the sale were recorded as a credit to the sales account and a debit to the bank account.

  Depreciation for the year ended 31 October 2007 is to the annual rates:
- 2.

4% based on cost Business premises Plant and equipment 20% based on cost

Motor vehicles 25% on reducing balance basis

3. Depreciation on motor vehicles is to be apportioned as follows:

Rate 50% Production overhead Selling overhead 25% Administration overhead 25%

Depreciation on other assets is to be allocated to production overhead.

- Inventory of raw materials as at 31 October 2007 was valued at Sh 1400000. This inventory included raw material which cost Sh 300000 and could only realized a scrap value of Sh 100000.
- Closing work-in progress as at 31 October 2007 was valued as follows: 5.

Sh. Direct labour 500000 Direct material 125000 Production overhead 200000 Total 1700000

- 6. The year end stock taking for finished goods was done on 3 November 2007. These goods were valued at Sh 1300000 being the cost production.
- 7. The following transactions took place between 1 November 2007 before the stock taking of the finished goods was carried out.

Sh. ☐ Sales to customers at selling price 500,000 ☐ Returns by customers at selling price 125,000 ☐ Completed work-in progress at total production cost 200,000

The goods sold to customers during the period 1 November 2007 to 3 November 2007 were at a uniform mark-up of 25% on the production cost.

### Required:

- Manufacturing, trading and statement of comprehensive income for the year ended 31 October 2007. (12 marks)
- b) Statement of financial position as at 31 October 2007. (8 marks) (Total 20 marks)





# **Question 1 (June 2003 Question 1)**

The following balances have been extracted from the books of Limuru Manufacturers, a small scale manufacturing enterprise, as at 31 December 2002:

		Sh. '000'
Stocks as at 1 January 2002:	Raw materials	7,000
	Work in progress	5,000
	Finished goods	6,900
Purchases of raw materials		38,000
Direct labour		28,000
Factory overheads:	Variable	16,000
	Fixed	9,000
Administrative expenses:	Rent and rates	19,000
	Lighting	6,000
	Stationery and postage	2,000
	Staff salaries	19,380
Sales		192,000
Plant and machinery:	At cost	30,000
	Provision for depreciation	12,000
Motor vehicles (for sales deliveries):	At cost	16,000
	Provision for depreciation	4,000
Creditors		5,500
Debtors		28,000
Drawings		11,500
Balance at bank		16,600
Capital at 1 January 2002		48,000
Provision for unrealized profit at 1 January 2002		1,380
Motor Vehicle running costs		4,500

### Additional information:

1. Stocks at 31 December 2002 were as follows:

	Sh.
	<b>'000'</b>
Raw materials	9,000
Work in progress	8,000
Finished goods	10,350

2. The factory output is transferred to the trading account at factory cost plus 25% of factory profit.

Depreciation is provided at the rates shown below on the original cost of fixed assets held at the end of each financial year.

Plant and machinery - 10% per annum

Motor vehicles - 25% per annum

Amounts accrued at 31 December 2002 for direction and rent and rates prepaid at 31 December 2002. 3.

4.

### Required:

- (a) Manufacturing, trading and profit and loss account for the year ended 31 December 2002. (12 marks)
- (b) Statement of financial position as at 31 December 2002.

(8 marks)

(Total: 20 marks)



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# **Chapter eight**

# FINANCIAL STATEMENT ANALYSIS

### **▶** OBJECTIVES

After you have studied this chapter, you should be able to:

explain now the use of ratios can help to analyze the profitability, liquidity, efficiency and capital structure of a firm.
Calculate the main accounting ratios.
Interpret the results of calculating accounting ratios
Explain the advantages and disadvantages of the gearing of an organization being high or low.
Explain how the proportion of costs that are fixed and variable impacts profit at different levels of activity.

### **▶ INTRODUCTION RATIO ANALYSIS**

**Fast forward** - A financial ratio is a relationship between financial variables and helps ascertainfinancial condition of the firm.

Ratio analysis is a means of comparing and quantifying relationships between financial variables in the statement of comprehensive income and the Statement of financial position. A financial ratio is a relationship between financial variables and helps ascertain financial condition of the firm. With ratios, financial statements can be interpreted and usefully applied to satisfy the needs of the users of financial statements.

### **► EXAM CONTEXT**

This like all chapters is a very important chapter. It has been examined frequently and can be tested in any sitting.

### **▶ INDUSTRY CONTEXT**

Financial statements analysis reports give a frank financial account into the current state of the business, regarding stock turnover and the ability to meet short and long term debts. Managers, Shareholders, Creditors etc all take an interest in Ratio Analysis. For example, managers can use the information to see if the company's liquidity is struggling and they may have to take out short term finance such as an overdraft to overcome this.

in the state of th However its drawbacks include that it purely only covers the financial aspects of how a business is performing and therefore managers should take into account the current state of the market. Is it in a period of recession? This may reflect depressing ratios - depressing ratios may also mean that the company is growing and investing heavily into marketing or research and development which means it will have very small amounts of working capital. It should also be used as part of a trend of data for example - Gearing over a number of years, is it decreasing or increasing - and why and what is the result of this?

### **CLASSIFICATION OF RATIOS**

### Ratios can be classified into:

Liquidity ratios.

- b) Leverage or gearing ratios.
- Activity ratios. c)
- d) Profitability ratios.

### **USERS OF RATIOS**

There are a vast number of parties interested in analyzing financial statements including shareholders, lenders, customers, employees, government, and competitors. In many occasions, they will be interested in different things therefore there is no any definite, allencompassing list of points for analysis that would be useful to all these stakeholders. However, it is possible to construct a series of ratios that together will provide all of them with something that they find relevant and from which they can investigate further if necessary.

Ratio category	Examples of interested parties
Profitability	Shareholders, management, employees, creditors, potential investors
Liquidity	Shareholders, suppliers, creditors, competitors
Efficiency	Shareholders, potential purchasers, competitors
Shareholder	Shareholders, potential investors
Capital structure	Shareholders, lenders, creditors, potential investors



# 1. Liquidity ratios

These measure firm's ability to meet its short-term maturing obligations as and when they fall due. The lower the ratio, the higher the liquidity risk and vice versa. Failure to meet short term liabilities due to lack of liquidity may lead to poor credit worthiness, litigation by creditors and insolvency.

### 2. Leverage or gearing ratios

These measure extent to which a company uses its assets which have been financed by non owner supplied funds. They measure financial risk of the company. The higher the ratio, the higher the financial risk. Gearing refers to the amount of debt finance a company uses relative to its equity finance.

### 3. Activity ratios

These measure the efficiency with which a firm uses its assets to generate sales. They are also called turnover ratios as they indicate the rate at which assets are converted into sales.

### 4. Profitability ratios

They measure the management's effectiveness as shown by returns generated on sales and investment. They indicate how successful management has been in generating profits of the company.

### 5. Investment or equity ratios

These are used to evaluate the overall performance of a company. E.g. in determining company's dividend policy, determining theoretical value of company's securities and predicting effects of rights issue.

### 1. LIQUIDITY RATIOS

**Fast forward** – These measure firm's ability to meet its short term maturing obligations as andwhen they fall due.

Current ratio. This is computed by dividing total current assets by total currentliabilities:

Current ratio = <u>Current assets</u> Current liabilities

Current ratio of more than one means that a company has more current assets than current liabilities.

 Acid test or quick ratio. This is calculated by dividing total current liabilities excludingstock by current liabilities. A firm with a satisfactory current ratio may actually be in a poor liquidity position when inventories form most of the total current assets.

Acid test ratio = <u>Current assets less stock</u> Current liabilities

### 2. GEARING OR LEVERAGE RATIOS

**Fast forward** - These measure extent to which a company uses its assets which have beenfinanced by non-owner supplied funds.

 Debt ratio or capital gearing ratio. This measure the proportion of debt finance tocapital employed by a company. A company is highly geared if the ratio is greater than 50%.

Debt ratio = <u>Total long term debt</u> x 100% Capital employed

 Debt equity ratio. This measures the proportion of non owner supplied funds toowner's contribution to the company. A company is highly geared if the debt equity ratio is greater than 100%.

Debt equity ratio = Long term debt

Equity or Net worth

 Times interest cover. This shows number of times earnings by a company cover itscurrent payments. The higher the ratio, the lower the gearing position and thus the lower the financial risk.

Times interest cover = <u>Earnings before interest and tax + Depreciation</u>
Interest charged

### 3. PROFITABILITY RATIOS

**Fast forward** - These measure management's effectiveness as shown by returns generated onsales and investment.

• Return on capital employed (ROCE). This measures the efficiency with which a companyuses long term funds or permanent assets to generate returns to shareholders.

ROCE = <u>Profit before interest and tax or operating profit</u>

Total capital employed

Capital employed consists of shareholders funds (ordinary share capital, preference share capital, share premium and retained earnings) and long term debts. Capital employed can also be calculated as fixed assets plus net working capital.



 Gross profit margin. This ratio shows how well cost of production has been controlledin relation to distribution and administration costs.

Gross profit margin = Gross profit X 100% Sales

• **Net profit margin**. This measures firm's ability to control its production, operating andfinancing costs.

Net profit margin = Net profit X 100% Sales

• **Net assets turnover**. This gives a guide to productive efficiency i.e. how well assetshave been used in generating sales.

Net assets turnover = <u>Sales</u> Capital employed

 Operating profit/margin ratio. This indicates efficiency with which costs have beencontrolled in generating profit from sales.

Operating profit ratio = Profit before interest and tax or operating profit X 100% Sales

 Operating expenses ratio. This indicates a firm's ability to control production andoperating costs to generate a given level of sales.

Operating expenses ratio = Operating expenses X 100% Sales

• **Return on investment**. This measures the efficiency with which a company uses itstotal funds in capital employed to generate returns to owner's funds.

Return on investment =  $\underbrace{\text{Net profit after tax}}_{\text{Capital employed}} X 100\%$ 

• **Return on equity. (ROE)** This measures the efficiency with which a company othersupplier's funds to generate returns to shareholders.

Return on equity = <u>Earnings attributable to equity shareholders</u> X 100% Equity

Equity comprises of ordinary share capital, share premium and reserves.

### ■ 4. ACTIVITY RATIOS

Fast forward - These measure the efficiency with which a firm uses its assets to generate sales

• **Debtor's turnover.** This shows the number of times debtors pay within the year. Itindicates how efficient the firm is in management of credit. The higher the ratio, the more efficient management is in managing its credit policy.

Debtor's turnover = <u>Credit sales</u> Average debtors

 Debtor's days or ratio. This is also called the average collection period. It showsthe average period of credit taken by customers who buy on credit. It is compared the company's allowed credit period by suppliers to give an indication of credit administration efficiency.

Debtor's days or ratio = <u>Average debtors</u> X Number of days in a year.

Credit sales

- = Number of days in a year Debtor's turnover
- Creditor's turnover. This indicates the number of times creditors are paid by a companyduring a year.

Creditor's turnover = <u>Credit Purchases</u> Average creditors

• **Creditor's days or ratio**. This is also called the average deferral period. It indicates the average time that suppliers allow a company to settle its dues.

Creditor's days or ratio = Average creditors X Number of days in a year.

Credit purchases

= Number of days in a year Creditor's turnover

• Stock or inventory turnover. This indicates the efficiency of a firm in selling its productsso as to generate sales. It shows the times stock is turned over or converted into sales within a year. It shows how rapidly stock is being turned into cash through sales.

Stock or inventory turnover = Cost of sales

Average stock







Stock days/inventory conversion period. This indicates the number of days it takesto convert inventory into sales. The fewer the number of days, the more efficient a company is in converting stock into sales.

Stock days/inventory conversion period = <u>Average stock X</u> Number of days in a year. Cost of sales

> = Number of days in a year Inventory turnover

Cash working cycle/Working capital cycle/Operating cycle. This is the period forwhich working capital financing is needed. The higher the working capital cycle, the higher the investment in working capital. It is the period of time that elapses between the point at which cash is spent on production or purchase of raw materials/stock to time stock is converted into cash or cash is collected from a customer.

Average collection period XXX Add inventory conversion period XXX Less average deferral period (xxx)Working capital cycle XXX

Cash turnover/Operating turnover. This shows number of times a company needs toreplenish its working capital in a year.

Cash turnover/Operating turnover = Number of days in a year Working capital cycle

Fixed assets turnover. This indicates level of sales generated by fixed asset base ofa company. It shows the efficiency with which a company utilizes its assets to generate sales.

Fixed assets turnover = Sales Total fixed assets



### ■ 5. INVESTMENT OR EQUITY RATIOS

### Fast forward - These are used to evaluate the overall performance of a company

• Earnings Per Share (EPS). This indicates the amount shareholders expect to generate form of earnings for every share invested. It shows profitability of a company on a per share basis.

EPS = <u>Earnings attributable to equity shareholders</u>
Number of ordinary shares

• **Dividend Per Share** (DPS) This represents the amount of cash dividend that shareholders expect to receive for every share invested in the company.

Dividend Per Share = <u>Total ordinary dividends</u> Number of ordinary shares

• **Dividend pay out ratio.** This indicates proportion of earnings attributable to equityshareholders that are paid out to common shareholders as dividends. It is used in analysis of dividend policy of the firm.

Dividend pay out ratio = <u>Total common dividends</u> X 100 Earnings attributable to equity shareholders

Dividend per share X 100
 Earnings per share

Dividend retention ratio.

Dividend retention ratio = Retained earnings X 100

Earnings attributable to equity shareholders

Dividend cover.

Dividend cover = <u>Earnings per share</u> Dividend per share

Earnings yield. This measures the potential return that shareholders expect to earn
forevery share invested in a company. It evaluates the shareholders returns in relation
to the market value of a share.

Earnings yield = Earnings per share X 100

Market price per share







 Dividend yield. This ratio measures how much an investor expects to receive fromcash dividends for every share purchased or invested in a company.

 Price earnings ratio. This indicates how much an investor is prepared to pay for acompany's share given its current earnings per share. The higher the price earnings ratio, the more confident investors are that the company will perform well in future.

### **LIMITATIONS OF RATIOS**

- Subjectivity. Ratios are subjective to accounting information that depends on the accounting policies adopted by a particular organization hence making it impossible for cross sectional analysis if a company uses different accounting policies. It is difficult to categorize firms due to diversifications i.e. some companies have more than one line of business and thus will fall into several industries thus difficult in ratio comparison.
- Irrelevance. Ratios are historical figures which may irrelevant in making future decisions.
- **Qualitative aspects are ignored**. Qualitative aspects such competent management, experience and motivation of employees are not captured in computation of ratios.
- o **Ambiguity.** Different people will use different stances to describe financial informatione.g. including preference share capital in equity or return on capital being referred to as gross capital employed.
- Usefulness. Ratios are computed at a specific point in time. By the time they
  areanalyzed for decision making, circumstances may have changed thus ratios are
  only useful in the short term
- **Monopoly**. For a company without competitor, it may not be .possible to analyze itsperformance with other companies in the same industry.

# **CHAPTER SUMMARY**

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### Ratios can be classified into:

Liquidity ratios.
Leverage or gearing ratios
Activity ratios.
Profitability ratios.

Ratio category	Examples of interested parties
Profitability	Shareholders, management, employees, creditors, potential investors
Liquidity	Shareholders, suppliers, creditors, competitors
Efficiency	Shareholders, potential purchasers, competitors
Shareholder	Shareholders, potential investors
Capital structure	Shareholders, lenders, creditors, potential investors

# CASE STUDY

### Comparative Analysis of Barclays, KCB & Stanchart (2008)

### **Profitability**

Barclays recorded the highest Profit Before Tax (PBT) of Sh7.1 billion followed by Standard chartered with Sh 4.9 billion and KCB with Sh 4.2 billion. KCB and Standard Chartered registered impressive growth levels of 33% and 29% in PBT compared to Barclays 9%.

### Reason for profitability difference

KCB's impressive growth was attributed to a 42% increase in loans and advances to it customers given their wide branch network and aggressive marketing. Its operational expenses rose by 20% as the bank opened 11 branches across Kenya and a new subsidiary in Kampala Uganda.

Standard Chartered Bank's remarkable growth is attributed to a 49% rise in foreign exchange income. However the bank had a rise of 23% in operational expenses as it opened 2 new branches and increased its number of employees.

Barclays' dismal growth in PBT is attributed to a 43% rise in operational expenses. The bank increased its network by 95 new Automatic Teller Machine (ATM), 47 branches and 3,003 employees.





### **Balance sheet reviews**

Standard Chartered has a healthy balance sheet and recorded the lowest cost to income ratio of 46% followed by Barclays at 59% and KCB at 65%. This means that Standard Chartered is able to generate more income at a lower cost.

Lending Capacity

Standard Chartered is able to lend more as its gross loans and advances to deposits ratio stood at 56% compared to Barclays whooping 99% and KCBs 77%. In essence Barclays has lend out most of the customer deposits.

	Barclays	Standard chartered	KCB
	Sh <del>.</del>	Sh	Sh
Earnings Per Share	3.6	12.14	1.49
<b>Dividend Per Share</b>	1.65	10	0.7
Price/Earning Ratio	20.28	17.3	20.13
Yield Curve	2.26	4.76	2.67
Average stock price	73	210	30

(Source, http://markets.nairobist.com/)

### **CHAPTER QUIZ**

- 1. What do the profitability ratios measure?
- 2. What are the limitations of ratios?
- 3. How is dividend cover calculated?

# **ANSWERS TO CHAPTER QUIZ**

- www.masomonsindi.com Profitability ratios measure management's effectiveness as shown by returns generated on sales and investment. They indicate how successful management has been in generating profits of the company.
- 2.
- Irrelevance

- Qualitative aspects are ignored.
- Ambiguity.
- Can't be used by monopolies for comparison.
- Subjectivity.

3.

Dividend cover = <u>Earnings per share</u> Dividend per share

# **PAST PAPER ANALYSIS**

12/06, 6/05, 6/05, 12/04, 12/03

### **EXAM TYPE QUESTIONS**

# **Question 1 (June 2005 Question 5)**

- Explain the importance of ratio analysis to a business enterprise. (2 marks)
- Identify with reasons, one party who may be interested in each of the following ratios: b)
  - (i) Current ratio
  - (ii) Net profit margin
  - (iii) Stock turnover

(2 marks)

(2 marks)

(2 marks)



c) Citing suitable examples, briefly explain of the following terms:

(i) Accounting concepts (2 marks

(ii) Accounting policies (2 marks)
(iii) Accounting standards (2 marks)

- d) Explain the accounting treatment that would be applicable in dealing with the following transactions relating to the accounts of Mlachake Ltd. for the year ended 31 December 2004:
  - (i) A debtor who owed the company Sh 200,000 was declared bankrupt on 1 February 2005. 25% of the debt had been recovered when the accounts were approved by the directors on 15 March 2005. (2 marks)
  - (ii) Some items of inventory purchased for Sh 300,000 were damaged in the warehouse during the year. These items were repaired at Sh 50,000 and sold to a customer on 2 February 2005 at 75% of the normal selling price of Sh.400,000 (2 marks)
  - (iii) On 10 December 2004, the company secured an order worth Sh 1.2 million from a foreign based company. The goods were shipped on 10 January 2005 and included in sales for December 2004. (2 marks)

(Total: 20 marks)

### **Question 2 (December 2005 Question 3)**

- (a) State four purposes of ratio analysis
- (b) The following information was extracted from the financial statements of Sunrise Ltd. and Sunset Ltd. in respect of the year ended 30 September 2005:

# Statement of comprehensive income extracts for the year ended 30 September 2005:

	Sunrise Ltd.	Sunset Ltd.
	Sh <del>.</del> '000'	Sh. '000'
Sales	497,000	371,000
Cost of sales	258,000	153,000
Operating profit	138,000	79,000
Interest expense	19,000	-



# Statement of financial position extracts as at 30 September 2005:

Non-current assets	<b>Sunrise Ltd. Sh. '000'</b> 142,000	Sunset Ltd. Sh. '000' 92,000
Current assets: Inventory Debtors Cash at bank	100,000 46,000 40,000	87,000 42,000 44,000
Current liabilities	98,000	108,000
Long-term loan Shareholders funds	33,000 197,000	- 157,000

### Required:

For each company, compute the following ratios:

(i) Acid test ratio	(2 marks)
(ii) Inventory turnover	(2 marks)
(iii) Average collection period	(2 marks)
(iv) Return on capital employed	(2 marks)
(v) Debt equity ratio	(2 marks)

(c) (i) On the basis of the ratios computed in (b) above, comment on the overall performance of Sunrise Ltd. and Sunset Ltd. and advise which of the two companies would provide better investment. (3 marks) (ii) Explain the possible shortcomings of relying on your analysis in (b) above.

(3 marks)

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(Total: 20 marks)



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# ACCOUNTSCOMPANY



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# **CHAPTER NINE**

# **COMPANY ACCOUNTS**

### **▶** OBJECTIVES

After you study this chapter, you should be able to:

Define a company and understand the capital structure of a company and issuance of
share capital by a company
Compare and contrast a Company and other forms of business
Prepare financial statements for a limited liability company and understand the true and fair view requirements
Account for forfeiture of shares and reissue of forfeited shares
Calculate rights and determine number of shares issuable give in specific number

### INTRODUCTION

A company form of business formed by a group people called the promoters. Once formed, the law recognizes the company as a legal person separate from the owners by all means. This means that it can sue or be sued in its own name; it can borrow funds in its own name or even enter into contract in its own name. This concept is sometimes referred to as the **veil ofincorporation**.

A company is greater in size and complexity than either the sole proprietorship or the partnership discussed earlier. It's also a more recent form of business. It actually came into existence after the partnership in an effort to cover the shortfalls of a partnership form of business.

	Partnership's draw back Partnership membership is limited to 20 hence thus limiting the capital raising capability	Solution offered by a Company     There is no limit to the number of members for a public company hence more capital can be raised
•	The liabilities of the members are unlimited.	The liability of the members is limited to the capital contributed
	The death of partner may cause the dissolution of a partnership	A company's life is not pegged on the life of the members and can only be terminated through a legal winding up procedure.
	Have difficulties in securing loans and contracts since the law doesn't recognize it as a separate entity with contractual capacity.	Can easily secure loans and contracts since the law recognizes it as an artificial person with contractual capacity
	Limited growth due to limited capital available	Can expand rapidly since capital is readily available from the large number of members

### **▶** DEFINITION OF KEY TERMS

www.masomonsindi.com Capital is the amount of money or other assets introduced by the owner of the business A Company is an organization that is a legal entity and has limited liability

### **► EXAM CONTEXT**

This chapter is very important for this papers preparation for exams and forms a basis for more in-depth company accounting that we will look into in other financial accounting papers that we shall tackle. This include consolidating accounts for subsidiaries and associates to parent companies

### **▶ INDUSTRY CONTEXT**

Most private and public companies in Kenya will require that financial statements be prepared and audited by independent auditors. All companies listed in the Nairobi Stock Exchange are required to prepare true and fair financial statements and have them audited by independent auditors.

This stresses the need to understand very well this chapter not just for audit and accounting careers, but also to be able to interpret company financial statements as shareholders.







# 9.1 PUBLIC AND PRIVATE COMPANIES

Fast forward - Companies can be classified as either public company or private company.

The major differences between the two are:

Public company	Private company
They have no maximum limit for membership	Has a maximum limit of 50 members
Their membership is open to the public	Membership open only for relatives or close associates of the existing members
Can raise capital through the issue of shares to the public	Cannot raise capital from the general public
There is free transfer of shares amongst shareholders	Transfer of shares is restricted and must be authorized.

### 9.2 THE BOARD OF DIRECTORS

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**Fast forward** – Company owners delegate the running of their business to a group of peoplereferred to as the **directors** who together form the board of directors.

In the sole proprietorship and partnerships, the owners of the business i.e. the sole proprietor and the partners respectively, oversee the day to day running of the business

In the case of a company, such an arrangement is impossible to maintain due to the large number of owners (shareholders) and the complexity of the activities undertaken by the company. For this reason the owners delegate the running of their business to a group of people referred to as the **directors** who together form the board of directors. They may be shareholders as well but not necessarily. They combine their expertise to manage the affairs of the company on the shareholders behalf.

### 9.3 THE COMPANY'S CAPITAL

The major types of capitals that a company has are:

Loan capital (debentures)

This is capital borrowed from creditors which will be repaid later at an interest. It's actually a liability to the company. This will be discussed later in this topic.

### SHARE CAPITAL

To become an owner of any company a person must have contributed to its capital. To facilitate this there total capital required by the company is divided into small units or **shares**. One becomes a member of a company (shareholder) by purchasing one or more of the shares. Share capital is thus the capital raised from members of the company. As expected shareholders expect return on their investment. Thus the profits made by the company are distributed to the shareholders in proportion to the number of shares held. The profit distributed to the shareholders is referred to as a **divided**. This amount is determined and proposed to the share holders for approval by the directors. The shareholders; however, are only allowed to review the proposal downwards. The accounting for and distribution of profits shall be covered comprehensively later on.

# Share capital can be divided into two types of shares:

- i) Preference shares
- ii) Ordinary shares

**Preference shares**; holders of these shares receive their dividend at an agreed rate before theordinary shareholders receive anything.

**Ordinary shares** the ordinary shareholders receive their dividends after the preferenceshareholders, if there is any profit left.

The preference shares are further divided into:

Cumulative preference shares: these are preference shares whose agreed percentage ofdividend accumulates over the period they are fully paid.



- Non-cumulative preference shares: these are preference shares which if not paid thepercentage of divided agreed upon in a given period lose the right to claim such dividends ever again in future periods.
- Participating preference shares: these are shares that receive an agreed percentage ofdividends before the ordinary shareholders and still receive a portion of the remaining profits being distributed to the ordinary shareholders.
- Non participating preference shares these are the preference shares that receive only theagreed percentage of dividend, no more.

### SHARE CAPITAL

Fast forward – Share capital can be;

- a) Authorized share capital
- b) Issued share capital
- c) Called up capital
- d) Calls in arrears
- e) Paid up capital.

In this section we shall consider the process of obtaining share capital and the accounting entries involved. However, for better understanding, it's important to defi ne the following terms fi rst:

- i) Authorized/registered/normal share capital: this is the amount of capital that thecompany is allowed to issue as indicated in its Articles of Association. A company may issue only a portion of the authorized share capital to shareholders. The remaining capital not issued remains as security to the company incase more capital is needed in future, and only then shall it be issued. However, no company is allowed to issue more shares than the amount authorized. The authorized share capital is normally shown in the statement of fi nancial position under the equities section but its value is not summed up together with the rest of the equity items.
- **ii) Issued share capital:** this is the part of the share capital that has already been issued to the shareholders.
- iii) Called up share capital: once the company issues the capital to the shareholders itmay not require them to pay for the whole amount for the shares purchased. Instead it may prescribe that certain amounts be paid fi rst and the rest to be paid when the company requires. The total amount that a company has already requested to be paid on the shares, up to a specifi ed date is referred to as the called up share capital. The part remaining unpaid on the shares is referred to as the uncalled share capital.
- iv) Paid up share capital: It's that part of the issued share capital for which calls have been made and payments of the calls actually received by the company.

- Calls in arrears: out of the called up capital, not all of it is paid for. The balance of called up capital that remains unpaid is referred to as calls in arrears.

  Calls in advance; some shareholders may pay for the theirshares even before makes the calls for it calls in advance. vi) Calls in advance; some shareholders may pay for the outstanding amount on

### The following example will help illustrate the above terms.

Intel Solutions Ltd was formed with the legal right to be able to issue 400000 shares of Sh 4 each. However they actually issued 300000 of which none was fully paid.

So far Intel Solutions Ltd has made calls of Sh 3 per share. All shares have been paid by the shareholders except for Sh 150000 shares whose shareholders have only paid Sh 1 per share.

### Required:

### Determine

- Authorized share capital a)
- b) Issued share capital
- Called up capital c)
- Calls in arrears d)
- Paid up capital. e)

### Solution:

### **Authorized share capital:**

 $400,000 \times 4 = 1,600,000$ 

Issued share capital

 $300000 \times 4 = 1200000$ 

Called up capital

 $300000 \times 3 = 900000$ 

Calls in arrears

 $150000 \times (3-1) = 300000$ 

### Paid capital

900000 (obtained from d above) -300000 = 600000





### RESERVES

These are funds that the business sets aside for purposes of future financial obligations and appear in the financed-by section of the Statement of financial position.

They are categorized into two:

**Capital reserves** 

Revenue reserves

**Revenue reserves:** these are the reserves which can be distributed to the shareholders if needbe in a form such as bonus shares. They are generally used for the expansion or purchase of non-current assets. They include:

- Retained profits the balance after appropriation
- General reserves

**Capital reserves**: capital reserves on the other hand cannot be distributed to the share holders. They include:

- Share premium –representing the amount paid on the issued shares above their par
- Revaluation reserve representing the amounts by which assets appreciate after a revaluation is done.
- Capital redemption reserve fund representing the amount transferred from the retained earnings to finance the redemption of preference shares. If the amount is transferred to cater for the redemption of debentures, the reserve created for that purpose is referred to as the Debenture redemption fund. These shall be explained further in later section of the topic.

'

### 9.4 FINANCIAL STATEMENTS OF A LIMITED COMPANY

# STATEMENT OF COMPREHENSIVE INCOME

Like any other business entity, the company is formed with the intention of making profit. This profit is reported in the company's statement of comprehensive income just like in sole proprietorship or partnership form of business. However some expense items are unique to the company's profit and loss statement e.g. director's remuneration, audit fee. Companies are also required to pay tax on the profits earned in the form of a corporation tax which currently stands at 30% of the net profit earned in one trading period.

Unlike in sole proprietorship and partnership, a company's statement of comprehensive income statement also includes an extra section which shows how the profits made by the company are distributed or appropriated. This section is referred to as the **appropriation account.** 

FINANCIALACCOUNTING			wing format:
			250,
Generally the Trading and Statement of comprehen	nsive income will	have the follow	wing format:
			in
XYZ STATEMENT OF COMP	REHENSIVE INC	COME	<b>,</b>
FOR THE PERIOD EN	NDED XXXXXX		
		Sh	Sh
Sales		XX	SII
less return inwards		(xx)	
net sales			Xxx
less cost of sales			
opening stock		XX	
add purchases carriage inwards	XX XX		
camage inwards	XX		
less return outwards	(xx)		
net purchases		xx	
goods available for sale		xxx	
less closing stock		(xx)	<del></del>
cost of sales			Xxx
gross profit			Xxx
add other incomes			V
discount received profit on disposal of assets			Xxx Xxx
income from investments			Xxx
other incomes e.g. interest received from bank			Xxx
-			Xxx
less expenses			
administrative expenses		XX	
operating expenses selling and distribution expenses		XX XX	
debenture interest		XX	
audit fees		XX	
directors remuneration		XX	
amortization of goodwill		XX	
total expenses			(XXX)
net profit for the period before tax corporation tax			Xxx (xxx)
net profit for the period after tax			Xxx
appropriation section:			
net profit for the period after tax			Xxx
add retained profit b/f			Xxx
1 transfers to seemend recommon			Xxx
less transfers to general reserves preference dividend		XXX	
interim paid	XX		^
final proposed	XX	<del></del>	2
		xxx 🗸	)
ordinary dividend		3	
interim paid final proposed	XX	120	
ililai proposed	XX	— XXX	
		7001	(xxx)
retained profit c/d			Xxx



### THE STATEMENT OF FINANCIAL POSITION

The Statement of financial position of a company is also similar to that of a partnership except for the capital section of the Statement of financial position. For company the capital section is also referred to as the 'financed by' section. Just as the name suggests, this section shows the funds used to finance the net assets. This stems from the basic accounting equation where:

### Capital = assets - liabilities = net assets

Therefore the figure obtained for net assets must necessarily tally with that in the financed by section i.e. all other factors e.g. errors held constant, the statement of financial position should balance.

The general format of a statement of financial position is as follows:

# XYZ COMPANY LTD STATEMENT OF FINANCIAL POSITION AS AT XXXXX

	Sh	Sh	Sh
Non-current assets			
land and buildings		VV	XXX
plant and equipment less accumulated depreciation		xx (xx)	
icss accumulated depreciation		(^^)	- xx
fixtures, furniture and fittings		XX	AA.
less accumulated depreciation		(xx)	
·			XX
motor vehicles		XX	
less accumulated depreciation		(xx)	_
			XX
total non-current assets			XXX
Current Assets			
stock		XX	
Debtors	XXX	<i>7</i> / <i>7</i>	
less provision for doubtful debts	(xxx)		
·		XXX	
Prepayments		XXX	
short term investments		XXX	
cash at bank		XXX	
cash in hand		XXX	_
total current assets		XXX	
less Current Liabilities			^
bank overdraft	XXX		128716371
Creditors	XXX		163
Accruals	XXX		1
interest payable (debenture interest)	XXX		12°
tax payable	XXX	C	5/1
dividends payable	XXX	_	
		(xxx)	_
net current assets			XXX
total assets			ууууу

### www.masomornsindi.com Financed By authorized share capital 1,000,000 ordinary shares of Sh 1 each 1,000,000 preference shares of Sh 1 each issued and fully paid 800,000 ordinary shares of Sh 1 each XXX 500,000 10% preference shares of Sh 1 XXX XXX capital reserves share premium XXXrevaluation reserve XXX capital redemption reserve XXX XXX revenue reserves general reserve XXX profit and loss account XXX XXX XXX non current liabilities 10% debentures XXX уууу

### TRUE AND FAIR VIEW 9.5

Fast forward - A basic requirement for the financial statements of the company is that they mustportray a true and fair view of the company.

It is expected that the Trading and Statement of comprehensive income will portray a true and fair view of the results of trading activities over a given accounting period. The statement of financial position is also expected to give a true and fair view of status of the company's assets vis-à-vis the company's liabilities as at the statement of financial position date. Actually this forms part of the major objectives of an audit of a company's financial statements. The auditor states in his report whether or not in his opinion the financial statements are a true and fair reflection of the company's results and state of affairs.







### **Examples on preparation of financial statements**

### The following is the trial balance of Transit Ltd as at March 19x8

	Sh	Sh
Ordinary share capital (Sh 1 each)		42,000
Leasehold property at cost	75,000	
Motor vans at cost(used for distribution)	2,500	
Provision for depreciation motor van to 31 march 19x7		1,000
Administration expenses	7,650	
Distribution expenses	10,000	
Stock 31 march 19x7	12,000	
Purchases	138,750	
Sales		206,500
Director's remuneration	25,000	
Rent receivables		3,600
Investment at cost	6,750	
Investment income		340
7% debentures		15,000
Debenture interest	1,050	
Bank interests	162	
Bank overdraft		730
Debtors and creditors	31,000	24,100
Interim dividend paid	1,260	
Profit and loss account		17,852
	311,122	311,122

### You ascertain the following:

All the motor vans were purchased on 1 April 19x5. Depreciation has been and is to be provided at the rate of 20% per annum on cost from the date of purchase to the date of sale. On 31 march 19x8 one van, which had cost £ 900 was sold for £550,as part settlement of the price of £ 800 of a new van, but no entry with regard to this transactions were made in the cashbooks.

The estimated corporation tax liability for the year to March 10x8 is £12700 It is proposed to pay a final dividend of 10% for the year to 31 march 19x8 Stock at the lower of cost or net realizable value on 31 March 19x8 is £16700

### Required:

Prepare without taking into account the relevant statutory provisions:

- a) Profit and loss statement for the year ended 31 march 19x8.
- b) A statement of financial position as at that date.



F I N A N C I A L A C C O U N T I N G		www.masomonsindi.com
Transit Ltd		MINASON
Profit and loss statement for the year ende		
Gross profit Profit on disposal of van Rent receivable	£	£ 72,450 190 3,600
Less: expenses Depreciation on motor van Administration expense Distribution expense Debenture interest Bank interest	500 32,650 10,000 1,050 162	76,240
Trading profit for the year  Add: investment income  Profit before tax  Taxation  Profit after tax  Less: dividends Interim paid  Final proposed	1,260 4,200	(44,362) 31,878 340 32,218 12,700 19,518
Retained profit for the year Retained profit b/f Retained profit c/f		(5,460) 14,058 17,852 31,910

# **Transit Ltd** Statement of financial position as at 31.3.19x8

	£	£	£
non-current assets			
Leasehold property	75,000	-	75,000
Motor vans	2,400	960	1,440
_	77,400	960	76,440
Investments	77,100	000	6,750
IIIVEStillerits		_	
Current assets			83,190
Stock		16,700	
Debtors		31,000	
Command lightilities		47,700	
Current liabilities			
Bank overdraft	980		
Creditors	24,100		
Tax payable	12,700		
Proposed dividend	4,200		
'	,	(41,980)	
		(11,000)	5,720
		-	88,910
Financed by :		_	00,310
Authorized issued and fully paid			16 3
4200 ordinary shares of £ 1			42,000
Revenue reserves		0	12,000
Statement of comprehensive income c/f		12°	31,910
Statement of complehensive income c/i		0,	
Non current liabilities			73,910
			4 = 000
7% debentures		_	15,000
		_	88,910





### Workings:

Sales	206,500
l	

Less: cost of sales

12,000 Opening stock **Purchases** 138,750

150,750 (16,700)

Less: closing stock

134,050

Gross profit 72,450

### Motor vehicle depreciation

Disposal	540	Bal b/d	1,000
Bal c/d	960	P&L	500
	1,500		1,500

### Motor vehicle

Bal b/f	2,500	Disposal	900
Disposal	550	Bal c/d	2,400
Cash book	250		
	3,300	]	3,300

### Motor vehicle disposal

Disposal P & L		motor vehicle depreciation	550 540
	1,090		1,090

#### **ISSUANCE OF SHARES** 9.6

www.masomornsindi.com Profit to a company is earned by using the resources at its disposal in the most efficient manner. These resources are contributed by the shareholders in the form share capital and from creditors in the form of loan capital also called debentures.

The shareholder provides the share capital buying shares issued by a company. For public limited companies such shares are offered through the stock exchange.

# The share issuing process

The process of issuing shares to the public starts with the company issuing a **prospectus**. This is a document that invites the public to purchase shares from the company. It contains details of the companies operations and the benefits that shall accrue from investing in the company.

Once the prospectus is issued, applications follow. Shareholders respond to the prospectus by applying to purchase the shares. In most cases more shares are applied for than the company had initially offered for sale i.e. there is an over-subscription. If the shares applied for are less than what the company had offered this will be referred to as under-subscription.

## Allotment

At this stage successful applicants are awarded the shares for in a process called allotment. In the event of an over subscription the issuing company allots to the share holders only a proportion of the shares applied for in the most equitable manner to cater for all the successful applicants.

# Refund to unsuccessful applicants

For the unsuccessful applicants any fees paid on application is refunded. For the applicants allotted fewer shares than applied for, they may as well be refunded their application fee or the same could be used to offset future payments on the shares if they were issued payable in installments.

# The call stage

If shares are issued payable in installments, only a certain portion of the shares issue price is payable on application. The rest becomes payable as and when the company feels the need to request for the payment. The placement of a request for the payment of the amount due on the shares by a company to its shareholders is referred to as a call. The company may make several calls e.g. first, second, third calls.





## Forfeiture of shares

If share holder fails to respond to the calls made within the stipulated time, the company may decide to cancel the shares allotted to such a share holder. This is what is referred to as forfeiture of shares. A shareholder whose shares are forfeited foregoes any amounts previously paid to the company on the shares.

## Reissue of forfeited shares

The company may decide to offer the shares forfeited to any other willing buyer at a price which should be at least equal to the called up amount.

# ACCOUNTING ENTRIES TO RECORD ISSUE OF SHARES I

## Before handling the accounting entries it is important to note the following:

- Share can be issued at a premium or a discount (at a price higher or lower than the par value respectively)
- The shares may not necessarily be payable in full on application they may be issued on installment basis each installment carrying a given proportion of the issue price of the share e.g. 20% on application 25% on allotment, 30% on first call and 15% on second and final call.
- When shares are issued at a premium and on installment basis, the share premium may be attached uniformly throughout the installments or may be attached to certain installment, say on allotment.

# I. Accounting for shares payable fully on application

## a) Issued at par:

- i) Dr Bank account xxx
   Cr. Share applications account xxx
   (To record cash received on application)
- ii) Dr Share applications account xxx
  Cr. Bank account xxx
  (To record refunds to unsuccessful applicants)
- iii) Dr. Share applications account xxx
  Cr. Ordinary share capital account xxx
  (To transfer application fees to the ordinary share capital account)

## b) Issued at a premium

i) Dr Bank account xxx

Cr. Share applications account xxx

(To record cash received on application)

ii) Dr Share applications account xxx

Cr. Bank account xxx

(To record refunds to unsuccessful applicants)

iii) Dr. Share applications account xxx

Cr. Ordinary share capital account (par value) xxx

Cr. Share premium account (share premium) xxx

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(To transfer application fees to the ordinary share capital account and recognize share premium)

# Il accounting for shares issued on installment basis with only two calls made

## a) At par

## On application:

i) Dr Bank account xxx

Cr. Share applications account xxx

(To record cash received on application)

ii) Dr Share applications account xxx

Cr. Bank account xxx

(To record refunds to unsuccessful applicants)

iii) Dr. Share applications account xxx

Cr. Ordinary share capital account xxx

(To transfer application fees to the ordinary share capital account)

### On Allotment:

iv) Dr. Bank account xxx

Cr. Allotment account xxx

(To record amount payable on allotment)

Note if some of the excess cash paid on application is used to offset amounts payable on allotment instead of being refunded the entry would have been:

Dr. Bank account xxx

Dr. Applications account (excess amount on application) xxx

Cr. Allotment account xxx



Cr. Ordinary share capital account xxx
(To transfer amount paid on allotment to the ordinary share capital account)

call:

Dr. Bank xxx

Cr. Tr. V)

#### On First call:

- vi) Cr. First call account xxx (To record cash received on first call)
- vii) Dr. first call account xxx Cr. Ordinary share capital account xxx (To transfer first call to the ordinary share capital account)

#### On second and final call:

- Dr. Bank xxx vi) Cr. Second and final call account xxx (To record cash received on first call)
- vii) Dr. second and final call account xxx Cr. Ordinary share capital account xxx (To transfer second and final call to the ordinary share capital account)

# b) At a premium payable on allotment

All other entries for the application, first call, and second and final call would remain as above. However the entries on allotment would be:

### On Allotment:

- iv) Dr. Bank account xxx Cr. Allotment account xxx (To record amount payable on allotment)
  - Dr. Allotment account xxx
    - Cr. Ordinary share capital account xxx
    - Cr. Share premium account (share premium) xxx

(To transfer amount paid on allotment to the ordinary share capital account asWell as recognize the premium paid together with the allotment money)

## >>> Illustration 1

Markers Ltd issued 1000 shares to the public at Sh 10 each payable as to sh. 2.5 on application, Sh 5 on allotment and Sh 2.5 on first and final call. They received applications for 2000 shares of which they returned one half and then proceeded to allot the rest.

## Required:

- Show the journal entries to record the issue
- ii) Show the accounts as they would appear in Markers Ltd's books.

# Suggested Solution:

# a) Journal entries;

# On application:

		Sh.	Sh.
i)	Dr Bank account  Cr. Share applications account  (To record cash received on application)	5,000	5,000
ii)	Dr Share applications account Cr. Bank account (To record refunds to unsuccessful applicants)	2,500	2,500
iii)	Dr. Share applications account  Cr. Ordinary share capital account  (To transfer application fees to the ordinary share)	2,500 e capital accou	2,500 int <b>)</b>

## On Allotment:

iv)	Dr. Bank account	5,000	
	Cr. Allotment account		5,000
	(To record amount payable on allotment)		
v)	Dr. Allotment account	5,000	
	Cr. Ordinary share capital account		5,000
	(To transfer amount paid on allotment to the	ordinary share capit	al account)

## On First and final call:

vi)	Dr. Bank	2,500	
	Cr. First call account		2,500
	(To record cash received on first call)		
vii)	Dr. first call account	2,500	
	Cr. Ordinary share capital account		2,500
	(To transfer first call to the ordinary share c	apital account)	



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Dr		Bank ac	count	Cr
		Sh		Sh N
	Application a/c	5000	Application a/c	2500
	Allotment a/c	5000	Balance c/d	10000
	First and final call	2500		
		12500	-	12500
Dr		Share app	lication account	Cr
		Sh		Sh
	Bank a/c	2500	Bank a/c	5000
	Ordinary share capital a/c	2500		
		5000		5000
			=	
Dr			ent account	Cr
		Sh		Sh
	Ordinary share capital a	a/c 5000	Bank a/c	5000

Dr	First and final call		Cr	1
Ordinary share capital a/c	Sh 12500	Bank a/c	12500	(b) \

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Dr	Ordinary s	Ordinary share capital account	
	Sh		Sh 1/2
Balance c/d	10000	Application a/c	2500
		Allotment a/c	5000
		First and final call	2500
	1000	<u>0</u>	10000

## >>> Illustration 2

Chakaza Ltd issued 1000 shares to the public at Sh 25 each payable as to Sh 5 on application, Sh 15 on allotment and Sh 5 on first and final call. They received applications for 4000 shares of which they rejected 1000 half and then proceeded to allot the rest of the applicants one share for every three held.

## Required:

Show the journal entries to record the issue

## Suggested solution:

a) Journal entries;

## On application:

		Sh.	Sh.
i)	Dr Bank account	20,000	
	Cr. Share applications account		20,000
	(To record cash received on application)		
ii)	Dr Share applications account	5,000	
	Cr. Bank account		5,000
	(To record refunds to unsuccessful applicants)		
iii)	Dr. applications account (excess amount on application) Cr. Allotment account	10,000	10,000
	(To record excess amount paid on application used to	11	0
	off-set amount due on allotment)	128	
iv)	Dr. Share applications account	5,000	
,	Cr. Ordinary share capital account	•	5,000

account) ( T o t r а n s f e r a p p I С a t i 0 n f е е s t o t h е 0 r d i n а r У s h a r е С a p i t a I

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## On Allotment:

iv) Dr. Bank account 5,000

Dr. Applications account (excess amount on application) 10,000

Cr. Allotment account 15,000

(To record amount payable on allotment)

v) Dr. Allotment account 15,000

Cr. Ordinary share capital account 15,000

(To transfer amount paid on allotment to the ordinary share capital account)

## On First and final call:

vi) Dr. Bank 5,000

Cr. First call account 5,000

(To record cash received on first call)

vii) Dr. first call account 5,000

Cr. Ordinary share capital account 5,000

(To transfer first call to the ordinary share capital account)

# 9.7 FORFEITURE OF SHARES

So far we have assumed that the share holders were very cooperative and paid all the due calls as and when required to do so. Sometimes; however, a shareholder may fail to pay the calls requested from him within the stipulated time in which case the shares will be forfeited. Any amounts already paid will be lost to him. Between the time of call and the forfeiture time the amounts due will be in a debtor's account; the **calls in arrears account** from where they will be transferred to the **forfeiture account**.

## The journal entries for forfeiture are as follows:

Dr. Calls in arrears a/c

Cr. (the call not paid for) for the amount owing

(To record the accrual of calls made but not paid for)

Dr. Forfeiture account

Cr. Calls in arrears a/c

(To record forfeiture of shares whose calls have remained in arrears for a period exceeding the allowed limit.)

Dr. Ordinary capital share capital

Cr. Forfeiture account

(To record the cancellation of the shares from the issued share capital)

Note: any balance in the forfeiture account id transferred to the share premium account.

## >>> Illustration 3

Assume that 100 Sh 10 shares were allotted to member who paid Sh 7.5 on application and allotment but who failed the first and final call of Sh 2.5. How would such forfeiture be shown in the books of account?

## Suggested solution

Dr. Calls in arrears a/c 250

Cr. First and final call 250

(To record the accrual of calls made but not paid for)

Dr. Forfeiture account 250

Cr. Calls in arrears a/c 250

(To record forfeiture of shares whose calls have remained in arrears for a period exceeding the allowed limit.)

Dr. Ordinary capital share capital a/c 1,000

Cr. Forfeiture account 1,000

(To record the cancellation of the shares from the issued share capital)

## Reissue of forfeited shares

If the forfeited shares are reissued to another shareholder, the following entries will be made:

- Dr. Bank a/c
  - Cr. Reissue of forfeited shares a/c

(To record the amount paid for the shares by the new shareholders)

Dr. Reissue of forfeited shares a/c Cr.

Ordinary share capital a/c (To record the reissue of shares)

- Dr. Forfeiture a/c
  - Cr. Reissue of forfeited shares a/c

(To transfer the balance in the Reissue of forfeited shares a/c to the forfeiture account)

- Dr. Forfeiture account
  - Cr. Share premium account

(To transfer the balance in the forfeiture a/c to the share premium account)



## >>> Illustration 3 - continued

Assume that the shares forfeited were reissued at Sh 5. The entities would follow as thus.

Dr. Bank a/c 500

Cr. Reissue of forfeited shares a/c 500 (To record the amount paid for the shares by the new shareholders)

Dr. Reissue of forfeited shares a/c 1000

Cr. Ordinary share capital a/c 1000 (To record the reissue of shares)

Dr. Forfeiture a/c500

Cr. Reissue of forfeited shares a/c 500

(To transfer the balance in the Reissue of forfeited shares a/cTo the forfeiture account)

Dr. Forfeiture account 250

Cr. Share premium account 250

(To transfer the balance in the forfeiture a/c to the share Premium account)

## The accounts showing the forfeiture and re issue of the shares would appear as follows:

## Calls in arrears a/c

	Sh		Sh.
First and final call	250	Forfeiture account	250
		-	

### First and final call

Sh		Sh.
	Calls in arrears a/c	250

## Forfeiture account

	Sh	Sh.
Calls in arrears a/c	250	Ordinary capital share capital a/c 1000
Reissue of forfeited shares a/c	500	170
Share premium account	250	128
	1000	1000

0	rdinary capi	tal share capital a/c	W.M.
	Sh		Sh.
Forfeiture account	1000	Reissue of forfeited shares a/c	1000
		I	
	Ban	k a/c	
	Sh		Sh.
Reissue of forfeited shares a/c	500	ı	

## Reissue of forfeited shares a/c

Sh		Sh.
ordinary capital share capital a/c 1000	Bank a/c	500
	Forfeiture account	500
1000		1000

# 9.8 RIGHTS ISSUE

**Fast forward** – rights are normally given on pro-rata basis.

A rights issue is an option on the side of the shareholder given by the company given to existing shareholders to purchase the company's shares at a price lower than the prevailing market value of the share. The option is normally given on pro-rata basis.

## In response to the rights issue the shareholder may:

- Buy the shares and exercise the rights
- Sell the rights to a third party in the market or
- Ignore the rights, in which case the directors may decide to issue the shares in any other way.
- The rights issue is beneficial to a company since it provides a cheap means to raise

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> r e s

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## **ISSUE OF DEBENTURES**

As explained earlier, a debenture is a loan capital to the business. The entries for issue of debentures are similar to those for the shares. Actually if the word debenture was to replace the word share capital, the entries in the accounts would be identical.

# Redemption of Redeemable Preference Shares and Redeemable Debentures

## Redeemable preference shares

Redeemable preference shares are shares that can be redeemed (bought back by the company from the shareholders) at later date as stipulated in the terms laid down.

The redemption is necessitated by the fact that the company might have been in need of large amounts of capital initially but not indefinitely since accumulated profits will take its place.

Preference shares are not a cheap source of capital considering that fixed dividends have to be paid to them in each period dividend is declared. Redemption of preference shares is thus a relief to the company.

## During redemption the following should be observed:

- 1. The preference shares being redeemed must be fully paid
- 2. There must be funds to cater for the redemption provided from:
  - New issue of shares
  - Profit reserves
  - Partly from the issue of new shares and partly from the profit reserves.

If funds are obtained from the profit reserves, they are first transferred to a **capitalredemption reserve fund.** This account replaces the redeemed preference shares in the Financed-by section of the Statement of financial position.

- 3. If the shares are redeemed at a premium e.g. Sh 10 preference shares being redeemed at Sh 15, the funds to cater for the premium on redemption should be obtained from:
  - Share premium account if one exists
  - In the absence or insufficiency of share premium then use the profit reserves

In the section following, we shall consider the journal entries necessary to record the redemption as well as statement of financial position extracts showing the effect of the redemption of the preference shares. Actually, most examiners will require students to prepare journal entries showing the redemption of the shares.

## >>> Illustration I

**During the year ended 31 December 2007 ABC company ltd redeemed** 1000 Sh 5 preferenceshares at par.

## As at 31 December 2006 the statement of financial position revealed:

	Sh
Other assets	13000
Bank	7000
Ordinary share capital	5000
Redeemable preference share capital	5000
Statement of comprehensive income	7000
Creditors	3000

## Required:

- a) make journal entries to record the above information
- b) prepare the statement of financial position as at 31 December 2007

## **Assuming that:**

- 1. To cater for this Abc company issued 1000 Sh 5 new ordinary shares.
- 2. No new shares are issued to cater for the redemption
- 3. 500 Sh 5 ordinary shares are issued

## Suggested solution:

## 1. a)

## **Journal entries**

Dr. bank 5000 Cr ordinary share capital 5000

(To record issue of ordinary shares at par)

Dr. redeemable preference shares 5000

Cr. Bank 5000

(To record redemption at par)







## 1 b)

# **Statement of financial position extract:**

Abc company Itd

Statement of financial position as at 31 st	December 2007
Other assets	13,000
Bank	7,000
	20,000
Financed by	
Ordinary share capital	10,000
Statement of comprehensive income	7,000
Creditors	3,000
	20,000

## **Solution**

## 2 a)

Dr. Profit and loss account	5,000
Cr. Capital redemption reserve fund	5,000
(To record transfer of funds to the capital redemption reserve funds to the capital redemption redempti	nd)
•	5,000
Cr. Bank	5,000
(To record redemption at par)	

# 2 b)

# Statement of financial position extract:

# Abc company ltd Statement of financial position as at 31 December 2007

Statement of illiancial position as at 3	i December 2007
Other assets	13,000
Bank	2,000
	15,000
Financed by	
Ordinary share capital	5,000
Statement of comprehensive income	2,000
Capital redemption reserve fund	5,000
Creditors	3,000
	15,000

## **Solution**

## 3 a)

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	Editor.
n	anni Mas
)	3
Dr. bank	2,500
Cr ordinary share capital (To record issue of ordinary shares at par)	2,500
Dr. Profit and loss account	2,500
Cr. Capital redemption reserve fund	2,500
(To record transfer of funds to the capital redemp	tion reserve fund)
Dr redeemable preference shares	5,000
Cr. Bank	5,000
(To record redemption at par)	

# 3 b)

# Statement of financial position extract:

## Abc company Itd Statement of financial position as at 31 December 2007

13,000
4,500
17,500
7,500
4,500
2,500
3,000
17,500





## The major types of capital that a company has are:-

Share capital – Both preference and ordinary share holdings.

Loan capital.

The major differences between the public and private companies are:

Public company	Private company
They have no maximum limit for membership	Has a maximum limit of 50 members
Their membership is open to the public	Membership open only for relatives or close associates of the existing members
Can raise capital through the issue of shares to	Cannot raise capital from the general
the public	public
There is free transfer of shares amongst	Transfer of shares is restricted and must be
shareholders	authorized.

# **CASE STUDY**

The announcement by <u>Equity Bank</u> that their shares will trade on the NSE beginning 7th August, 2006 surprised many, mostly because they had refused to sell new shares to an expecting public. The bank may have been motivated to take this path for several reasons:-

## ☐ Fear to dilute the stake of anchor shareholders.

The bank's ownership structure now stands as: IFC & AFRICAP 18%, BRITAK 12% OTHERS 75%.

If the bank was to float new shares, they would have to reduce the stakes of these three. This must have been a scaring prospect for these shareholders as they would like to maintain the control they now have over the bank

## CMA, NSE & brokers' fees.

By avoiding to list new shares, the bank have deftly avoided a substantial chunk of the fees payable to these institutions while at the same getting to trade at the NSE. They have also managed to escape to pay fees to a myriad of market operatives including brokers, lawyers, and agents (read banks). In the Scanad IPO which is much smaller, this is a hefty Sh 70m. Equity's would have hit nearly Sh 200m in fees alone.

## (Source, http://gathinga.blogspot.com)

# **CHAPTER QUIZ**

- 1. Which share holders received dividend first?
- 2. What is the difference between Participating and non participating preference shares?

## **ANSWERS TO CHAPTER QUIZ**

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- 1. **Preference shares** are the shareholders who receive their dividend at an agreed ratebefore the ordinary shareholders receive anything.
- Participating preference shares are shares that receive an agreed percentage
  ofdividends before the ordinary shareholders and still receive a portion of the
  remaining profits being distributed to the ordinary shareholders, while Non
  participatingpreference shares only receive the agreed percentage of dividend, no
  more.

# **PAST PAPER ANALYSIS**

6/07, 6/06, 12/05, 6/05, 12/04, 6/04, 6/03, 12/02

# **EXAM TYPE QUESTION**

# **Question 1 (June 2007 Question 1)**

- a) (I) distinguish between share premium and revaluation reserves. (2 marks)
  - (ii) Briefly explain how a company can utilize its share premium (2 marks)



b) The following trial balance was extracted from the books of pata Ltd., as at 31 December 2006:

	Sh. '000'	Sh. '000'
Ordinary shares of Sh 10 each		150.000
8% preference shares of Sh 10 each		50.000
7% debentures		100.000
Share premium		20.000
General reserves		65.000
Retained earnings (1 January 2006)		35.000
Land at cost	111.000	
Plant and machinery at cost	382.000	
Provision for depreciation – plant and machinery		85.500
Sales		290.000
Discounts allowed/received	3.200	4.600
Accounts receivable/payable	48.000	27.000
Inventory (1 January 2006)	35.000	
Cash at bank	7.500	
Carriage inwards		1.000
Purchases	165.000	
Salaries and wages	32.100	
Electricity	2.900	
Interest on debentures	7.000	
Directors fees	12.000	
Provision for bad and doubtful debts		1.500
General expenses	11.900	
Interim dividends paid Ordinary	7.500	
Preference	2.000	
Suspense account		400
	<u>829.000</u>	829.000

## **Additional information:**

- 1. During the year, land was revalued to Sh 180 million by the directors, the revaluation reserve arising from land revaluation was partly utilized to finance the issue of Sh 1 bonus share for every 10 ordinary shares held
  - The bonus shares were issued to the existing ordinary shareholders on 29 December 2006 although no entry had been recorded in the books of Pata Ltd.

- 2. Inventory as at 31 December 2006 was valued at Sh 41 million.
- 3. Corporation tax is estimated at Sh 3 million while unpaid wages as at 31 December 200t amounted to Sh 150 000.
- 4. General expenses include an insurance premium amounting to Sh 200.000 for the period 1 April 200t to 31 March 2006.
- A machine which had cost Sh 2 million was disposed of on 1 January 2006. The
  accumulated depreciation on disposal of the machine was Sh 1.5 million. The cash
  received in respect of the sale was Sh 400.000 which was recorded in a suspense
  account.
- 6. A provision is to be made for bad and doubtful debts at the rate of 2  $\frac{1}{2}$  % of the accounts receivable.
- 7. The company depreciates its plant and machinery on straight line basis at the rate of 10% per annum.
- 8. The directors propose to pay a final ordinary dividend of 5% and also transfer Sh 5 million to general reserves.

## Required:

- i. Trading, statement of comprehensive income for the year ended 31 December 2006. (8 marks)
- ii. Statement of financial position as at 31 December 2006.

(8 marks)

(Total: 20marks)

# **Question 2 (December 2005 Question1)**

Araka Ltd., a company dealing in retail products, extracted from the following trial balance as at 30 September 2005:

	Sh. '000'	Sh. '000'
Freehold land: Cost	121,500	
Buildings: Cost	431,000	
Accumulate depreciation		68,960
Plant and machinery: Cost	64,172	
Accumulated depreciation		16,074
Sales		1,312,567
Purchases	839,004	
Cash in hand	1,268	
Creditors ledger control account		21,172
Electricity	6,917	
Ordinary share capital		50,000
Cash at bank	1,210	
Debtors ledger control account	61,074	
Suspense account	4,300	^
Inventory as at 1 October 2004	41,912	
Retained profits		296,057
Motor vehicle expenses	4,174	1/0
Sundry expenses	2,002	1
Salaries and wages	121,600	
Directors remuneration	48,999	
Bank charges	1,621	
Motor vehicles: Cost	28,900	4.4.740
Accumulated depreciation		14,712
	<u>1,779,542</u>	<u>1,779,542</u>



## Additional information:

- 1. Provision for doubtful debts should be made at 2% of the debtors ledger balances after writing of bad debts amounting to Sh 1,370,000.
- 2. The suspense account was analyzed as follows:

	Sh <del>.</del> '000'	Sh <del>.</del> '000'
Bad debts written off during the year		512
Motor vehicle purchased on 1 April 2005		7,400
		7,912
Less: motor vehicle sold on 1 April 2005	3,000	
Amounts received in respect of a bad debt recovered	<u>612</u>	<u>(3,612)</u>
		<u>4,300</u>

- 3. The motor vehicle sold during the year had been purchased on 1 February 2002 for Sh 6,500,000.
- 4. Bank statement as at 30 September 2005 showed bank charges of Sh 533,000. This had not been recorded in the cash book.
- 5. The debtors' ledger control account did not agree with the list of balances in personal accounts. You ascertain that some invoices for October 2005 had been posted in the personal accounts as at September 2005. The list of balances was overstated by Sh 4,300,000.
- 6. Estimated corporation tax for the year ended 30 September 2005 was Sh131,700,000.
- 7. The value of inventory as at 30 September 2005 was amounted to Sh 62,047,000.
- 8. The directors proposed to pay ordinary dividend of 10%.
- 9. The following petty cash expenditure had not been recorded:

	Sh. '000'
Motor vehicle expenses	412
Sundry expenses	91
Casual workers wages	36

10. Depreciation is provided at the following

rates: Buildings – 2% per annum on cost

Plant and machinery - 20% per annum on reducing balance

basis. Motor vehicle - 25% per annum on cost

Full year's depreciation is provided in the year of purchase and none in the year of disposal.

## Required:

a) Statement of comprehensive income for the year ended 30 September 2005.

(12 marks)

b) Statement of financial position as at 30 September 2005

(8 marks)

(Total: 20 marks)

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# **CHAPTER TEN**

# **INCOMPLETE RECORDS**

## **OBJECTIVES**

After you study this chapter, you should be able to:

- To calculate figures of cost revenue and profit for a business that is not maintained through double entry using the various methods.
- Use control accounts to check the accuracy of posting in the ledgers.
- Explain why we maintain control accounts.

## **▶** INTRODUCTION

As we discussed previously, recording of business transactions in the company's books is a systematic process. Information is transferred from one stage to the next for further processing and analysis. In some cases however we may not be able to identify the process from its start to its end. This may be as a result of the business having incomplete records due to failure to keep proper accounting records or the records being destroyed accidentally

With incomplete records however, we may still be able to compute values for revenues, costs and profits. This will usually be done by adopting a backward approach.

## **EXAM CONTEXT**

Incomplete records can be tested in all forms of accounts; manufacturing accounts, partnership accounts and company accounts are just example of other chapters that can be examined together with this chapter.

## **► INDUSTRY CONTEXT**

Buildings do burn and all or part of the records lost. In such a case we still have with the limited records available have to provide financial statements for all stakeholders.

Incomplete records are therefore very crucial. They could be used by insurance companies to back up claims on damages.

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# **10.1 WORKING WITH INCOMPLETE RECORDS**

**Fast forward** – incomplete records can be used to prepare financial statements by adopting abackward approach

To arrive at the figures of cost revenue and profit for a business that is not maintaining double entry, the following methods can be used:

- Use of control accounts
- Use of ratios

- Estimating income from net assets
- Use of simple cashbook and bank statement

Most business enterprises use a blend of methods i) and iv) to arrive at the figure of financial statement presentation. Control accounts are largely divided into two:

- a) Debtors ledger control account
- b) Creditors ledger control account

The two accounts help one to arrive at the figure of both sales and purchases respectively.

The cashbook and the bank statement help one to account for transactions involving cash receipts and cash payments. This include expenses paid in cash, cash purchases, cash sales etc

Method (iii) is usually a simper method. It is based on the fundamental accounting equation.

$$A = C + L$$

This would mean that for a business that does not generate profits in a given period the assets at the beginning should be equivalent to assets as to the end.



Assuming there is no new capital injected into a business enterprise, then any increase in the net assets will be brought about by profits and if net assets decrease it could be as a result of either losses or drawings or both.

Profit /loss = Closing Capital - Opening Capital - Drawing - Capital injected during period.

## >>> Examples:

# Rongai traders had the following opening balances as at the beginning of the year

	2005 Sh
Land and buildings(N.B.V)	200,000
Furniture and fittings(N.B.V)	75,000
Motor vehicles(N.B.V)	120,000
Cash in hand	7,000
Debtors	42,000
Creditors	64,000
Bank overdraft	78,000
Long-term loan	50,000
Stock	28,000

## The closing balances at the end of the year were as follows:

	Sh
land and buildings (N.B.V)	180,000
furniture and fittings (N.B.V)	70,000
motor vehicles (N.B.V)	100,000
cash in hand	21,000
Cash at bank	87,000
Debtors	96,000
Creditors	72,000
long-term loan	40,000
Stock	18,000

Drawings made during the year amounted to Sh 14200

Compute the profit for the year 2005.

## Solution:

We know that,

Profit/loss = closing capital - opening capital - drawings - capital injected

To get the opening capital, we use the equation

A = C + L

Hence C = A - L



## Computation of opening capital

Assets	Sh	
land and buildings(N.B.V)	200,000	
furniture and fittings(N.B.V)	75,000	
motor vehicles(N.B.V)	120,000	
cash in hand	7,000	
Debtors	42,000	
Stock	28,000	
	472,000	
less liabilities		
Creditors	64,000	
bank overdraft	78,000	
long-term loan	50,000	
	-192,000	
beginning capital	280,000	
Closing capital balance:		
Assets	Sh	
land and buildings(N.B.V)	180,000	
furniture and fittings(N.B.V)	70,000	
motor vehicles(N.B.V)	100,000	
cash in hand	21,000	
Cash at bank	87,000	
Debtors	96,000	
Stock	18,000	
	572,000	

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long term loan	40,000	
Creditors	72,000	
		-112,000
		460,000

## From the above:

To estimate the beginning or ending balance, we can use a Statement of affairs. As the name suggests a statement of affairs is a statement from which the capital of an owner can be found by estimating assets and liabilities as at a given time. A statement of affairs adopts the same format as that of a statement of financial position only that the objective of this statement is to obtain the figure for the capital balance.



**Capital difference** 



## **XYZ Limited**

## Statement of affairs as at xx xx xx

Non-current assets land and buildings plant and equipment less accumulated depreciation fixtures, furniture and fittings less accumulated depreciation	Sh Cost	Sh Accumulate depreciation xx (xx) xx (xx)	Sh NBV xxx
motor vehicles less accumulated depreciation total non-current assets		xx (xx)	xx xx xxx
Current Assets stock debtors less provision for doubtful	xxx (xxx)	xx	
prepayments short term investments cash at bank cash in hand total current assets		xxx xxx xxx xxx xxx	
less Current Liabilities bank overdraft creditors accruals interest payable (debenture interest) tax payable dividends payable	XXX XXX XXX XXX		
net current assets total assets Financed By long term liabilities 6% long term loan 10% debenture		xxx xxx xxx	xxx yyyyy (xxxx)

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XXXX

## **10.2 DRAWING FINANCIAL STATEMENTS**

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From the preceding example you will realize that we only obtain profits as the difference between the opening and the closing capital balances (net of drawings)

However, you will also realize that the figures only give the profit for the period. There is no other information that can be deducted from it.

Financial statements are meant to give a true and fair view of the results of the operations. This enables the management to make informed decisions. Apart from the profitability for a given period, an organization will be interested in knowing the following:

- i) Total sales during the period
- ii) Total cost of sales during the period
- iii) Total operating expenses on an item to item basis
- iv) The profit mark-up margin

This therefore raises the need for more comprehensive/detailed financial statements and more so a detailed P & L account.

To achieve this objective when dealing with incomplete records, we make use of control accounts.

# **10.3 CONTROL ACCOUNTS**

**Fast forward** – Control accounts are basically used to check the accuracy of posting in theledgers.

## TYPES OF CONTROL ACCOUNTS

## We are going to cover two control accounts:

- i) Sales ledger control account
- ii) Purchases ledger control account

Control accounts operate on the principle that if the opening balance of an account is known, additions and deductions are known, and then the closing balance can be calculated. Put in another way, when we have the opening balance of a control account, we know some of the items affecting both the credit and the debit side of the account as well as the closing balance, and then we can obtain the missing balances.



# **Sales Ledger Control Account**

This also referred to as the debtors control account. A sales ledger control account is similar to the account of an individual debtor only that the items that will be reflected in the account will be for all the debtors and the transactions affecting them during a specific period of time.

## This account comprises the following entries:

- · opening balances of debtors
- · closing balance of debtors
- credit sales during the period
- returns by debtors
- set-off's
- cash received from debtors(both cash and cheque)
- · discounts allowed
- refund to customers

- · dishonored cheque
- · bad debts recovered
- · bad debts written off
- cash received from bad debts recovered
- · purchases ledger contra
- allowances to customer

In most cases, all the figures will be available from the information given apart from the total credit sales. It is for this reason that we prepare the sales ledger control account to help us obtain the figure for credit sales that will assist us in obtaining total sales to be used in the statement of comprehensive income

## Format for the sales ledger control account

Dr			Cr
balance b/d (debit balance)	XX	balance b/d (credit balance)	XX
credit sales during the period	XX	cash received from debtors	XX
refund to customers	XX	cheques received from debtors	XX
bad debts recovered	XX	total returns by debtors	XX
dishonored cheque	XX	discounts allowed	XX
		allowances to customer	XX
		cash received from bad debts recovered	XX
		bad debts written off	XX
		purchases ledger contra	xx
			10
total credit balance c/d (balancing figure)	XX	total debit balance c/d (balancing figure)	XXX
94.0)	XXX	( )	xxx

## Notes:

NN Mason on Sindicom It is possible to have balances brought forward in the sales ledger control account as i) both a debit and a credit balance.

Debit balance is the normal total of the account. A credit balance will arise when one or more debtor accounts have a credit balance i.e. the company owes them refund. This is most common when there is overpayment by a debtor.

ii) Purchases ledger contra;

> This is also termed as set-off. It occurs when companies/individuals trade with each other in such a way that both companies sell products to each other and also buy from each other. E.g. assume a hardware that sells timber to a carpenter. One day, it orders for a set of tables to be made by the carpenter. They could enter into an agreement whereby the carpenter will take the timber and make the table then net off what is to be paid to the hardware.

iii) Allowances

These are price reductions in excess of discounts allowed to customers.

iv) Refund to customers

> This happens when a customer has a credit balance in his account. This could happen when goods have been returned to us or there had been an overpayment.

- Cash sales are not included in the sales ledger control account. Only credit sales and V) cash received from credit sales is included.
- vi) Provision for doubtful debts is not including in the sales ledger control account.
- Only cash discounts allowed are entered in the sales ledger control, trade discounts are not included.

# ii) Purchases ledger control account

This account is also known as total creditors control account. This account is similar to an individual; creditors account only that it will include details and transactions entered into by all the creditors, hence the name 'total creditors account'.

## The account comprises the following entries:

total credit balance brought forward total debit balance brought forward total cheques paid to creditors (for credit purchases) total cash paid to creditors (for credit purchases) total discounts received allowances by suppliers sales ledger control total return outwards total credit purchases from the journal refund from suppliers total credit balance and total debit balances.





# Format of a purchases ledger control account

Dr			Cr
total debit balance brought forward	XX	total credit balance brought forward	XX
total cheques paid to creditors (for credit purchases)	XX	total credit purchases from the journal	XX
total cash paid to creditors (for credit purchases)	XX	refund from suppliers	XX
total cash discounts received	XX		
allowances by suppliers	XX		
sales ledger	XX		
total return outwards	XX		
total credit balance c/d(balancing figure)	xx	total debit balance c/d(balancing	xxx
	XXX		XXX

### **Notes**

- i) It is possible as was the case with the sales ledger to have both a debit and creditbalance brought forward in the total creditors account. This is because we could have over paid our suppliers and thus has a debit balance in our account. We could also have returned goods for which we had paid.
- **ii) For cash** paid and cheques paid to creditors, we only consider the amount paid for thecredit sales. Cash sales are not part of the creditors control account since this account only records purchase on credit. Cash purchases are accounted for differently to arrive at the total purchases figure for the period.
- **iii) Refund from suppliers**: This happens incase we overpaid the suppliers or we returnedgoods we had paid for among other reasons.
- iv) Allowance by suppliers this reduction in price in excess of cash discounts received.
- v) We only consider the cash discount received. Trade and other discounts are notconsidered in the purchases ledger control.



# REASONS FOR MAINTAINING CONTROL ACCOUNTS

- 2. Ensures arithmetic check on the accounting record
- 3. Incases of incomplete records
- **4.** Provides a quick figure for total balances as at a given time to be reflected in the statement of financial position as debtors and debtors respectively
- **5.** Detect and prevent fraud In the suppliers and the customers accounts
- **6.** Facilitate allocation of duties among the debtors and creditors-handling staff.

The same principle of preparing the purchases ledger control account and the sales ledger control account applies when preparing financial statements. However, in the case of incomplete records, of utmost importance is to obtain the figure for credit purchases and credit sales. In most cases, we can trace in some way the other balance and hence our balancing figures would be credit sales in the sales ledger control account and credit purchases in the purchases ledger control account.

## Having obtained the above figure, the next step would be to obtain the following:

- i) Expenses for the period
- ii) Cash sales for the period
- iii) Credit sales for the period

When there is no accrual or prepayment of expenses, the amount shown in the cashbook as paid for the period will amount to total expenses for the period. However, incase there are accruals, or prepayments, we would need to prepare the specific expenses accounts that would help us get the actual expenses for the period.

# **10.5 STOCK LOSS**

**Fast forward** – to estimate stock loss we would have to use a gross profit percentage wherethere are no stock record documents.

Sometimes stock could be lost, or even destroyed through fire. We would need to establish the amount of stock loss for our purpose of establishing profits. Possible scenarios are that:

- i) We could be keeping perpetual stock taking records and hence it would be easy to extract the figure of stock stolen, lost or destroyed.
- ii) We would have had a stock count before the loss

However in most business organizations and especially the small business organizations there are no stock record documents. Therefore to identify the amount of stock loss, we would have to use a gross profit percentage.



#### >>> Example

On 29<sup>th</sup> November 2005 there was a fire out break at the premises of Wajibu enterprises. The whole of his stock, purchases and sales journal all got burnt in the fire except for stock worth Sh 24600 that was in the loading bay even though cleared in by the supplier. However the sales ledger and the purchases ledger were salvaged.

#### The following figures were available on 30<sup>th</sup> November 2005:

- a) Stock at the last statement of financial position date 31 st December 2004 was Sh 249000
- b) Receipts from debtors during the period to 29<sup>th</sup> November was Sh 634900 Debtors were Sh 285560 on 31<sup>st</sup> December 2004 and Sh 246660 on 29<sup>th</sup> November 2005
- c) Payments to creditors during the period 1st January 05 29<sup>th</sup> November 05 was Sh 345400. Creditors were Sh 152000on 31<sup>st</sup> December 04 and 125780 on 29<sup>th</sup> November 2005
- d) The gross profit margin on all sales has been constant at 25%

All sales were made on credit and all purchases made on credit

#### Required

Compute the amount of stock destroyed by fire on 29<sup>th</sup> November 2005

#### Solutions:

First compute the amount of credit sales and credit purchases

#### Sales ledger control account

Dr				Cr
	balance b/f credit sales	285,560 596,000	Bank	634,900
			balance c/d	246,660
		881,560	]	881,560

#### **Purchases ledger control account**

Dr			Cr 🔑
bank	345,400	balance b/f credit purchases	152,660 318,520
balance c/d	125,780		
	471,180	<u> </u>	471,180

#### **WAJIBU ENTERPRISES**

#### TRADING ACCOUNT FOR THE PERIOD ENDED 30TH NOVEMBER 2005

	Sh	Sh
sales		596,000
less cost of sales		
opening stock	249,600	
add purchases	318,520	
goods available for sale	568,120	
less closing stock	X	
cost of sales		XX
gross profit at 25%		149,000

$$G.P - \underline{25} \times 596000 = 149,000$$

$$100$$

596,000 - (Cost of sales) = 149,000 (gross profit)

Cost of sales = 596,000 - 149,000 = 447,000

Goods available for sale - closing stock = cost of sales

Closing stock = goods available for sale – cost of sales

Closing stock = 568,120 - 447,000 = 121,120

Stock destroyed = closing stock – salvaged stock

= 121,120 - 24,620

= Sh 96,500

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To arrive at the figures of cost revenue and profit for a business that is not maintaining double entry, the following methods can be used.

- i) Use of control accounts
- ii) Use of ratios
- iii) Estimating income from net assets
- iv) Use of simple cashbook and bank statement

Control accounts are basically used to check the accuracy of posting in the ledgers. The major types of control accounts used are:

- i) Sales ledger control account
- ii) Purchases ledger control account

#### **CASE STUDY**

A good example closer home would be the Nakumatt Downtown Store that burned down in February, 2009. Most of the records for the day must have burned down; stocks worth millions were lost in the furnace. The stock had to be accounted for so that all stakeholders could be given a figure on how much was lost. These stakeholders include owners, bankers and the insurance company that would need good backing before compensating any damages.

Incomplete records accounting had to come into play to give correct information on the losses for inclusion into the chains financial statements.

#### **CHAPTER QUIZ**

- 1. In the absence of a sale account or sales day book, how can a figure of sales for the year be computed?
- 2. What methods can be used to arrive at the figure of cost revenue and profit for a business that is not maintaining double entry?
- 3. A business has opening payables of Sh 75 million and closing payable of Sh 65 million and discounts received of Sh 3 million. What is the figure for purchases?

#### **ANSWERS TO CHAPTER QUIZ**

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- 7. By using the trade accounts receivable control account to calculate sales as a balancing figure.
- 8. Use of control accounts
  - Use of ratios.
  - Estimating income from net assets.
  - Use of simple cash book and bank statement.

3.

#### **Payables control**

	Sh (millions)	Sh M	illions
Bank	65	Opening payables	75
Discounts received	3	Purchases	58
Closing payables	65		
	<u>133</u>		<u>133</u>

#### **PAST PAPER ANALYSIS**

6/07, 12/06, 12/04, 12/03





#### **EXAM TYPE QUESTIONS**

(6 marks)

(8marks)

#### **QUESTION 1**

Crown Garments Wholesalers Ltd., was burgled on the night of 14 December 2006. The burglars stole all the cash takings for the day together with the petty cash and some of the expensive clothing.

On 30 November 2006, the owner had taken a physical stock count which established the value of stock at Sh 32540000. The stock of clothing left after the burglary amounted to sh11300000 at cost. Deliveries of additional stock items from suppliers between 1 December 2006 and 14 December 2006 were invoiced at Sh 5784000 after deducting trade discounts of sh 732000.

#### Sales to retail customers (at selling prices) were as follows:

Period	Cash sales	Credit sales
	Sh.	Sh
1 December 2006 to 6 December 2006	1429710	6.250.290
7 December 2006 to 13 December 2006	1644500	8.079.500
14 December 2006	259320	1200680

#### Additional information:

- The cash takings from 1 December 2006 to 13 December 2006 (inclusive) had been 1) banked intact.
- 2) Cheques for Sh.168.920 and Sh 192670 had been drawn to pay staff wages.
- Credit customer had paid cheques amounting to Sh 15867110 (all of which had been banked) in full settlement of accounts totaling Sh 16102830.
- The company had paid credit suppliers a total of Sh 17118360 (all of which had been 4) presented to bank) in full settlement of accounts totaling Sh 17532800.
- The petty cash imprest account had been replenished to its established level of 5) sh.25.000 on 1 December 2006 by withdrawal from the bank of Sh 9740. Subsequent disbursements to 14 December 2006 had amounted to Sh 13690.
- The cash book balances in the firms records on 30 November 2006 were as follows: 6)

Sh.

Balance at bank 6.625.080 (debit) Cash in hand 129.600 Petty cash 15.260

The gross profit margin had been at the rate of 30% throughout the year 2006. 7) However, from 7 December 2006 the company reduced the mark-up on cost to 331/3% as a strategy to boost sales.

#### Required:

- The amount of cash stolen. a)
- The value of stock (at cost) stolen. b)
- The balance at bank close of business on 14 December 2006. c) (6 marks)

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### **CHAPTER ELEVEN**

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#### COMPUTERISED ACCOUNTING

#### **▶** OBJECTIVES

#### After studying this chapter, you should be able to:

- ☐ Identify the different accounting packages.
- ☐ Explain the rationale for computerized accounting system.
- List the components of a computerized accounting system.
- ☐ Select a good computerized accounting system.
- Explain the challenges of a computerized system.
- Explain current trends in computerized accounting software.

#### **▶** INTRODUCTION

Keeping accurate accounting records is a vital part of managing an organization. Apart from helping to keep it afloat financially and legally, it is also a requirement of funding bodies. Smaller groups can usually manage with simple book-keeping procedures but bigger groups juggling with larger sums of money and more complex financial transactions may find their workload eased by using a computerized accounting system. The good news is that there are easy to use and reasonably priced computerized accounting package are available on the market.

#### **▶** DEFINITION OF KEY TERMS

- **1. Portfolio** In finance, a portfolio is an appropriate mix of collection of investments heldby institutions or a private individual.
- 2. Configuration In communications or computer systems, a configuration is anarrangement of functional units according to their nature, number, and chief characteristics. Often, configuration pertains to the choice of hardware, software, firmware, and documentation. The configuration affects system function and performance.

#### **EXAM CONTEXT**

This is a new chapter. It has not been examined in the past and could be examined considering the fact that most entities have moved to computerized accounting and this is what accountants and auditor are using.

#### **► INDUSTRY CONTEXT**

WWW.masomornsindi.com Most entities have moved to computerized accounting owing to its advantages (notably high speed and accuracy). It's therefore increasingly become a requirement that accountants and auditors be conversant with computerized accounting.

#### 11.1 CLASSIFICATIONS OF COMPUTERISED ACCOUNTING

Fast forward - Accounting software that is designed for home use is often referred to as personalaccounting software.

There are many types of accounting software applications on the market today. Some applications are intended to perform accounting functions for large corporate organizations. Others are meant for personal use. Still other applications fall somewhere in between, performing functions suited to small businesses, as well as those suited to the average person. Available software ranges from the very simple to the very complex, with much variation in price as well.

Accounting software can be useful in such functions as recording and processing accounts receivable and accounts payable transactions. Some software applications can be used in payroll processing, the documentation of tax transactions, and the creation of related reports. Accounting software can also be used in billing clients and customers and debt collection. Some accounting programs even provide for timesheet record keeping, useful for professionals who need to keep track of the hours they work.

Accounting software that is designed for home use is often referred to as personal accounting software. This type of software is used mostly in managing household budgets and expenses. Some personal accounting software makes it possible to download bank account information directly from the Internet for use with the software.

Low-end accounting software is generally used by smaller businesses and can typically befound for sale by a variety of retailers. Usually, software in this class is not highly specific and can be used for a wide range of businesses. This type of accounting program is usually adequate for such uses as generating invoices, reconciling accounts, and handling payroll.



The next step up in the realm of accounting software consists of applications capable of performing a variety of functions important to business accounting. Referred to as **mid-marketsoftware**, accounting applications in this class perform general business accounting functions and frequently include integrated management information systems. Many software applications at this level are capable of providing for accounting in several different currencies. Mid-market accounting software is usually purchased from a dealer.

**Higher-end accounting software** is more expensive than other types and is usually much morecomplex. Generally designed for use by large businesses with millions of dollars in transactions, high-end accounting programs usually have very sophisticated features and options. Software in this class also allows for a high level of customization. Typically, higherend software is sold through a dealer.

Some companies choose to develop their own accounting software, gearing it completely towards their unique needs. Other companies choose to purchase ready-made software packages.

Many organizations employ a combination of the two, purchasing software and applying local modifications to make it more efficient.

#### 11.2 TYPES OF ACCOUNTING PACKAGES

#### 1. QuickBooks

QuickBooks is a line of business accounting software developed and marketed by Intuit. Small businesses use QuickBooks for most financially-related business processes, from entering sales receipts, tracking expenses, preparing and sending invoices, sales tax tracking and payment, preparation of basic financial statements and reports, and inventory management. The program does not include MICR line printing, but does include check printing and options for employee payroll and time tracking. For most tasks, QuickBooks doesn't require users to understand standard accounting procedures, including double-entry bookkeeping. Most transactions are recorded using on-line screens that closely resemble paper based forms such as invoices or checks.

Options now include versions for manufacturers, wholesalers, professional service firms, contractors, non-profit entities and retailers, in addition to one specifically designed for professional accounting firms who service multiple small business clients. In May 2002 Intuit launched QuickBooks Enterprise Solutions for medium-sized businesses.

#### 2. Sage Pastel

Sage Pastel is a leading developer of accounting, payroll, ERP and business management software for the small, medium and large enterprise market. Founded in 1989, Sage Pastel has developed an in-depth knowledge and understanding of the industry, establishing itself as the market leader.

asomons indicom Sage pastel has been developed to provide comprehensive accounting and business solutions for start-up, small, medium and larger sized companies. Sage Pastel Accounting also offers a range of add-on modules that can assist your business with CRM, Business Intelligence, legal and auditing solutions.

#### 4. CreditQuest

CreditQuest is an end-to-end commercial Credit Management System that brings origination, financial analysis, underwriting, documentation and executive reporting together in a collaborative, streamlined workflow. It combines a unified, relationship-centric view of the customer's financial data and supporting documents with portfolio management capability. Data from CreditQuest passes seamlessly to LaserPro Harland Financial Solutions' industryleading documentation solution.

CreditQuest is composed of four key functional areas, supported by a robust Report Manager and over 40 standard reports.

- П Credit Manager
- **Decision Manager**
- Financial Analyzer
- **Project Analyzer**
- Report Manager
- Portfolio Manager

CreditQuest is mainly used by banks for credit and financial analyses.

#### 11.3 FEATURES OF A GOOD COMPUTERIZED SYSTEM

#### 1. Scalability

It is always very important to remember that as the company business expands, the business accounting software should also change accordingly. This is particularly true pertaining to the increase in products and services offered and the number of employees.

Wherever possible, when we choose our accounting package we should try to visualize our business in 3 or 5 years time and how different it will be. Use this information to guide the purchase decision. It may well be better to pay a little more now for the software knowing that it can be easily upgraded when needed with minimum disruption and cost to our business



#### 2. Support

It is important that any software has great support for when something goes wrong (and it always does).

Secondly, we should ensure that the support should be local or as close as possible to us. Imagine that things need done with the software by someone trying to help you over the phone.

Wherever possible, make some enquiries with other businesses about the package they use and who helps them.

#### 3. Accountant Interface

It's most unlikely we will handle every aspect of our businesses accounting. The accountant is an important factor in making the right decision. What software are they used to working with and what do they prefer?

Can we easily supply them data and reports from our accounting package without the need for any extra work (which we will have to pay for)?

We should interface with them when we are thinking of buying the accounting software.

#### 4. Best Value for Money

Once we have selected the right package for your business the most logical step is to shop for the best value for money.

Shop around as the price can vary greatly and the product is exactly the same unless the price differential is with good support or installation assistance.

#### 5. Major Brands

Wherever possible, we should choose the most popular and major brand to avoid the hustle of dealing with some unknown accounting software house.

Furthermore by choosing a major brand we can get regular updates and also know that the company will be around as long as your business needs them.

#### 6. Ease of Use

Ease of use is a personal thing but it is worth trying the software before you buy it if you can. Remember to get the person who will be the main user to test the software as well.

Also consider how well the package can interact with other software we are using.

W.Masomonsindi.com Nowadays, the modern accounting software should come with the import and export data function where the import and export of data to spreadsheet or vice versa are easily done. With these capabilities, just in case, there can be more detailed analysis to be done.

#### 7. Features Needed

Most accounting software packages come in several different versions.

If we don't need certain features now and can't see a need for them in the future then we need not buy them.

The major differences are usually - number of users allowed, number of reports available and others.

#### 11.4 Comparison Of The Steps Of An Accounting Cycle Under The Manual System and Under The Computerized System

#### **Fast forward** – All accounting processes in manual systems are manual.

	Steps In Accounting Cycle	Manual System	Computerized System
1.	Analyze source documents	Manual	Manual
2.	Record transactions in journal	Manual	Manual data entry includes manual electronic coding
3.	Post to Ledger accounts	Manual	Automatic
4.	Prepare Unadjusted Trial Balance	Manual	Automatic
5.	Journalize adjusting entries	Manual	Manual
6.	Post adjusting entries	Manual	Automatic
7.	Prepare adjusted Trial Balance	Manual	Automatic
8.	Journalize closing entries	Manual	Automatic
9.	Post closing entries	Manual	Automatic
10.	Prepare post-closing Trial Balance	Manual	Automatic
11.	Prepare financial statements	Manual	Automatic





#### Advantages of a computerized accounting system

- a) Faster and efficient in processing of information.
- b) Automatic generation of accounting documents like invoices, cheques and statement of account.
- c) With the larger reductions in the cost of hardware and software and availability of user-friendly accounting software package, it is relatively cheaper like maintaining a manual accounting system.
- d) More timely information can be produced.
- e) No more manual processing of the data- all automatically been posted to the various ledgers/accounts.
- f) Many types of useful reports can be generated for management to use in decision making.

#### ■ Disadvantages/ Challenges of a computerized accounting system

- a) Power failure, computer viruses and hackers are the inherent problems of using computerized systems.
  - b) Once data been input into the system, automatically the output are obtained hence the data being input needs to be validated for accuracy and completeness, we should not forget concept of GIGO (Garbage In (Input) Garbage out (Output).
  - c) Accounting system not properly set up to meet the requirement of the business due to badly programmed or inappropriate software or hardware or personnel problems can cause more havoc.
    - d) Danger of computer fraud if proper level of control and security whether internal and external are not properly been instituted.

Fast forward – like manual accounting, computerized accounting also has controls.

## 11.5 CONTROLS IN ACCOUNTING SYSTEM

#### COMPUTERIZED

- a) Proper transaction authorization. Input control needs to be instituted like input data needs to be verified for accuracy and completeness by a person different from the one who is keying in the data.
- b) Besides the above input control, there should be processing and output controls to ensure integrity of the transaction data is intact.
- c) No unauthorized access to computer files, data, etc. All kept under lock and key and proper log is maintained.
- d) Uses of password control to access data.

#### **CHAPTER SUMMARY**

The fact that this is a new chapter and the trend in the industry it is a very important chapter both for your exams and industrial use.

Most companies have moved to computerized accounting, even the small companies have their computerized need catered for by affordable off the shelf software as mentioned earlier.

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#### **CHAPTER QUIZ**

- 1. Analyzing source documents in both manual and automated accounting systems is done manually. True or false?
- 2. Preparation of post-closing trial balance is done automatically in both manual and computerized accounting systems. True or False?

#### **CHAPTER QUIZ ANSWERS**

1. True.

2. False, like all other processes in the manual system it's done manually.

#### **EXAM TYPE QUESTION**

You started work in ABC Company Ltd. The management is asking you to implement a computerized accounting system. The following questions were posed to you:-

- (a) What benefits will a computerized accounting system bring your company? State up to **five** possible benefits. (5 marks)
- (b) There are so many different packages on the market. What should I be looking for whenselecting a computerized package? List **seven** factors. (7marks)
- (c) If we get a Sales Ledger package what kind of reports should we expect? List **six** types of report you would expect. (6marks)
- (d) What's the difference between a *stand-alone* package and an *integrated package*? What are the advantages and disadvantages of each? State the difference and give **two** advantages and **two** disadvantages of an integrated package. (10 marks)
- (d) Our computer support staff says that we'll have to *configure* the package before we can use it. What do they mean by that? Explain what configuration involves. (5 marks)

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# CHAPTER TWELVE WITH THE STATE OF THE STATE O

#### **PUBLIC SECTOR ACCOUNTING**

#### **▶** OBJECTIVES

After studying this chapter, you should be able to:

	List and explain the features of public sector accounting.
	Explain the relevance of accounting concepts, basis and policies to public sector
	accounting.
	Explain what fund accounting is and its relationship with entity theory.
	Explain the different ways of income measurement and valuation in the public sector.
	Prepare, analyze and interpret financial statements of government units.
П	Deal with accounts of state corporations and similar organizations.

#### **▶** INTRODUCTION

There is increasing demand for public accountability and transparency by all stakeholders in the Public Sector in Kenya. Revelations during the Public Accounts Committee (PAC) hearings and in the Auditor-General's reports raise issues of financial accountability and transparency.

In the past, financial reporting by the Government has largely been seen as inadequate, government ministries/bodies do not provide understandable financial reports. The reports have been complex, confusing, and voluminous.

The preparation of transparent and understandable financial statements is an important way for Government departments/other agencies to demonstrate their accountability to citizens who fund them through taxes, as well as development partners.

#### **▶ DEFINITION OF KEY TERMS**

- 1. **Stewardship** - is personal responsibility for taking care of another person's property orfinancial affairs or in religious orders taking care of finances.
- 2. Transparency - is a management approach in which (ideally) all decision making iscarried out publicly.

#### **► EXAM CONTEXT**

www.masomornsindi.com This is a new chapter. It has not been examined in the past and could be examined considering the fact that most public sector accounting has increasingly become important with donors and taxpayers demanding transparency.

#### **► INDUSTRY CONTEXT**

The number of qualified accountants in Kenya has increased tremendously over the years. However, the IPSAS is a new concept which is not understood by many. The Government, as the leading user of these standards, will therefore require undertaking massive training to enlighten its accountants on IPSAS.

There has been an increasing need for transparent and understandable financial statements by both taxpayers and donors. This has created the demand for public sector accounting hence the need for all accountants to understand, be able to prepare and interpret public sector accounts.

#### 12.1 FEATURES OF PUBLIC SECTOR ACCOUNTING

Fast forward - The International Public Sector Accounting Standard Board (IPSASB) is the global organization for the accounting profession founded in 1977.

International Public Sector Accounting Standards (IPSAS) are a set of high quality, independently developed, accounting standards aimed at meeting financial reporting needs of the public sector.

IPSAS are developed by the International Public Sector Accounting Standard Board (IPSASB), which is an arm of the International Federation of Accountants (IFAC); the global organization for the accounting profession founded in 1977.



IFAC has 157 member bodies drawn from 122 countries. It represents 2.5 million accountants around the world. Transition to IPSAS as an accounting framework is designed to improve the quality and consistency of financial reporting, enhance transparency and accountability; facilitate better decision making, financial management and good governance in our entire public sector.

The above reform in financial reporting will mean that the Government will now be able to produce a consolidated set of general purpose financial statements — it will be interesting and encouraging seeing the Government's consolidated financial statements just like those that companies listed on the Nairobi Stock Exchange prepare.

The International Public Sector Accounting Standards Board (IPSASB) focuses on the accounting and financial reporting needs of national, regional and local governments, related governmental agencies, and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance and facilitating the exchange of information among accountants and those who work in the public sector or rely on its work. A key part of the IPSASB's strategy is to converge the IPSASs with the International Financial Reporting Standards (IFRSs) issued by the IASB. To facilitate this strategy, the IPSASB has developed guidelines or "rules of the road" for modifying IFRSs for application by public sector entities.

Members of the IPSASB are nominated by IFAC member bodies (like ICPAK) and, for public members, through nominations from member bodies, other organizations, and the general public.

Anne Owuor is Kenya nominee to the IPSASB; she became a member of the International Public Sector Accounting Standards Board in January 2008. She was nominated by the Institute of Certified Public Accountants of Kenya (ICPAK).

The IPSASB's objective, scope of activities and membership are set out in its Terms of Reference. They are also summarized in a fact sheet. The IPSASB's Strategic and Operational Plan, 2007-2009 sets out the direction for the board in fulfilling these objectives.

Adoption and implementation of IPSAS is not a requirement for the Government or any of its entities, it is a best practice issue, IPSASB or even IFAC cannot enforce compliance.



## 12.2 FUND ACCOUNTING AND ITS RELATIONSHIP WITH ENTITY THEORY

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Fast forward – in the fund theory accountability is measured instead of profitability.

#### FUND ACCOUNTING

Fund accounting serves any non-profit organization or the public sector. These organizations have a need for special reporting to financial statements users that show how money is spent, rather than how much profit was earned.

System used by nonprofit organizations, particularly governments. Because there is no profit motive, Accountability is measured instead of profitability. The main purpose is stewardship of financial resources received and expended in compliance with legal requirements. Financial reporting is directed at the public rather than investors.

The accounting equation is **Assets = Restrictions on Assets**.

Funds are established to ensure accountability and expenditure for designated purposes. Revenues must be raised and expended in accordance with special regulations and restrictions. Budgets are adopted and recorded in the accounts of the related fund. Contractual obligations are given effect in some funds.

#### ENTITY THEORY

View in which a business or other organization has a separate accountability of its own.

It is based on the equation:

#### Assets = Liabilities + Stockholders' Equity

The entity theory considers liabilities as equities with different rights and legal standing in the business. Under the theory, assets, obligations, revenues, and expenses and other financial aspects of the business entity are accounted for separately from its owners. In other words, the company has an identity distinct from its owners or managers. The firm is viewed as an economic and legal unit.





#### ■ Relationship Between entity and fund theory

Both the fund theory will focus on ensuring that assets availed to the entity in question are used appropriately (according to restriction). In the case of fund theory according restriction on assets (without having to make a profit), this will also be the case for entity theory only that in this theory it has to be for maximum profits within the restrictions.

#### 12.3 FINANCIAL ACCOUNTING TECHIQUES

Public sector organizations may adopt different accounting techniques; the most important being:-

#### 1. BUDGETARY ACCOUNTING

Budgetary accounting is the preparation of operating accounts in form of budgets. A budget is a management plan that has been transformed into figures necessary to evaluate the achievement of the organization's objectives.

Under budgetary accounting, the concept is based on the forecasted cash flows; ad operations must be limited to the budget estimates. The organization cannot spend above budget restrictions without parliamentary approval.

The executive branch of the government unit proposes the budget, the legislature branch reviews, modifies and enacts the budget and finally the executive branch implements the budget.

Budget accounting therefore aims to achieve the following:

- a. Ensure efficiency of managers.
- b. Communicate the objectives of the organization to the employees.
- c. Provide controls.
- d. Provide a yardstick for measuring performance of employees.

#### 2. CASH ACCOUNTING

Under this system only cash inflows and outflows are recognized and recorded. The system does not recognize any revenue or expenditure that has not been received or paid (i.e. accrued).

#### 3. ACCRUALS ACCOUNTING

The accruals concept states that revenues and costs are recognized as they are earned and incurred. Most of the organizations in the private sector prefer this method. However, under public sector accounting, both cash and accruals accounting can be used by different entities or kinds of organizations e.g. if part of an organization is charged with the responsibility of running activities on the same basis as commercial organization s, such an entity may adopt accrual accounting irrespective of the accounting techniques adopted by the main organization.

#### 4. COMMITMENT ACCOUNTING

This accounting system recognizes transactions when the organization is committed to them. It means the transaction is not recognized when cash is paid or received, nor when an invoice is received or issued, but at an early stage where orders are received and placed. This accounting method is meant to ensure that government units do not overspend because transactions will only be entered into after checking committed balances.

#### 5. FUND ACCOUNTING

An organization may be composed of various entity funds; each fund will have its own books of account as if it was completely independent from the whole organization.

#### 12.4 ANNUAL ACCOUNTS FOR GOVERNMENT

Every government unit will prepare financial statements to account for the money allocated to them. The financial statements differ according to the nature of the activities undertaken by the government unit. However the following types of accounts are common among government units:

#### 1. INCOME AND EXPENDITURE ACCOUNTS

This is similar to income and expenditure accounts for nonprofit making organizations. It's however prepared by government units, which provide commercial services e.g. a staff canteen or student's welfare



#### 2. STATEMENT OF ASSETS AND LIABILITIES

Just shows the assets and liabilities in the organization.

#### 3. GENERAL ACCOUNTS OF VOTE (GAV)

During a budget speech, the Minister for Finance will give detailed appropriation (allocations) of funds to different governmental units. Through an appropriation bill, Parliament will approve different estimates to individual governmental units. The amount approved to each governmental unit by parliament is then recorded into a particular account known as "General Account of vote" (GAV). This account therefore records funds allocated to various governmental units.

#### 4. THE EXCHEQUER ACCOUNT

All incomes of the government are received and recorded into an account called the "Exchequer account". The total amount available in the exchequer represents the consolidated fund, i.e. the consolidated fund operates an account called exchequer.

#### 5. PAYMASTER GENERAL ACCOUNT (PMG)

The Paymaster General Account (PMG) is the cash account operated by the individual governmental units. It records amounts so far withdrawn from the exchequer.

#### 6. APPROPRIATION- IN- AID (AIA)

AIA is the amount to be generated by the governmental unit from its internal activities. It is subtracted from the gross estimate (gross vote) to arrive at net estimate of (net vote) which is approved by parliament to be released from the consolidated fund. An AIA account may be maintained,

Where: when AIA is received from own operations:

DR PMG account

CR AIA account

At the end of the year:

DR AIA account

CR GAV account



# T. APPROPRIATION ACCOUNT Shows the following in tabular form: Approved estimates Actual expenditure Amounts under-spent Amounts over-spent 8. REVENUE ACCOUNT

A revenue account records only the estimated revenue and actual revenue from each particular revenue source for the governmental unit. The difference between the two, if significant must be explained by the accounting officer. Alternatively the significant difference between two can be used to correct future estimations by the governmental unit. It could also represent new factors emerging during the year which were not taken into account during the previous budget.

#### **CHAPTER SUMMARY**

**IPSAS 1, Presentation of Financial Statements**, sets out the overall considerations for the presentation of financial statements, guidance for the structure of those statements and minimum requirements for their content under the accrual basis of accounting.







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#### **CHAPTER QUIZ**

- 1. Which accounting equation is used in the fund theory?
- 2. Which accounting equation is used in the entity theory?

#### **CHAPTER QUIZ ANSWERS**

- 1. The accounting equation is **Assets = Restrictions on Assets**
- 2. Assets = Liabilities + Stockholders' Equity

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# CHAPTER THIRTEEN



ANSWERS TO EXAM TYPE QUESTIONS

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# ANSWERS TO EXAM TYPE OF THE QUESTIONS

#### **CHAPTER ONE**

#### **Question One**

#### Mary Statement of financial position as at

31.12.2003		
Non current assets	Sh <del>.</del>	Sh <del>.</del>
Freehold premises		25,000
Plant		12,000
		37,000
Current assets W1		
Stock	8,000	
Debtors	7,000	
Cash at Bank	1,000	
Cash in hand	6,000	
		22,000
		59,000
Capital [34,000 + 5,000 - 10,000] W2		29,000
Non current liabilities		
Loan from bank		20,000
Current liabilities		
Creditors W4		10,000
		59,000

#### **Workings**

**W**1

Stock: 11,000 + 34,000 - 37,000= 8,000Cash at bank: 5,000 - 16,000 - 2,000 - 1,000 - 36,000 + 54,000 - 3,000 = 1,000Cash hand: 3,000 - 10,000 + 9,000 + 16.000 - 10,000

#### W2

Capital	Sh <del>.</del>
Balance b/f	34,000
Add profit W3	5,000
	39,000
Less drawings	(10,000)
	29,000
W3	
Profit:	
Sales	60,000
Cost of sales	(37,000)
Electricity	(2,000)
Rates	(1,000)
Wages	(10,000)
Sundry expenses	(2,000)
Bank interest	(3,000)
Net profit	5,000

#### W4

Creditors = 12,000 + 34,000 - 36,000 = 10,000

#### **Question Two**

Accounting is defined as the process of identifying, measuring and reporting economic information to the users of this information to permit informed judgment

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Many businesses carry out transactions. Some of these transactions have a financial implication i.e. either cash is received or paid out. Examples of these transactions include selling goods, buying goods, paying employees and so many others.

Accounting is involved with identifying these transactions measuring (attaching a value) and reporting on these transactions. If a firm employs a new staff member then this may not be an accounting transaction. However when the firm pays the employee salary, then this is related to accounting as cash involved. This has an economic impact on the organization and will be recorded for accounting purposes. A process is put in place to collect and record this information; it is then classified and summarized so that it can be reported to the interested parties.

#### **Accounting equation**

A business owns properties. These properties are called assets. The assets are the business resources that enable it to trade and carry out trading. They are financed or funded by the owners of the business who put in funds.

These funds, including assets that the owner may put is called capital. Other persons who are not owners of the firm may also finance assets. Funds from these other sources are called liabilities.

The total assets must be equal to the total funding i.e. both from owners and non-owners. This is expressed in form of accounting equation, which is stated as follows:

ASSETS = LIABILITIES + CAPITAL





		ANSWERS TO EXAM TY	PE QUESTIONS	3 discom
			.0	, CO,
Profit is determined by redra	ofting the second s	ection of the Statement of finan	cial position	
•	•		ciai position.	
Remember that net assets w	vill be the same as	capital.	m	
Opening and closing capital	are determined as	s follows:		
01.01.2003		31.12.2003		
Non –Current Assets	Sh <del>.</del>	Non – Current Assets	Sh <del>.</del>	
Property	20,000	Property	20,000	
Machinery	6,000	Machinery	9,000	
Ç	26,000	,	29,000	
Current Assets:		Current Assets:		
Debtors	4,000	Debtors	8,000	
Cash	1,000	Cash	1,500	
	5,000		9,500	
Total assets	31,000	Total assets	38,500	
Current Liabilities:		Current Liabilities:		
Creditors	5,000	Creditors	3,000	
Overdraft	6,000	Overdraft	9,000	
	11,000		12,000	
Net assets	20,000	Net assets	26,500	
Opening capital	20,000	Closing capital	26,500	  - 

	Sh
Opening Capital	20,000
Add additional capital	5,000
Add net profit (Missing figure)	6,000
	31,000
Less drawings	(4,500)
Closing Capital	26,500

Profit may be also computed as follows:

Using the extended accounting equation

Net profit = closing capital (net assets) – opening capital + drawings – additional capital

$$= 26,500 - 20,000 + 4,500 - 5,000$$

= Sh 6,000

#### **CHAPTER 2**

#### **Question 1**

#### **Skates**

#### Trading, Statement of comprehensive income for the year ended 31 September 2002

Sales Less: returns outwards	Sh <del>.</del>	Sh <del>.</del>	Sh- 13,090,000 (55,000) 13,035,000
Cost of sales:			
Opening stock		2,391,000	
Purchases	9,210,000		
Add carriage inwards	<u>21,500</u>		
	9,231,500		
Less returns outwards	(30,700)	9,200,800	
		11,591,800	
Less closing stock		<u>(2,747,500)</u>	(8,844,300)
			4,190,700
Less expenses			
Wages and salaries		1,282,000	
Carriage outwards		30,900	
Motor expenses		163,000	
Rent and rates		297,000	
Telephone		40,500	
Insurance		49,200	
Office expenses		137,700	
Sundries		<u>28,400</u>	(2,027,700)
Net profit		<u>20,400</u>	_2,163,000
ινοι ρισιιι			_2,100,000

#### **Skates**

#### Statement of financial position as at 30 September 2002

Non current assets Office equipment Motor van	Sh <del>.</del>	Sh-	Sh <del>.</del> 625,000 <u>410,000</u> 1,035,000
Current assets Stocks Debtors Bank Cash Current liabilities		2,747,500 1,239,000 <u>311,500</u> <u>29,500</u> 4,318,500	1,030,000
Creditors		(937,000)	3,381,500 4,416,500
Capital Add net profit			3,095,500 2,163,000
Less drawings			5,258,500 (842,000) 4,416,500





# **Question 2**

Cash Book"							
	Disct	Cash	Bank		Disct	Cash	Bank
Bank							
Bal b/d		230	4756	Rent			120
R Burton	7		133	N Black	9		351
E Taylor	11		209	P Towers	12		468
R Harris	15		285	C Rowse	20		780
J Cotton: loan			1000	Motor expenses		44	
H Hankins	3		74	Wages	160		
C Winston	13			Cash			350
R Wison & Son	17		323	Drawings		120	
H Winter	23			T Briers	7	133	
Bank		350		Fixtures			650
Commission			88	Balances c/d		123	4833
	89	580	7,552		48	580	7,552

# Discounts Received

3/1 Sundry Creditors 48

# Discounts Allowed

3/1	Sundry Debtors	89		

# CHAPTER 3

# **Question 1**

# **Mary Carter**

# Statement of financial position as at 31.12.2001

Non current assets Freehold premises Plant	Sh <del>.</del>	Sh <del>.</del>	Sh <del>.</del> 25,000 12,000 37,000
Current assets Stock Debtors Cash at Bank Cash in hand		8,000 7,000 1,000 <u>6,000</u> 22,000	37,000
Current liabilities Creditors		(10,000)	12,000 49,000
Capital [34,000 + 5,000 10,000]	-		29,000
Non current liabilities Loan from bank			20,000 49,000

# **Workings**

Stock: 11,000 + 34,000 - 37,000 = 8,000Debtors: 10,000 + 51,000 - 54,000 = 7,000

Cash at bank: 5,000 - 16,000 - 2,000 - 1,000 - 36,000 + 54,000 - 3,000 = 1,000

Cash hand: 3,000 - 10,000 + 9,000 + 16,000 - 10,000 - 2,000 = 6,000

### Capital

Bal b/f	34,000
Add profit	_5,000
•	39,000
Less drawings	(10,000)
· ·	29,000
Profit:	
Sales	60,000

 Sales
 60,000

 Cost of sales
 (37,000)

 Electricity
 (2,000)

 Rates
 (1,000)

 Wages
 (10,000)

 Sundry expenses
 (2,000)

 Bank interest
 (3,000)

 Net profit
 5,000

Creditors

$$= 12,000 + 34,000 - 36,000 = 10,000$$

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# CHAPTER 4

# QUESTION 1 (December, 2006 Q 1)

# (a) Baraka

# Statement of comprehensive income for year to 30 September 2006

	Sh ".000"	Sh".000"
Sales: Cash	4,814	
Credit	<u>584</u>	5,398
Cost of sales:		
Purchases	4,121	
Less: Closing inventory	(360)	<u>(3,761)</u>
Gross profit		1,637
Expenses		
Wages	410	
Rent and rates	100	
Lighting expenses	50	
Insurance	20	
Stationery and postage	26	
Sundry expenses	56	
Bank charges	110	
Depreciation: Premises	50	
Fixtures and fittings	<u>30</u>	<u>(852)</u>
Net profit		<u>785</u>

# (b) Baraka

# Statement of financial position as at 30 September 2006

Non Current assets	Sh <del>.</del> "000"	Sh " <del>.</del> 000"	Sh <del>.</del> "000"
Premises	2,500	(50)	2,450
Fixtures and fittings	<u>300</u>	<u>(30)</u>	<u>270</u>
	<u>2,800</u>	<u>80</u>	2,720
Current assets			
Inventory		360	
Receivables		177	
Prepayments		20	
Cash at bank		493	
Cash in hand		<u>10</u>	
		1,060	
Current liabilities			
Payables	403		
Accrued expenses	<u>16</u>	<u>(419)</u>	641
			3,361
Capital			3,176
Net profit for year			<u>785</u>
			3361
Less: Drawings			<u>(600</u> )
Ţ			<u>3,361</u>

# Workings

# 1.

# **Cash and Bank**

FINANCIAI	LACCOUI	NTING				asomornsinoji.co <sup>4</sup>
Workings 1.		Cash an	nd Bank		nnik	,2501
	Cash	Bank		Cash	Bank	
	Sh.000	Sh.000		Sh.000	Sh.000	
Capital	500		Cash Contra		20	
Bank contra	20		Fixtures and fittings		300	
Suppliers		10	Suppliers – purchases		3,728	
Customers		382	Insurance of inventory		40	
Banking-contra		3,769	Bank charges		110	
Customers			Wages	400		
Uncredited amount		30	Lighting expenses	50		
Cash sales	4,814		Drawings	600		
			Bank contra	3,769		
			Bal. c/d (inclusive-5000)	15	493	
	4,834	4,691		4,834	4,691	

# 2.

# Receivables

	Sh.000		Sh.000
Sales	584	Cash	382
		Cash	30
		Balance c/d	172
	584		584

# 3.

	Sh.000		Sh.000	
Cash	3,728	Cash	10	
Balance c/d	403	Purchases	4,121	
	4,131		4,131	

# 4.

	Sh.000		Sh.000
		Premises	2,500
		Cash at bank	500
		Rent and rates	100
		Lighting expenses	50
Balance c/d	3,176	Stationery and postag	e 26
	3,176		3,176





# **CHAPTER 5**

# **Question 1 (June 2006 Question2)**

(a)

# **Umoja Women's Welfare Society**

Water tank statement of comprehensive income for the year ended 30 April 2006

	Sh <del>.</del> '000'
Sales	45,000
Cost of sales	<u>(41,000</u> )
Gross profit	4,000
Selling expenses	(2,000)
Net profit	<u>2,000</u>

(b)

# **Umoja Women's Welfare Society**

# Income and expenditure account for the year ended 30 April 2006

Income	Sh .'000'	Sh .'000'
Net profit from water tank		2,000
Subscriptions		9,100
Raffle tickets		2,800
Donations from members		2,500
Membership fees		<u>800</u>
		17,200
Expenditure		
Office expenses (4,100+400)	4,500	
Rent - Office	4,000	
Depreciation of Motor vehicle	200	^
Raffle prizes paid	1,200	16,2
Cost of raffle tickets	<u>300</u>	<u>(10,200</u> )
Surplus for the year		<u>7,000</u>

(c)

# **Umoja Women's Welfare Society**

# Statement of financial position as at 30 April 2006

Non current assets	Sh '000'	Sh .'000'	Sh .'000'
Machinery	22,000	(6,100)	15,900
Motor Vehicles	10,000	(5,000)	<u>5,000</u>
	32,000	<u>11,100</u>	20,900
Current assets			
Raw materials		20,000	
Subscriptions receivable		2,000	
Cash at bank		<u>500</u>	
		22,500	
Current liabilities			
Payables	2,800		
Subscriptions paid in advance	1,500		
Accrued office expenses	<u>400</u>	(4,700)	<u>17,800</u>
			<u>38,700</u>
Accumulated fund b/f			25,000
Surplus for the year			7,000
			32,000
Membership fees fund (see			6,700
note)			
			<u>38,700</u>

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# Note on Membership fees fund

Note number 3 on the membership fee fund is ambiguous. The examiner does not indicate clearly the source of the fund (whether it is from the surplus from the period, whether there are donations made or whether it is funded by the members of the society). Therefore we have ignored the note, but other alternatives may apply and this will depend on the assumption. For example if we assume that the members are meant to fund the amount of Sh 800,000, then we can increase the fund to Sh 7,500,000 and have a receivable of Sh 800,000 as part of the current assets.

# Other workings

# (i) Cost of sales

	Sh.'000'	
Raw materials used	35,000	. 1
Factory wages	600	3,
Factory overheads	1,000	16
Factory rent	1,000	2
Factory staff bonus	1,500	<b>O</b>
Depreciation – Machinery (5%X22m)	1,100	
- Motor vehicles (80% X1m)	<u>800</u>	
	<u>41,000</u>	





### (ii) **Subscriptions**

All on		ANSWERS TO	EXAM TYPE QUESTIONS	3,34,04,
			250	roll.
(ii) Subsc	riptions		w.Mc	
Balance b/d		Sh.'000' 3,500 Balance b/d	Sh.'000 <sup>31N</sup> .Ma <sup>S</sup> O 2,100	
Income & (bal)	Expenditure	9,100 Cash	10,000	
Balance c/d		1,500 Balance c/d	<u>2,000</u>	
		<u>14,100</u>	<u>14,100</u>	

# **Question 2**

# Workings

# Wk 1

# **Statement of affairs**

# Bakari Sailors club

# As at 1<sup>st</sup> June 2006

Assets	Sh.'000'	Sh <u>-</u> '000'
Repairs workshop	5,000	
Freehold premises	40,000	
Boatyard and lunch facility	8,000	
Fixtures and fittings	3,000	
Club-owned boats and yachts	35,000	91,000
Members subscription accrued	,	400
Bank balance '		11,070
Bar stocks		3,100
		105,570
Liabilities		
Members subscription prepaid		560
Creditors for bar		500
Accumulated fund (bal., fig)		104,510
( 3)		105,570

# Wk 2

Disposal of boat

Net book value	2,000,000
Cash	(200,000)
Less to income and expenditure a/c	1.800.000

# Wk 3

Depreciation (reducing balance)		'000'
Free hold premises	40,000 x 5%	2,000
Boatyard and Lunch facility	8,000 x 5%	400
Fixtures and fittings	300 x 10%	300
Repairs Workshop	5,000 x 10%	500



# Wk 4

Bar trading account for the year ended 31st May 07

•	Sh '000'	Sh. '000'
Bar sales		8,000
Opening inventory	3,100	
Purchases (5,010 + 610)	5,620	
Closing inventory	(2,850)	<u>(5,870)</u>
Bar gross profit		2,130
Less bar wages (35 + 1,260)		(1,295)
Bar Net profit		<u>835</u>

# Wk 5

Repair of boats 320
Receipts and payments 1,920
2,240

# Wk 6

120% - 1,960 100% - ? 20% - ? (20 x 1960)/ 120 = 81.75 = 82

# Wk 7

# Club owned boats and yachts

Balance b/d	35,000	Disposal	2,000
Receipts and payments 5,000		Depreciation	2,050
Fixtures & fittings	3,000	Bal c/ld 38,950	

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# Bahari Sailors club Income and expenditure a/c

# For year 31<sup>st</sup> May 2007

	Sh '000'	Sh '000'
Incomes		
Subscription W7	20,370	
Bar profits W3	835	
Receipts from training school	2,050	
Boat hire charges M.	900	
W.M	1,960	
Yacht racing	<u>3,080</u>	29,195
Expenses		
Repairs of boats Wk 4	2,240	
Donations Wk 5	82	
Depreciation Club owned Wk 6	2, 050	
Premises	2,000	
Boat yard and lunch facility	400	
I and F	300	
Repairs workshop	500	
Loss on disposal	1,800	
Yacht racing competition	1,870	
Salaries	1,500	
General expenses	2,200	<u>(14,942)</u>
		<u>14,303</u>

# Bahari Sailors club Statement of financial position

# As at 31<sup>st</sup> May 2007

	Sh '000'	Sh '000'
Non-current assets (N B V)		
Repairs workshop	5,000	
Depreciation	(500)	4500
Free hold Premises	40,000	
Depreciation	(2,000)	38000
Boat facility L.F	8,000	
Depreciation	(400)	7600
F&F	3,000	
Depreciation	(300)	2700
N.B.V. (W6)		<u>38,950</u>
		91,750
Current Assets		
Bar stocks	2,850	
Accrued subscription	350	
Bank balance	28,590	
Current Liabilities		
Donations	(82)	
Creditors (610+35+320)	(965)	
Prepaid subscription	<u>(790)</u>	<u>29,953</u>
·		121,703
Accumulated fund	104,510	
Surplus	14,313	
Donated boat	3,000	121,703
Donatou boat	3,000	121,703

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# **CHAPTER 6**

# **Question 1 (December 2007 Question2)**

# Taba Ltd Manufacturing Trading and loss a/c for the year ended 31 October 2006

Raw materials	Sh'000'	Sh'000'
Opening stock of R .M	1,200	
Purchases of R.M	<u>16,400</u>	
Cost of R.M available for use	17,600	
Less: closing stock of R.M	<u>(1,400)</u>	
Raw materials consumed	16,200	
Direct manufacturing wages	<u>18,000</u>	
PRIME COST	34,200	
Factory overheads		
Production overheads	10,400	
Depreciation plant	3,200	-
Depreciation Business premises	800	-
Depreciation M. Vehicle	500	<u>14,900</u>
Total cost of production	19,100	
Add: Opening W.I.P	800	
Less: Closing W.I.P	<u>(1,700)</u>	
Cost of finished goods	48,200	
Sales	67,100	
Less: Proceeds from sale of plant	(600)	
	66,500	
Less: cost of sales		
Opening stock	1,600	
Add: Cost of finished goods	48,200	
	19,800	
Less: Closing stock of finished goods	<u>(1,300)</u>	<u>48,500</u>
Gross profit	18,000	
Less: Expenses: Loss on disposal	200	
Administration o/heads (4,900 + 250)	5,150	^
Selling O/heads (2,600 + 250)	<u>2,850</u>	(8,200)
Net profit	9,800	116
		(8,200)
		$\sim$

Taba Ltd
Statement of financial position as at 31 October 2006

Non-current assets	Cost	Acc. Depreciation	NBV
		•	
Business premises	20,000	4,000	16,000
Plant and equipment	18,000	12,200	5,800
Motor vehicle	6,400	3,400	<u>3,000</u>
			24,800
Current assets			
Trade receivables		4,600	
Cash in hand		300	
Bank Balance		32,900	
Stock: Raw materials		1,400	
Work in progress		1,700	
Finished goods		<u>1,200</u>	
		40,000	
Current liabilities			
Trade payables	2,800		
Other payables: PAYE	1,300		
VAT	2,800	(6,900)	33,300
			<u>58,100</u>
Ordinary share capital			15,000
•			•
Share premium		20.200	5,000
Retained earnings b/f		28,300	
Profit for the year		9,800	
Retained earnings c/f			<u>38,100</u>
			58,100

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# **Question 2 (June 2003 Question 1)**

# **LIMURU MANUFACTURERS**

# MANUFACTURING ACCOUNT FOR THE YEAR ENDED 31 ST DEC 2002

	Sh'000	Sh'000
Opening stock of raw materials		7,000
Add: Purchases of raw materials		38,000
Less Closing stock of raw materials		<u>(9,000)</u>
Cost of raw materials consumed		36,000
Direct labour		<u>31,000</u>
PRIME COST		67,000
Add: Factory overheads		
Variable & fixed	25,000	
Depreciation of plant & machinery	_3,000	<u>28,000</u>
		95,000
Add: Opening WIP		5,000
Less: Closing WIP		_(8,000)
Production cost		92,000
Add: Manufacturing profit (25% Production cost)		_23,000
Market value of manufactured goods		<u>115,000</u>

# LIMURU

# STATEMENT OF COMPREHENSIVE INCOME

# FOR THE YEAR ENDED 31 DEC 2002

	Sh'000	Sh'000
Sales		192,000
Less Cost of sales		
Opening stock finished goods	6,900	
Market value of goods produced	115,000	
Less Closing stock of finished goods	(10,350)	<u>(111,550)</u>
Gross profit		80,450
Add: Manufacturing profit		_23,000
		103,450
Less: Expenses		
Rent & rates	17,000	
Lighting	6,000	
Stationery & postage	2,000	
Staff salaries	19,380	
Depreciation of motor vehicles	4,000	3
Motor vehicle running costs	<u>4,500</u>	(52,880)
	. (	<b>%</b> 50,570
Add: Opening stock figure - unrealized profit	$\sim$	1,380
Less: Closing stock figure – unrealized profit		(2,070)
Net profit		<u>49,880</u>

### LIMURU MANUFACTURERS

BALANCESHEET

AS AT 31<sup>ST</sup> DECEMBER 2002

	Sh'000	Sh'000
NON CURRENT ASSETS Plant and machinery Motor vehicles	15,000 8,000	15,000 <u>8,000</u> 23,000
CURRENT ASSETS Stock: Raw materials WIP Finished goods Less; provision for unrealized profit Debtors Prepayments	9,000 8,000 8,280 28,000 2,000	23,000
Bank	16,600	<u>71,880</u>
TOTAL ASSETS		<u>94,880</u>
EQUITY & LIABILITIES Capital Opening balance Add: Net profit Less: Drawings		48,000 49,880 (11,500) 86,380
CURRENT LIABILITIES Creditors Accruals TOTAL EQUITY & LIABILITIES	5,500 3,000	<u>8,500</u> <u>94,880</u>

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### **CHAPTER 7**

# Question 1 (June 2006 Question 4)

- (a) Goodwill is that advantage that an existing business may have over a newly established business. The advantage is in the form of the ability to generate revenue and profits as a result for example customer loyalty, location and marketing.
- (i) On admission of a new partner, the new partner will start enjoying the benefits of the existing partnership as a result of the goodwill created by the previous partners. The newly admitted partner should therefore pay for his share of the goodwill.
- (ii) On retirement of one of the partners, the remaining partners will continue enjoying the benefits that the retired partner helped create. Therefore it will be important for the retiring partner to be paid his share of the goodwill.





(b)

# Akili, Busara and Chema

# Trading, profit, loss and appropriation account for the year ended 30April 2006

Sales (20-0.6) Cost of sales					Sh'000'	<b>Sh'000'</b> 19,400
Opening Purchases	Inventory				3,000 <u>10,300</u> 13,300	
Closing Gross profit	Inventory				(2,600)	(10,700) 8,700
Expenses Interest(10% Operating	X 3m)				300 6,400	<u>(6,700)</u>
Net profit	1 <sup>st</sup> six	Months	2 <sup>nd</sup> six	Months		2,000
Int. on cap.		1000		1000	_	2000
A B C	62.5 50 <u>25</u>	(137.5) 862.5	71.5 71 <u>49</u>	<u>(197.5)</u> 802.5	140 121 <u>74</u>	(335) 1,665
Salaries A B C	0 120		0 60		0 180	,
Balance	<u>0</u> 247.5	<u>(120)</u> 742.5	60 341.25	<u>(120)</u> 682.5	60 588.75	(240) 1,425
A B C	247.5 247.5 <u>247.5</u>	(742.5) <u>0</u>	204.75 136.5	(682.5) <u>0</u>	453.25 384	(1,425) 0

(b)

# **Capital account**

	Α	В	C		A	В	С
	Sh.'000'	Sh.'000'	Sh.'000'		Sh.'000'	Sh.'000'	Sh.'000'
Goodwill	600	360	240	Bal.b/d	2,500	2,000	1,000
				Goodwill	400	400	400
Bal.c/d	3,100	2,840	<u>1,960</u>	Rev.gain	800	800	800
	3,700	3,200	2,200		3,700	3,200	2,200

# **Current account**

							^
	Α	В	С		A	В	C
	Sh.'000'	Sh.'000'	Sh.'000'		Sh.'000'	Sh.'000'	Sh. 000'
Drawings	300	400	200	Bal.b/d	200	3,00	200
				Intcap	140	120	74
				Salaries	0	180	60
				Profits	588.75	452.25	
Bal.c/d	628.75	753.25	<u>718</u>	Int.Loan	0	100	200
	3,700	3,200	2,200		3,700	3,200	2,200

(c)

# Akili, Busara and Chema

# Statement of financial position as at 30 April 2006

F I N A N C I A L A C C O U N T I N G			sindi.com				
Akili, B	Busara and Chema	<u>~</u>	an masomon sindi.com				
Statement of financial position as at 30 April 2006							
Non Current assets	Sh.'000'	Sh.'000'	Sh.'000'				
Land and buildings	8,000	0	8,400				
Plant and Machinery	<u>7,000</u>	(4,000)	<u>3,000</u>				
	15,000	(4,000)	11,400				
Current assets							
Inventory (2,400+200)		2,600					
Receivables		<u>3,400</u>					
		6,000					
Current liabilities							
Bank Overdraft	1,100	:: 100\					
Payables	<u>3,300</u>	<u>(4,400)</u>	<u>1,600</u>				
O with A committee			<u>13,000</u>				
Capital Accounts			2 400				
Akili Busara			3,100 2,840				
Chema			•				
Cilettia			<u>1,960</u> 7,900				
Current account			7,000				
Akili		628.75					
Busara		753.25					
Chema		<u>718</u>	<u>2,100</u>				
			10,000				
Non current liabilities							
10% Loan : Busara		1,000					
: Chema		<u>2,000</u>	<u>3,000</u>				
			<u>13,000</u>				







# a) Statement of comprehensive income for the year ended 30 September 2006

		Sh <u>".</u> 000"	Sh ".000"
Sales:			
1 October 2005 to 31 March 2	2006		14,000
1 April 2006 to September 20	06		21,000
			35,000
Opening Inventory		4,800	
Purchases (16,400 + 200)		16,600	
		21,400	
Closing inventory		(5,100)	(16,300)
Gross profit			18,700
·		Six months 1.10.2005	•
0 (", ( )", (, (, (, (, (, (, (, (, (, (, (, (, (,		to 31.3.2006)	to 30.9. 2006)
Gross profit (ratio of 14:21)		(7,480)	(11,220)
Expenses:			
Salaries (5,200 – 1,330)		(1,935)	(1,935)
Rent, rates and electricity 1,240 + 600 +60 – 260)		(820)	(820)
Shop wages		(1,100)	(1,100)
Professional charges (420-21	0)	(110)	(110)
General expenses (2,640 – 12	,	(1,410)	(1,110)
Depreciation: Motor vehicles 6	,	(340)	(340)
Shop fittings	60	(30)	(30)
Amortization of lease		(00)	(33)
(1/25 x (6,000 +200)		(124)	(124)
Provision for doubtful debts		(120)	(40)
Net profit (Shared in PSR)		1,491	<u>5,611</u>
Net profit (Ghared III i Git)		<u>1,<del>4</del>31</u>	<u> </u>
Grace 2	: 2	994	2,244.4
Beatrice 1	: 2	497	2,244.4
Catherine 0	: 1	0	1,122.2



# b) Statement of financial position as at 30 September 2006

FIN A N C I A L A C C O U N T I N G				asomornising).com
				OI,
b) Statement of financial position a	as at 30 Septer	mber 2006	wile,	a50th
	Cost	Depreciation	Net book value	
	Sh '.000'	Sh '.000'	Sh '.000'	
Non-Current Assets:				
Leasehold premises	6,200	248	5,952	
Motor vehicles	3,400	1,880	1,520	
Shop fittings	1,200	460	740	
	10,800	2,588	8,212	
Current Assets:				1
Stocks		5100		
Accounts receivable	<u> </u>	<u></u>		
(900 – 180)	760			
Provision for bad debts	160	560		
Prepayments	+	260		
Cash at bank	+	9.280	15,300	
Suspense	+	100	23,512	
Capital:	†	-		
Fixed capital				

Grace		3,000
Beatrice		2,000
Catherine		<u>1,500</u>
		6,500
Current account		
Grace	7,438.4	
Beatrice	3,261.4	
Catherine	<u>1,972.2</u>	
		12,672
Accounts payable (4,280+60		<u>4, 340</u>
		23,512

# c) Current accounts

	G	В	С		G	В	С
	Sh '.000'	Sh '.000'	Sh '.000'		Sh '.000'	Sh '.000'	Sh '.000'
Goodwill	4,800	4,800	2,400	Bal. b/d	1,600	1,200	
Drawings	600	480	250	Profit	3,238.4	2,741.4	1,122.2
Bal. c/f	7,438.4	3,261.4	1,972.2	Goodwill	8,000	4,000	2
				Rent		600	6
				Cash		^	3,500
	12,838.4	8,541.4	4,622.2		12,838.4	8,541.4	4,622.2







(a)

# Ali, Bakari, Chando Partnership Profit and loss and appropriation a/c

# As at 31<sup>st</sup> December 2006

	Sh '000'	Sh '000'	Sh '000'
Profit as per draft a/c			55,155
Add			
Reduction in provision for de	preciation		320
			55,475
<u>Less</u>			
Salary to Chando		2,000	
Less loss in stock realization		470	
Provision for bad debts		105	
Drawing of stock		2500	
Depreciation of business pre	mises	200	
Telephone expenses		120	<u>5,395</u>
			50,080
<u>Less</u>			
Interest on capital			
Ali		938	
Bakari		647	
Chando		450	(2,035)
			48,045
Less:			
Salaries			
Bakari		5,500	
Chomba		<u>4,500</u>	<u>10,000</u>
			<u>38,045</u>
Residue profit shared			
Ali (4/7)		21,740	
Bakari (2/7)		10,870	
Chando (1/7)		<u>5,435</u>	<u>38,045</u>



# Ali, Bakari, Chando Partnership Statement of financial position As at 31<sup>st</sup> December 2006

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	Sh '000'	Sh '000'	Sh. '000'
Non-current assets			
Business premises	20,800	200	20,600
Equipment	8,000	5,280	2,720
			23,320
Current assets			
Inventory		12,085	
Account receivable	3,500		
Less provision for bad debts	<u>(105)</u>	3,395	
Cash at bank		<u>8,800</u>	
		24,280	
<b>Current liabilities</b>			
Accounts payable	3,080		
Accruals	<u>2,250</u>	(5,600)	<u>18,800</u>
			<u>42,000</u>
Financed by:			
Capital: Ali		16,400	
Bakari		11,600	
Chando		<u>10,000</u>	38,000
Current accounts			
Ali		1,173	
Bakari		(3,708)	
Chando		<u>1,535</u>	(1,000)
			<u>37,000</u>

(b)			Current a	/c			
Bal b/d Drawings	Ali Sh -'000'	<b>Bakari</b> Sh .'000' 300	Chando Sh .'000'	Balance Interest	Sh .'000' 3,200	Bakari Sh -'000'	Chando Sh -'000'
Stock	23,705 1,000	19,525 900	8,250 600	on capital Salaries	938	647 5,500	450 4,500
Drawing Balance c/d	1,173	900	600	Profit share	21,740	10,870	5,435
	<u>25,878</u>	<u>20,725</u>	<u>10,385</u>	Bal c/d	<u>25,878</u>	3,708 <b>20,725</b>	<u>10,385</u>



# **CHAPTER 8**

# **Question 1 (June 2005 Question 5)**

# a) The importance of Ratio analysis

### I.) Evaluation of performance

By use of ratio analysis, a company is able to compare its present and past performance (vertical analysis) or even with other companies falling in the same industry (horizontal analysis)

### II.) Acts as control

Ratios are at times used as controls by companies. The employees of a company are given goals which they need to attain. At the end of the accounting period their performance is reviewed with an aim of finding what the problem might have been.

### b) Parties interested in the following Ratios

### I) Current Ratio

The current ratio measures the liquidity position of a business. The creditors would be interested in it so as to know the probability of their debt being paid.

# II) Net Profit Margin

This measures the profitability of a company. Almost all parties are interested in this ratio from the company itself to the government, employers, creditor, the general public at large, potential investors etc.,. It helps to know whether to invest in the company i.e. the investors and public; future prospects for the employees etc.

### III) Stock Turnover

This represents how fast the company is able to turn stocks to sales. The company management and even potential investors are interested in this. Further the suppliers would like to know this so as to know how frequently they ought to supply goods.

### c) Brief explanation of the following:

### I) Accounting concepts

These are broad assumptions which underlie preparation of financial statements of a company.

Examples of accounting concepts include the Historical Concept, Prudence, Accrual Basis etc.

# II) Accounting standards

They are authoritative statements of how particular types of transactions and events should be reflected in financial statements. They are developed to achieve comparability of financial information between and among different organizations.

### III) Accounting policies

These are the principles, bases, conventions, rules and practices applied by an entity that specify how the effects of transactions and other events are to be reflected in its financial statements though:

- i) Recognizing
- ii) Selecting measurement basis for a/c
- iii) Presenting assets, liabilities, gains, losses and charges to shareholders funds.

# d) Explanation of Accounting Treatments

# The debtor declared bankrupt

WWW.maschonsindi.com In the books of Mlachake Itd by 31 December 2004, the statement of financial position shows debtor's figure of Sh. 200,000. This was on assumption that such debtors would be recoverable. The declaration of the debtor bankrupt reduced the chances of realization of the debt. However this declaration is done after the statement of financial position date. In accordance to International Financial Reporting Standards, this is an event after the statement of financial position and it provides additional evidence of the conditions as they existed at the statement of financial position date. This therefore is an adjusting event and therefore the following adjustments should be made:

- 75% of the debt (Sh 200,000) should be written off in the statement of comprehensive income as a bad debt
- Bad debts recovered of 25% of Sh 200,000 should be recognized.

However, if the financial statements had been finalized to the point that the reports had been sent to stakeholders and shareholders, then it should be disclosed by way of note.

### II) The inventory which got damaged

Such inventory which has been damaged should be valued at the lower of cost and net realizable value. Further the cost of repairing the inventory should be incorporated in the cost of the inventory. As such, this would be consistent with Accounting Standard No.2 which deals with inventories.

### III) The secured order of Sh 12 million

In accordance to the Prudence concept, revenue/gains are recognized if their realization can be determined with reasonable certainty. In this case, the fact that a foreign based company secured an order for goods to be later demonstrates commitment of the customer to buy the goods. However the commitment is not enough to warrant the recognition of the sale in our books of account.

Therefore it was not proper for the sale to be recognized in December as it was since as at December 19<sup>th</sup> the Sale was still uncertain.

Those goods should only have been recognized for the month of January which is when their sale became certain.

# **Question 2 (December 2005 Question3)**

a)	Purp	poses of ratio analysis
		Assessing the company's financial performance
		To evaluate financial stability of a company
		To predict future performance and stability of a business entity
		To compare performance of the firm with past performance and within the industry.
		To detect and investigate inconsistencies due to errors and fraud.





b)

Ratio	Formula	Sunrise Ltd.	Sunset Ltd.	
i) Acid test ratio	Current asset – Inventory Current Liability	186 – 100 98 = 0.88:1	173 – 87 108 = 0.80:1	
ii) Inventory turnover	Cost of sales Average stock	258 100 = 2.58	153 87 = 1.76	
iii) Average collection period	365 x Average debtors Credit sales	365 x 46 497 = 34 days	365 x 42 371 = 41 days	
iv) Return on capital employed (ROCE)	Profit before interest & tax x 100 Capital employed	157 <sup>*</sup> x 100 230 = 68.2%	79 x 100 157 = 50.3%	
*Note that the operating profit is net of interest expense an this to be arrived at profits before interest. The interest expense must be added back. 19 + 138 = 157*				
v) Debt equity ratio	Debt Capital Equity Capital	33 x100 197 = 17%	0 x 100 197 = 0%	

(c)

(ii)

# (i) Comments on Performance

Shortcomings of relying on analysis in (b) above
is the best and for risk averse investors sunset would be the firm, to invest in.□
Overall sunrise has a better performance but a higher risk and thus for risk takers sunrise
Sunrise Ltd. has a better credit policy.
Sunrise Ltd. has better management of inventory.
Sunset Ltd. has a low gearing and thus less risky with high access to capital market.
Sunrise Ltd. has a better performance gauging by the return on capital employed.

- $\hfill \square$  Ratios are historical since they use past data.
- Comparison of ratios for companies maybe misleading due to different bases adopted e.g. in valuation of stock or depreciation.
- □ Ratios alone do not provide all the information required by users ○
- Ratios computed from inaccurate information will be misleading.

# **CHAPTER 9**

# **Question 1 (June 2007 Question 1)**

a)

i) Share Premium

This arises when a company issues shares at a price that is more than the par value. Revaluation reserve

The unrealized gain when the amount at which non-current assets are carried is increased above last.

- ii) How a company can utilize share premium
  - (i) Finance a fully paid bonus issue
  - (ii) Write off preliminary expenses
  - (iii) Write off expenses or commission paid or discount allowed on any issue of share or debentures.
  - (iv) Provide for premium payable on redemption of redeemable preference shares or debentures.

# b) Workings

(W1)

Dr. hand 69,000,000

Cr. Re-evaluation reserve 69,000,000

**W2** 

Dr. Re evaluation reserve 150,000,000

Cr. Ordinary share 150,000,000

No. of Shares = 150,000,000

10

Total no of share = 165,000,000

# <u>WK3</u>

Salaries & wages	32,100,000
Add Accrued	150,000
	32,250,000

### WK 4

General Expenses 11,900,000 200,000 11,700,000

Insurance premium 200,000 X  $\underline{9}$  = 150,000

12

Prepayment of insurance premium = 50,000









### WK5

Disp	osal	a/c
------	------	-----

		Dispusai arc	· N
Machine A/c	2,000,000	Provision for Depreciation	1,500,000
		Cash	400,000
		Loss on disposal(P&L)	100,000
	2,000,000		2,000,000

7,500,000 Cash at bank Cash in hand 400,000

### WK6

Correction of error

Dr. cash 400,000

> Cr. Suspense 400,000

Dr. Suspense 400,000

> Cr. Cash 400,000

### WK7

Provision for bad debts

Debtors = 48,000,000

Provision = 2 ½ % X 48,000,000 = 1,200,000

# Provision for Bad debts & doubtful debts

P&C Balance c/d	Sh '000' 300,000 1,200,000	Balance b/d	Sh '000' 1,500,000
Dalance C/u	2,000,000		2,000,000

### **WK 8**

Depreciation - Plant & Machinery

10% X 380,000,000

= 38,000,000

### Machine a/c

	Sh '000'		Sh '000'
		Disposal	2,000
Balance c/d	382,000	Balance c/d	380,000
	382,000		382,000

**Provision for Depreciation** 

Disposal Balance c/d	Sh '000' 1,500 <u>122,000</u> <u>123,500</u>	Balance b/d Depreciation	Sh '000' 85,500 38,000 <u>123,500</u>

# W9

700,000

a)

# PATA LTD STATEMENT OF COMPREHENSIVE INCOME A/C FOR THE YEAR ENDEND 31 ST DECEMBER 2006

	Sh '000'	Sh '000	' Sh '000'
Sales			290,000
Less cost of sales			
Opening stock	35,000		
Purchases	165,000		
Add carriage in	<u>1,100</u>	<u>166,100</u>	
		201,100	
Less closing stock		(41,000)	
			<u>(160,100)</u>
Gross profit			129,900
Add incomes			
Discount received		4,600	
Decrease in provision for dou	ıbtful debts	<u>300</u>	
		<u>4,900</u>	
			134,800
Less expenses			
General expenses		11,700	
Insurance premium		150	
Loss and disposal		100	
Depreciation of plant and made	chinery	38,000	
Discount allowed		3,200	
Salaries and wages		32,250	
Electricity		2,900	
Debenture interest		7,000	
Directors fees		12,800	<u>108,000</u>
Profit before tax			26,700
Taxation (corporation tax)			3,000
Profit after tax			23,700
Less transfer to general reser	rve		<u>(5,000)</u>
			18,700
Less: Dividends.			
Preference Dividends: Interim	•	2,000	^
•	roposed	2000	3
Ordinary dividends: Interim pa		7,500	16
Final pro	posed	<u>8,250</u>	19,750
Retained Profit for the year			(1,050)
Retained earnings b/d			35,000
Retained earnings c/d			<u>33,950</u>

100,000

492,950



b)



7% Debenture interest

	ANSWE	ERS TO EXAM T	YPE QUESTIONS	3 By Com
			wind.	Olyon 310 A Coly
	Pata Ltd		in	
	of financial pos			
	t December 20 Sh '000'	906 Sh '000'	Sh '000'	
Non –Current assets				
Land	180,000	-	180,000	
Plant and machinery	380,000	122,000	<u>258,000</u> 438,000	
Current assets				
Stock		41,000		
Account receivable	48,000			
Less provision for bad debts	<u>(1200</u> )	46,800		
Prepaid insurance premium		50		
Cash at bank		<u>7,500</u> 95,350		
Current liabilities				
Account payable	27,000			⊢
Proposed dividends: ordinary Preference	8,250 2,000			⊢   ⊢   ×
Tax payable	3,000			<b>&gt;</b>
Accrued wages	<u>150</u>	(40,400)	<u>54,950</u> <b>492,950</b>	STUDY
Financed by: Authorized share capital issued				
Ordinary share capital of Sh.10 ea	ch		165,000	
8% preference share capital of Sh			50,000 215,000	
Capital reserve				
Share premium		20,000		
Revaluation reserve		<u>54,000</u>	74,000	
Capital Redemption reserve		70.000		
General reserve		70,000	402.050	
Statement of comprehensive incor	ne	<u>33,950</u>	103,950	
Non currents liabilities			170	

# 2) Workings

# <u>Wk 1</u>

Interest on capital

 $Ali = 5\% \times 16,000,000 \times 3/12 = 200,000$ 

Bakari =  $5\% \times 10,000,000 \times 3/12 = 125,000$ 

 $= 6\% \times 11,600,000 \times 9/12 = 522,000$ 

647,000

Chando =  $6\% \times 10,000,000 \times 9/12 = 450,000$ 

<u>Wk 2</u>

### Goodwill a/c

'000'	Sh.	'000'	Sh.
Capital a/c: Ali	8,400	Capital: Ali	8,000
Bakari	5,600	Bakari	4000
		Chando	2,000
	<u>14,000</u>		<u>14,000</u>

# Capital a/c

	Sh '000'	Sh -'000'	Sh '000'		Sh -'000'	Sh -'000'	Sh -'000'
Goodwill c/f Balance c/d	Ali 8,000 16,000	Bakari 4,000 11,600	Chando 2,000 10,000	Balance b/d	Ali 16,000 8,400	Bakari 10,000 5,600	Chando
							12,000
	24,400	15,600	12,000		24,400	15,600	12,000

### Wk 3

Salaries:

Bakari = 
$$3/12x 4,000,000 = 1,000,000$$
  
=  $9/12 \times 6,000,000 = \underline{4,500,000}$   
 $\underline{5,500,000}$ 

Chomba =  $9/12 \times 6,000,000 = 4,500,000$ 

# <u>Wk 4</u>

Salaries expense =  $3/12 \times 8,000,000 = 2,000,000$ 



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Loss in sales of stock = 750,000 - 280,000= 470,000

# <u>Wk 6</u>

Provision for bad and doubtful debts

 $= 3\% \times 3,500,000 = 105,000$ 

# <u>Wk 7</u>

Equipment =  $10\% \times 8,000,000 = 800,000 \text{ (wrong provision)}$ 

Correct =  $15\% \times 3,200,000 = 480,000$ 

Reduction in provision for depreciation 320,000

Drawings in goods

= 100,000 + 900,000 + 600,000 = 2,500,000

# **Question 2 (December 2005 Question1)**

# **ARAKA LIMITED**

# STATEMENT OF COMPREHENSIVE INCOME

For the year ended 30/9/2005	Sh. '000'	Sh. '000
Sales Less cost of sales	<b></b> 555	1,312,567
Opening inventory	41,912	
Purchases	839,004 880,916	(0.40.000)
Less closing inventory Gross profit	(62,047)	<u>(818,869)</u> 493,698
Gain on disposal Bad debt recovered		1,375 612
Expenses		495,685
Electricity Motor expenses (4,174 + 412)	6,917 4,586	
Sundry expenses (2,002 + 91) Salaries and wages (121,600 + 36)	2,093 121,636	
Directors' remuneration	48,888	
Bank charges (1,621 + 533) Depreciation: Freehold building W3	2,154 8,620	
Plant and machinery  W3	9,620	
Motor vehicle W3 Bad debts (1,370 + 512)	7,450 1,882	
Provision for bad debts W2 Profit before tax	<u>1,194</u>	(215,040) 280,645
Corporation tax Profit after tax		(131,700) 148,945
Less proposed dividend		<u>(5,000)</u>
Retained profit for the year Retained profit b/f		143,945 <u>296,057</u>
Retained profit c/f		<u>440,002</u>

# Araka Limited Statement of financial position As at 30/9/2005

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	Sh. '000'	Sh. '000'	Sh. '000'
Non-current assets	Cost	Depreciation	NBV
Freehold land	121,500	-	121,500
Freehold buildings	431,000	(77,580)	353,420
Plant and machinery	64,172	(25,694)	38,478
Motor vehicles	29,800	<u>(17,287)</u>	<u>12,513</u>
	<u>646,472</u>	<u>120,561</u>	<u>525,911</u>
Current assets			
Inventory		62,047	
Accounts receivable (59,704 – 1,194)		58,510	
Cash in hand [1,268 – (412 + 91 +36)] N9		729	
Cash at bank (1,210 – 533) N4		677	
		121,963	
Current liabilities			
Accounts payable	21,172		
Tax payable	131,700		
Proposed dividends	5,000	<u>(157,872)</u>	<u>(35,909)</u>
			490,002
Ordinary share			50,000
Retained profits			440,002
			490,002

# **Workings:**

# 1. Gain on sale of motor vehicles

Disposal of vehicles A/c

Dioposai di vellisios 740			
Dr.	Sh.		Cr. Sh. '000'
Cost Profit and loss	<b>'000'</b> 6,500 1,375	Depreciation Bank	4,875 3,000
	<u>7,875</u>		<u>7,875</u>

Depreciation = 6,500 x 25% x 3 years = Sh 4,875

# 2. Accounts receivable

	Sh. '000'	Sn. '000'
As per trial balance		61,074
Less bad debts W/o	1,370	,
General provision 2% x (61,074 – 1,370)	1,194	(2,564)
,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,	, -	58,510

# 3. Depreciation of non-current assets

		SII. UUU
Freehold building	20% x 431,000	<u>8,620</u>
Plant and machinery	20% x[64,172 – 16,074]	9,620
Motor vehicles	25% [28,900 – 6,500 + 7,400]	7,450





# **CHAPTER 10**

# **QUESTION 1**

a) Am	ount of	cash	stolen
-------	---------	------	--------

Cash in hand	129600
Petty cash balance	15260
Reimbursement of petty cash	9740
Cash from sales 14 <sup>th</sup> DecDec	259320 413920
Disbursements	(13690)
Cash in store/Stolen	400.230

### b) Value of stock (at cost) stolen (Sh000)

Opening stock 1 <sup>st</sup> December	32,540
Additional stock	5784

Less stock sold

1<sup>st</sup> December - 6<sup>th</sup> December 5376 7<sup>th</sup> December – 13<sup>th</sup> December 14"' December 3091333

486.667 (8954)29370

Stolen stock (18070)Balance in store <u>11300</u>

# ♦ Value of stolen stock is 18,070,000

### c) Bank Balance

Balance b/f	6,625,080
Cash banked	
1 <sup>st</sup> December – 6 <sup>th</sup> December	1,429,710
7 <sup>th</sup> Dec. – 13 <sup>th</sup> Dec.	1,644,500
Cheques from customers	<u>15,867,110</u>
	25,566,400

# Withdrawals and payments

361590
17118360

(17,489,690) Petty cash 9749 8,076,710 Balance in bank

# **CHAPTER 11**

	FINANCIALACCOUNTING  CHAPTER 11
	CHAPTER 11
QUE	STION 1
(a) Wi	nat benefits will a computerized accounting system bring your company?
	automatic posting automatic reports generation automatic documents printing more accuracy more faster to prepare an accounting report
(b)	What should I be looking for when selecting a computerized package?
	easy to use suitable range of reports capable for the storage to store large amount of data provided security length expandability sufficient field length
(c)	If we get a Sales Ledger package what kind of reports should we expect?
	sales daybook/journal sales invoices sales analysis VAT analysis aged debtor analysis customer mailing lists statement of accounts examinations of accounts details
(d)	What's the difference between a stand-alone package and an integrated package? What are the advantages and disadvantages of each?
	I-alone package is an accounting software that have used to prepare a report and lating of the reports.
	rated package is an accounting software package where the insertion of one record





# Advantages of integrated packages:

- Automatic updating of report faster
- www.masomor Better for a large firm which has large amount of customers and employees - the firm can save more money.

# **Disadvantages**

- Inserted a wrong type of accounting is not easy to correct them
- Difficult to know which employee had done the error
- (e) Our computer support staff say that we'll have to configure the package before we can use it. What do they mean by that? Explain what configuration involves.
  - Configuration the package means that before we used the integrated package, we must match the software and hardware devices.
  - A typical system configuration involved:
    - o company name and address
    - o computer hardware configuration
    - o printer configuration
    - o page format configuration
    - o tax rate
    - o alter user table

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**PAPERSTESTREVISION** 

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# REVISION TEST PAPERS paper 1 on 1

# Test paper 1

# **Question 1**

NMGC Company is issuing one million 7% preference shares of Sh 1 each, payable 10% on application, 20% on allotment, 40% on first call and 30% on second call. Applications are received for 1550 shares. A refund of the money is made in respect of 50 shares, while for the remaining 1500 applied for, an allotment is to be made on the basis of 2 shares for every 3 applied for.

The excess application monies are set off against allotment monies asked for. The remaining requested installments are all paid in full.

You are required to show the journal entries of the above issue and then draw the relevant (20 marks) accounts.

## Question 2

The directors of Chimney, a limited liability company, wish to compare the firm's most recent financial statements with those of the previous year. The company's financial statements are given as follows:

# **Chimney income statements**

	Year ended 31st March	31st March	
Sales Revenue(80% on credit, 20% on	2006 Sh <del>.</del> '000	2007 Sh <del>.</del> '000	
cash)	1,800	2,500	
cost of sales(see note below)	1,200	1,800	1231
Gross Profit	600	700	5
Distribution costs	160	250	

FINANCIALACCOUNTING				www.rasonomsingi.com
				nasomo
Administrative expenses	200		200	mi,
operating profits	240		250	
Finance cost		50	50	-
Profit before tax	190		200	
Income tax expense		44	46	-
Net profit for the year	146		154	-

Note; cost of sales figures are made as

follows

Tollows	Year ended		
	31st March	31st March	
	2006 Sh <del>.</del> '000	2007 Sh. '000	
Opening stock	180	200	
Purchase( all on credit)	1,220	1,960	
	1,400	2,160	
Less closing inventory	200	360	
Cost of sales	1,200	1,800	





# Statements of financial position

As at

	31st Ma Sh <del>.</del> '000	rch 2006 Sh <del>.</del> '000	31st Ma Sh- 000	rch 2007 Sh <del>.</del> '000
Assets	3H <del>-</del> 000	311 <del>.</del> 000	3H <del>-</del> 000	311- 000
Non current assets at cost	3100		3674	
Less accumulated depreciation	1214		1422	
Current assets		1886		2252
Inventory	200		360	
Trade receivables	400		750	
Cash at bank	100	700	120	4000
total assets	_	700 2586	_	1230 3482
iolai assets	_	2300	-	3402
Equities and Liabilities Capital and reserves Issued ordinary share capital* Share premium account* Income statement	1000 400 168		1200 600 322	
moome statement	100	1568	322	2122
Non current liability				
10% Loan notes Current liabilities		500		500
Trade payables	210		380	
Sundry payables	260		430	
Tax payable	48	518	50	860
	_	310	_	000
	_	2586	_	2586

□ \*The additional share capital was issued on 1<sup>st</sup> April, 2006

# **Required**

- a) Calculate, for each of the two years, eight accounting ratios that should assist the directors in their comparison, using the closing figures for the statement of financial position items needed.
   (16 marks)
- b) Comment on the ratios. (4 marks)



FINANCIALACCOUNTING		a trial balance as at 3 December  Sh
		zono.
Question 3		N'ILOS
Chemilil Sugar Company, a leading manufac	cturer of sugar had a	a trial balance as at 31151 December
2006 as follows,		
	Sh	Sh
Delivery van expense	7,500	
Lighting and heating; factory	8,577	
Lighting and heating; office	3,330	
Manufacturing wages	136,410	
General expenses; factory	16,920	
Office	11,448	
Sales representative commission	23,580	
Purchases	117,162	
Rent; factory	14,400	
Office	6,600	
Machinery (cost of Sh 150,000)	97,500	
Office equipment (cost of Sh 45,000	0)33,000	
Office salaries	18,855	
Debtors	85,110	
Creditors		58,350
Bank	40,011	
Sales		409,500
Premises (cost of Sh 150,000)	120,000	
Stocks as at 31 <sup>st</sup> December 2005		
Raw materials	25,695	
Finished goods	88,440	<i>A</i>
Drawings	25,680	412,368
Capital		412,368



# Additional information;

a. Stocks as at 31<sup>st</sup> December 2006:

Raw materials Sh 27,150

Finished goods Sh 93,600

There is no work in progress.

- b. Depreciate machinery for Sh 6,000, equipment for Sh 4,500 and premises for Sh 3,000.
- c. Manufacturing wages due but unpaid at 31<sup>st</sup>December 2006 are Sh. 915, prepaid office rent, Sh 324

# **Required**

Prepare the manufacturing, statement of comprehensive income s for the year ended 31<sup>st</sup> December 2006 and a statement of financial position as at that date.

# **Question 4**

a) List three errors that affect control accounts separately, three that affect ledger balance separately and two that affect both the control accounts and ledger balances.

(8 marks)

b) The balances and transactions affecting Abramovich's control accounts for the month of May 2005 are listed below. You are required to prepare sales ledger and purchases ledger control accounts for the month of May. (12 marks)



	Billion Pounds
Balances as at May 1 <sup>st</sup> , 2005	
Sales ledger	91,230 debit
	2,110 credit
Purchases ledger	44,900 credit
	880 debit
Transactions during May,	
Credit purchases	181,350
Returns outwards	6,290
Banking by customers	273,700
Credit sales	367,550
Discounts received	11,050
Bankings to suppliers	154,130
Contra	30,460
Returns inwards	17,200
Bills of exchange receivable	65,060
Customers' cheques dishonored	4,890
Cash receipts from credit customers	3 42,010
Refunds to customers for overpaym	ents530
Discounts allowed	7,320
Balances as at 31 <sup>st</sup> May, 2005	
Sales ledger	1,360 credit
Purchases ledger	670 debit

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Differentiate between the following terms, giving examples where possible. i Matching concept and Realization concept

- ii. Capital expenditure and Revenue expenditure
- iii. Accrual concept and Prudence concept.
- iv. Profitability ratios and Solvency ratios
- v. Business entity concept and Going concern concept.

# (Each 4 marks)

# Test paper two

# **Question 1**

Victoria J is having problems reconciling her bank account with the cash book as at 31<sup>st</sup> October 2000. Her cashbook at that date had a credit balance of Sh 27,780.

The reconciled bank balance by the books as at November 1<sup>st</sup> 1999was an overdraft of Sh 52,240. The bank statement had a debit balance of Sh 19,740 at 31<sup>st</sup> October 2000.

Victoria J., a boutique operator in Westlands has no enough expertise to reconcile her bank account to her cashbook. She has requested for your expertise with the following information:

a) Cheques in respect to purchase of hair products on the following dates had not yet been presented to the bank prior to 31<sup>st</sup> October 2000:

28<sup>th</sup> August, 2000 3,300

14<sup>th</sup> September, 2000 3,920

25<sup>th</sup> September, 2000 10,520

26<sup>th</sup> September, 2000 400

29<sup>th</sup>October, 2000 1,580

- b) Bank charges of Sh 4,100 have been debited by the bank in the bank statement but no corresponding entries in the cashbook have been made.
- c) A subtotal of the credit side of the cashbook of Sh 444,000 had been carried forward to the subsequent page as Sh 440,400.

- d) In August 2000, Victoria took an 8% loan from Beckham of Sh 138,000. The loan interest payments were to fall due on the 2<sup>nd</sup> of each month, the first one falling due on August 2<sup>nd</sup>. All payments have to be made by standing orders on the due dates, but no payments relating to the payments have been made in the cashbook.
- e) A cheque amounting to Sh 1,580 lodged in the bank on May 31 st 2000 were returned by the bank marked 'refer to drawer'. Though it was not presented to the bank by 31 st October 2000, it was subsequently paid but no adjustments have been made in the cashbook in respect of the return of the cheque by the bank.
- f) A bank lodgment of Sh 18,620on October 6<sup>th</sup> 2000 has been entered in the cashbook as Sh 18,260.

Using your accounting expertise, update Victoria's cashbook balance and reconcile it with the bank statement amount for her as at 31 st October 2000. (20 marks).

# **Question 2**

Merv Fishback, a trader in shipping business had the following financial position on March 1<sup>st</sup>, 2004.

Premises	\$42,000
Motor vehicles	\$41,300
Cash at bank	\$10,500
Cash in hand	\$112
Trade debtors	\$490
Trade creditors	\$420
Stock	\$22,470





a) Enter the entries in the general journal and post the necessary accounts

The following transactions were carried out during the month of March 2004:

- 1. Sold goods on credit to Victor for \$5,800 and to Moore for \$6,100.
- 2. Anthony, a debtor by March 1st 2004 owing \$280 was Declared bankrupt and his debt written off.
- 3. Purchased goods on credit from Rose worth \$1,820 and from Frank for \$3,500
- 4. Paid Charles, the only creditor as at 1<sup>st</sup> March 2004 all his dues by cheque.
- 5. Withdrew \$2,590 from bank for office use.
- 6. Received goods being returns from Moore \$840.
- 7. David, a debtor by March 1<sup>st</sup> 2004 sent a cheque for \$140 and was allowed \$35 cash discount.
- 8. Sold goods for cash amounting to \$9,800.
- 9. Settled Rose's account by cheque, receiving a 10% cash discount.
- 10. Purchased motor vehicle on credit from General Motors company limited for \$21,000
- 11. Paid rent by cash \$392.
- 12. Banked \$9,450.
- 13. Purchased Plant and Machinery for \$11,900 paying by cheque.
- 14. Fishback deposited \$14,000 in the business bank account from his own money and immediately made \$2,800 purchases by cheque.
- 15. Paid wages for \$2,177 by cash.

# Required

- b) Enter the above transactions in the appropriate books of original entry using a triplecolumn cashbook.
- c) Post the entries from the books of original entry to the appropriate ledgers.
- d) Extract a trial balance as at 31 st March, 2005.

- Juni masomonsindi.com
  est Differentiate between the free-floating petty cash system and the imprest system.(5 a) marks)
- b) The petty cashier of Mugo and Farm Company had the following transactions in the month of April 2007.

# April

- 1. Received cash float Sh 35,000
- 2. Paid sundry expenses of Sh 350 and hotel charges of Sh 1,050
- 3. Paid Muhindi's account Sh 1,575
- 4. Settled Gorogoro account Sh.700
- 5. Paid for vehicle fuel Sh 350 and bought office envelopes Sh 525
- 6. Paid sundry expenses Sh 700 and hotel expenses Sh 1,225.
- 7. Made postages worth Sh 875
- 8. Fueled the company's vehicles for Sh 700 and settled Michael's ledger account for Sh 350
- 9. Purchased stationery for Sh 525, fuelled the manager's official car for Sh 350 and paid for hotel charges while on official duty Sh 1,225
- 10. Made sundry expenses Sh 175 and hotel charges Sh 1,575
- 11. Paid for petrol Sh 700, purchased postage stamps Sh 1,050 and settled Mutua's ledger for Sh 1,225.
- 12. Purchased office stationery for Sh 525
- 13. Received an amount to maintain the imprest.

# Required

Enter the above in a petty cashbook with analysis columns for hotel charges, postages and stationery, motor vehicle expenses, sundry and ledger accounts (15 marks)



Maendeleo ya Wanaume Society is a not-for profit organization that arranges for forums for its members. The society also runs school for the members' children. Subscriptions are separate for the school and for general membership. The society has given you the following information for the year ended 31stDecember 2001.

- a) Salaries and wages amounting to Sh 19,000 were outstanding at the start of the year and Sh 15,000 at the year end.
- b) Books for the school were purchased costing Sh 21,800, normally included in postage and stationery in the general accounts of the society.
- c) Salaries and wages paid to the school staff amounted to Sh 13,000
- d) Amounts owing to the society for vacancy adverts were Sh 14,400 at the start of the year and Sh 22,000 at year end.
- e) Sh. 51,800 is owing to suppliers of school stationery at the start of the year and Sh. 55,800 at the end of the year.
- f) Subscriptions for the school for the year of 2001 received in 2000 were Sh 47,600 and for 2002 received in 2001 were Sh 37,000.
- g) The society had office equipment in its assets at the start of the year at a cost of Sh 192,000 and an investment of Sh 878,000 also at cost.
- h) Annual subscriptions received include Sh 7,400 for 2000 and Sh 47,000 for 2002.
- i) Office equipment at the end of the year was valued at Sh 198,000.



Alongside the above information, the society treasurer also hands you the following account for the year ended 31<sup>st</sup> December 2001.

Receipts and P.

Bank halo

Receipts and Payments account				
Rank halanco January	Sh <del>.</del>		Sh <del>.</del>	
Bank balance, January				
1	118,000	School stationery	203,000	
Annual subscriptions	371,000	Society seminar costs	47,000	
Investment income	65,800	Postage and stationery	57,400	
	00.000		4.4.400	
School adverts	89,000	Telephone	14,400	
School subscriptions	189,800	Sundry expenses	57,800	
ochool subscriptions	109,000	Oundry expenses	37,000	
		New equipment	28,000	
		,	_0,000	
		Rent and rates	41,000	
		Salaries and wages	197,000	
		Bank balance,		
	-	December 31	190,000	
	835,600		835,600	

# Required

- a. prepare the statement of comprehensive income for the school for the year ended 31<sup>st</sup> December 2001.(6 marks)
- b. Prepare the general statement of comprehensive income for the same period.(6 marks)
- c. A statement of financial position as at the end of 2001. (8marks)



- a) Name six users of accounting information, the information is useful to each.
- b) Give four advantages of historical cost accounting (4 marks)
- c) Differentiate between a general ledger and the sales ledger. (4 marks)

# Test paper 3

# **Question 1**

- a) Give a brief overview of the accounting process (8 marks)
- b) Write short notes on:
  - i. Purchased goodwill and non-purchased goodwill (4 marks)
  - ii. Bonus shares and rights issue (4 marks)
  - iii. Interim dividends and proposed dividends. (4 marks)

# **Question 2**

(a) The net assets of Altese, a trader, at 1 January 2002 amounted to \$128,000.

During the year to 31 December 2002 Altese introduced a further \$50,000 of capital and made drawings of \$48,000.

At 31 December 2002 Altese's net assets totaled \$184,000.

# Required:

Using this information compute Altese's total profit for the year ended 31 December 2002.

(3 marks)

(b) Senji does not keep proper accounting records, and it is necessary to calculate her that total purchases for the year. Ended 31 January 2003 from the following information.

Trade payables 31 January 2003 from the following information.

31 January 2003 171,250

Payment to suppliers 888,400

Cost of goods taken from inventory by Senji for her personal use 1,000

Refunds received from suppliers 2,400

Discounts received 11,200

# Required:

Compute the figure for purchases for inclusion in Senji's financial statements. (3 marks)

(c) Aluki fixes prices to make a standard gross profit percentage on sales of 331/3%.

The following information for the year ended 31 January 2003 is available to compute her sales total for the year.

Inventory: 1 February 2002 243,000

31 January 2003 261,700

Purchases 595,400

Purchases returns 41,200

# Required:

Calculate the sales figure for the year ended 31 January 2003. (3 marks)

(9 marks)





# **Question three**

(a) The term 'reserves' is frequently found in company statements of financial position.

# Required:

- (i) Explain the meaning of 'reserves' in this context:
- (ii) Give two examples of reserves and explain how each of your examples comes into existence.
- **(b)** A company's issued share capital may be increased by a bonus (capitalization) issue or by a rights issue.

# Required:

Define 'bonus issue' and 'rights issue' and explain the fundamental difference between these two types of share issue.



FIN	A N C I A L A C C O U N T	「IN G				masomensindi.com
						Solution
QUESTION	N FOUR				12.	Was
Extracts fro	om the financial state	ments of Apill	lon for the yea	ars ended 3	31 March 2002 ar	nd 2003
are given b	elow:					
Year ended	d 31 March					
Statement	of comprehensive inc	come	2002		2003	
		Sh	Sh	Sh	Sh	
Sales re	evenue (including ca	sh sales				
(\$300,0	000 in 2002 and \$100	0,000 in 2003	3)	3,100,000	3,800,000	
Cost of	sales					
Openin <sub>(</sub>	g inventory	360,000		540,000		
Purchas	ses (all on credit)	2,080,000		2,580,000		
		2,440,000		3,120,000		
Less: cl	losing inventory	540,000	(1,900,000)	720,000	(2,400,000)	
Gross p	orofit		1,200,000		1,400,000	
Expens	ses		(900,000)		(1,100,000)	
Net prof	fit		300,000		300,000	
Balance SI	heet					
Current ass	sets					
	Inventory	540,000		720,000		
	Trade receivable	s 450,000		700,000		
			990,000		1,420,000	\
Current liab	oilities				1,420,000	
	Trade payables	410,000	690,000		01/10	
	Bank overdraft	20,000	430,000	170,000	860,000	





# Required:

- (a) Calculate the following for each of the two years:
  - **Current ratio**;
  - (ii) Quick ratio (acid test);
  - (iii) Inventory turnover period (use closing inventory);
  - (iv) Average period of credit allowed to customers;
  - (v) Average period of credit taken from suppliers. Calculate items (iii), (iv) and (v) in days.
- (b) Make four brief comments on the changes in the position of the company as revealed by the changes in these ratios and/or in the given figures from the financial statements.

## **QUESTION FIVE**

Mr. Ancentus Okwengo is the sole proprietor of a small business. The following trial balance was extracted from his books at March 2000

> Sh '000' Sh '000'

Capital Land Plant and machinery

Provision on depreciation of plant and machinery Delivery vans Provision for depreciation of delivery vans

Loose tools at valuation on April 1 199nce 9 Stocks on 1 April 1999 **Purchases** 

Loose tools Sales Wages and salaries

Rates and insurance Repairs and maintenance of buildings Sales expenses including vehicle running costs

Electricity and power Industrial training levy Administration expenses

Provision for doubtful debts Debtors and creditors



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# ANSWERS TO TEST PAPERS Question 1 General Jan.

	Debit	Credit
	Sh <del>.</del>	Sh
Bank Application account To record reception of application money	155,000	155,000
Application Bank To record refund on oversubscription	5,000	5,000
Application Allotment to move over application funds to offset allotment receivable	50,000	50,000
Application 7% Preference Share Capital To transfer Application account into 7% Preference share capital	100,000	100,000
account	450,000	
Bank	150,000	
Allotment account To record reception of allotment money		150,000
Allotment account 7% Preference Share Capital To transfer Allotment account into 7% Preference share capital	200,000	200,000
account	400.000	
First call account  7% Preference Share Capital	400,000	400,000
To record the making of the First call		100,000
Bank First Call account To record reception of First Call on Preference shares	400,000	400,000
Second Call account 7% Preference Share Capital To record the making of the Second Call on shares	300,000	300,000
Bank Second Call account To record reception of Second Call monies	300,000	300,000

FINANCIALAC	COUNTING			asomonsinoj.com
				COULO,
	ſ	Bank	76	182
Application Allotment First Call Second Call	155,000 150,000 400,000 300,000	Application Balance c/d	5,000 ann 1,000,000	
<b>C</b> 000 22	1,005,000		1,005,000	
	Applica	ition account		
Bank Allotment	5,000 50,000	Bank	155,000	
7% Preference Share Capital	100,000			
	155,000	]	155,000	
	Allotment	t account	_	
7% Preference Share		Bank	150,000	
Capital	200,000	Application	50,000	
	200,000		200,000	
	First (	Call account		
7% Preference Share Capital	400,000	Bank	400,000	
<del></del>		I Darik		
	Second	Call account		
7% Preference Share Capital	300,000	Bank	30,000	
	7% Preference			
Balance c/d	1,000,000	Application Allotment First Call Second Call	100,000 200,000 400,000 300,000 1,000,000	
			1,000,000	

70.8 days





# **Question two**

:\	Cross profit margin	<u>2006</u>	<u>2007</u>
i)	Gross profit margin 600/1800X 100 700/2500X100	33.30%	28.00%
ii)	operating profit margin 240/1800X100	13.30%	
	250/2500X100		10.00%
iii)	Return on capital employed 190/1568X 100 200/2122X100	12.10%	9.40%
iv)	Current ratio		
	700:518 1230:860	1.35:1	1.43:1
v)	Quick/ Acid test ratio 500:518 870:860	0.96:1	1.01:1
vi)	Inventory turnover(days) 200/1200X 365 360/1800 X 365	60.8 days	73.0 days
vii)	Trade receivables - Average collection p 400/1440 X 365 750/2000 X 365	period in days 101.4 days	136.9 days
	Trade payables - Average time to pay		
viii)	<u>in days</u> 210/1200 X 365	62.8 days	

# b)

380/1960 X 365

- i) Gross profit percentage on sales has declined from 33.3% to 28.0%, a substantial drop. This could possibly be due to a decision to lower prices in order to increase sales revenue, which has risen by38.9%. A drop in the gross profit percentage might be an indicator of possible error or fraud if another explanation such as lowering prices cannot be found.
- ii) Net profit as a percentage of sales revenue is down from 13.3% to 10%. This is a large drop, but not as large as the drop in gross profit percentage. A large rise in distribution costs as a percentage of sales helps to explain this drop.

- Return on capital employed has declined from 12.1% to 9.4%. It is a reflection of the decline in profitability as shown by ratio (ii) above.

  and v) The two liquidity ratios have changed minimally between may be suggesting that the liquidity position is a start of the inventory turns aster.
- vi) faster than the increases in cost of sales and sales revenue. The higher inventory level could be reflecting slowing demand for the company's products towards the end of the period and/ or slackness in the company's inventory control procedures.
- vii) The average receivables collection period has increased considerably from 101.4 days to a higher level of 136.9 days. The increase suggests slackness in the company's credit control and debt collecting procedures.
- viii) There has been a relatively small increase in the average time to pay suppliers. The increase I perhaps due to pressure on the company's liquid resources as a result of increased inventory and trade receivables.

# **CHEMILIL SUGAR COMPANY** MANUFACTURING ACCOUNT

EOD	THE	VEAD	<b>ENDED</b>	24 CT	DEC	EMDED	2006
FUR	INE	IEAR	ENDED	5151	DEG	CIVIBER	ZUUD

FOR THE YEAR ENDED 31ST	DECEMBER	<del>₹ 2006</del>
	Sh-	Sh-
Opening stock of Raw materials add purchases		25,695 117,162
less closing stock of raw materials Cost of Raw materials used		(27,150) 115,707
add direct wages Prime cost		137,325 253,032
Add factory overheads Lighting and heating	8,577	
General expenses Rent	16,920 14,400	
Depreciation on machinery	6,000	_
		45,897
Production cost		298,929





# CHEMILIL SUGAR COMPANY STATEMENT OF COMPREHENSIVE INCOME

FOR THE YEAR ENDED 31ST DECEMBER 2006

FOR THE YEAR ENDED 31ST	<b>DECEMBER</b>	2006
	Sh	Sh
Sales less cost of sales		409,500
Opening stock of finished goods add production cost	88,440 298,929	
less closing stock	(93,600)	
		(294,769)
Gross profit	- -	115,731
less expenses Office salaries	18,855	
General expenses Office rent	11,448 6,276	
Office lighting and heating Commission	3,330 23,580	
Delivery van expenses Depreciation on equipment	7,500 4,500	
Depreciation on premises	3,000	

(78,489)

37,242

# CHEMILIL SUGAR COMPANY STATEMENT OF FINANCIAL POSITION AS AT 31ST

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	DECEMBER 2	006	
Non Current assets	Sh-	Sh.	Sh.
Premises	150,000	33,000	117,000
Machinery	150,000	58,500	91,500
Equipment	45,000	16,500	28,500
	0.45.000	400.000	007.000
add working capital	345,000	108,000	237,000
Current assets			
Stock, finished goods		93,600	
Stock, raw materials		27,150	
Debtors		85,110	
Prepayment Bank		324 40,011	
	•	,	
		246,195	
less current liabilities	50.050	,	
Creditors Accrual	58,350 915		
71001001		59,265	
			186,930
			423,930
Financed by; Capital;			
Capital,			
Opening balance			412,368
add net profit			37,242
less drawings			25,680
			423,930

# **Question 4**

- a) Errors that affect the control accounts
  - ☐ Errors in the totals of the journals; overcastting and undercasting errors
  - Errors of omissions; transactions not recorded in the control accounts
  - ☐ Errors in posting entries in the control accounts e.g. total of sales journal posted to the credit side of the control account





# Errors that affect ledger balances

- Balances omitted from the list or entered wrongly e.g. a debit balance entered as a credit balance

  Arithmetical errors in calculating individual

  Errors :
- ☐ Errors of omission i.e. transactions not recorded in the ledgers

# **Errors that affect both**

- ☐ Error of original entry; when the entry in the journal is incorrect and the incorrect figure is carried forward to the ledger.
- □ Errors of complete omission from both the control accounts and in the ledger balances.

b)

**Sales Ledger Control account** 

			£,
Balance b/d Sales Dishonored cheques Refund			billion 2110 273700 30460 17200
Balance c/d		Bills Receivable Cash receipts	65060 42010
		·	
		Discount allowed Balance c/d	7320 29500
	467360		467360

**Purchases Ledger Control account** 

		£,
154130 6290 30460	Purchases Balance c/d	billion 44900 181350 670
11050 24110 226920		226920
	880 154130 6290 30460 11050 24110	880 Balance b/d 154130 Purchases 6290 Balance c/d 30460 11050 24110



WWW. Masomonsindi.com i) Matching concept states that revenues of a certain period should be compared with the expenses incurred in that period to earn the revenues. It dictates for exclusion of any prior period payments or the payments for future period expenses. It requires recognition of cost as expenses when the goods or services represented by the cost contribute to revenue.

Realization concept states that a sale should be recognized when the event from which it arises has taken place and the receipt of cash from the transaction is reasonably certain. For example, a sale should not be recognized when the order is placed by a prospective customer as there is no confirmation of the sale yet. The placing of an order should not be treated as a sale yet as the customer may decide to cancel the order. Instead the sale should be recognized when the when the sales invoice is prepared or when the goods are delivered to the customer.

Capital expenditure is made when a firm spends money either to buy a new fixed asset ii) or to add to the value of an existing one. Included in such amounts includes the cost of acquiring the asset, installation, delivery costs, legal costs of buying property and any other costs necessary to get the asset in a condition ready for use like testing and inspection fees, architect's fees, demolition costs of a building. Capital expenditure is shown in the Statement of financial position.

Revenue expenditure is incurred when money is spent for the day-to-day running of the business. They are amounts to restore and repair rather than to acquire and install. A repair to an existing motor vehicle is a revenue expenditure because it adds no value but restores the asset to its original value.

iii) In accrual concept, revenues and costs should be recognized when earned or incurred and not when the money is received or paid.

Prudence states that when alternatives exist, the one selected should be that which gives the most cautious presentation of the financial position or result of the business. Assets and profits should not be overstated, but a balance must be achieved to prevent the material overstatement of liabilities and losses. It means that accountants should not anticipate for gains but should provide for losses.

Profitability ratios are used to measure profit growth. Most of the values used to iv) measure the profitability ratio are found in the income statement. Examples include gross profit margin ratio, net profit margin ratio and return on capital employed.

Solvency ratios on the other hand measure a firm's capacity to pay its debts. The debt ratio indicates how much the company owes in relation to its size. It measures the proportion of liabilities to total assets. Gearing ratio measures the company's long-term capital structure. Gearing is the proportion of a company's total capital provided by loan capital as opposed to equity.





v) Business entity concept states that a business is a separate entity, distinct from its owners and managers. It means that the financial affairs of the business should not be mixed with those of its owners and other businesses. For example the withdrawal of a business asset for personal use should be recognized as a withdrawal of capital.

Going concern concept assumes that an enterprise will continue in operational existence for the foreseeable future. It guides the management towards the appropriateness of the financial statements. It means that the business is not assumed to close down, or at least the closure of the business is currently uncertain. The available financial information should be considered for the foreseeable future covering, but not limited to, the twelve months from the reporting date.

# Test paper 2 answers Question 1

**Updated Cashbook** 

	- Puu					
	Sh		SHSSh			
Cashbook error	340	Balance b/d	27780			
		Standing order	2760			
		Dishonored cheques	1560			
		Cashbook error	3600			
Balance c/d	39460	Bank charges	4100			
	39800		31880			

Victoria J
Bank Reconciliation Statement
As at 31st October 2000

Updated cashbook balance	(39,460)
Add unpresented cheques	19,720
Balance as per the bank statement	(19,740)

STUDY TEXT

a)

# General Journal

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Date	Particulars	Debit	Credit
2004		Sh	Sh
1-Mar	Premises	42,000	
	Motor vehicles	41,300	
	Cash at bank	10,500	
	Cash in hand	112	
	Trade debtors	490	
	Stock_	15,400	
	Trade creditors		420
	Capital		109,382
	To record opening balances	109,802	109,802

# Motor Vehicle account

2004	Sh	2004	Sh
1-Mar Balance b/d	41,300	5 .	
	21 000	Balance	62,300
General Motors	21,000	31-Mar c/d	62,300
	62,300		62,300
1-Apr Balance b/d	62,300		

# Stock account

2004	Sh	2004		Sh
1-Mar Balance b/d	22,470	31-Mar	Balance c/d	22,470
1-Apr Balance b/d	22,470		•	

# Capital account

	Capital account		
2004	Sh 20	004	Sh
		Balance	
	1-N	Mar b/d	109,382
31-Mar Balance c/d	123,382	Bank	14,000
	123,382		123,382
		Balance	110
	1-/	Apr b/d	123,382





# b) Books of original entry.

# Sales Journal

Date	Particulars	Invoice No.	Amount,Sh
2004			
March	Victor		5,800
	Moore		6,100
			11,900

# Purchases Journal

Date	Particulars	Invoice No.	Amount, Sh
2004			
March	Rose		1,820
	Frank		3,500
			5,320

# Sales Returns Journal

Date	Particulars	Credit note no.	Amount,\$
2004			
March	Moore		840
			840

ı rıpıe	Triple-column Cashbook								
		Disc.					Discount		
Date	Particulars	Allowed.	Cash	Bank	Date	Particulars	Received	Cash	Bank
2004		Sh	Sh	Sh	2004		Sh	Sh	Sh
1-Mar	Balance b/d		112	10,500	4-Mar	Charles			420
5	Bank		2,590		5	Cash			2,590
			,						,
7 8 14	David Cash sales Capital	35	9,800	140 14,000	9 10 12	Rose Rent Bank	182	392 9,450	1,638
					13	Plant& Mach			11,900
					14 15	Purchases Wages		2,177	2,800
					31	Balance c/d		483	5,292
		35	12,502	24,640			182	12,502	24,640
April									
1	Balance b/d		483	5,992					

# c) Ledgers

# Purchases ledger

Creditor Rose					
Bank 1,638					
182	Purchases	1,820			
1,820		1,820			
	1,638 182				

Creditor Frank					
Balance c/d	Purchases	3,500			
		Balance b/d	3,500		

# Sales Ledger

	Debtor Victor					
Sales Balance	5,800	Balance c/d	5,800			
b/d	5,800					
	Debte	or Moore				
		Sales				
Sales	6,100	Returns	840			
		Balance c/d	5,260			
Balance	6,100	-	6,100			
Dalaricc						
b/d	5,260					

# **General Ledger**

Purchases account				
Creditors	5,320			
Bank	2,800	Balance c/d	8,120	
	8,120		8,120	
Balance b/d	8,120			

Sales account					
		Debtors Cash	11,900		
Balance c/d	21,700	Cash	9,800		
	21,700		21,700		
·		Balance b/d	21,700		

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Plant and Machinery 11,900 Balance c/d Bank 11,900 11,900 Balance b/d Wages Cash 2,177 Balance c/d 2,177 2,177 Balance b/d Rent Cash 392 Balance c/d 392 Balance b/d 392

d)

# Merv Fishback Trial Balance

As at	31st 2004	
	Debit, Sh	Credit, Sh
Wages Purchases	2,177 8,120	
Motor Vehicles Rent	62,300 392	
Debtors Creditors	11,095	3,500
Returns Inwards Plant and Machinery	840 11,900	
Stock Capital	22,470	123,382
Bad debts Cash	1,960 483	
Bank General motors	5,992	21,000
Discount allowed Discount received	35	182
Sales Premises	42,000	21,700
	169,764	169,764

Run. Masomornsingl.com In free-floating petty cash system, the petty cashier makes payments intinitely getting refunds of whatever amounts he/she requests from the petty cash fund. There is normally no fixed time of refunding nor is there a fixed amount to be maintained by the petty cashier.

Imprest system on the other hand requires a reimbursement to the petty cashier only the amounts that have been used away from the set amount such that the opening balance is always at a fixed amount. The petty cashier also receives replenishments at certain specific times like at the end of each week, month or a fortnight.

b) Mugo and Farm co **Petty Cashbo** 

Receipts Sh	Folio	Date 2007	Particulars	Voucher no.	Total Sh	Hotel charges Sh
35,000	CB2	1-Apr 2	Cash Sundry expenses Hotel charges		350 1,050	1,050
		4 5 5 6 6	Muhindi Gorogoro Fuel Envelopes Sundry expenses Hotel charges Postages		1,575 700 350 525 700 1,225 875	1,225
		8 9 9 9 10	Petrol Michael Stationery Petrol Hotel charges Sundry expenses Hotel charges		700 350 525 350 1,225 175 1,575	1,225 1,575
		11 11	Petrol Postages Mutua Stationery		700 1,050 1,225 525	
					^	5,075
15,750 50,750			Cash Balance c/d		35,000 50,750	GL 10
35,000	CB5	14	Balance b/d		30,730	

ANSWERS TO TEST PAPERS	3355
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# Workings

Accumulated Fund calculation					
	39,083	39,447			
Bank	118,000	190,000			
Salaries and expenses owing	19,000	15,000			
School adverts owing	14,400	22,000			
School stationery owing	51,800	55,800			
Prepaid subscription income(school)	47,600	37,000			
Equipment	192,000	198,000			
Investment	878,000				
Annual subscription income owing	7,400				
Annual subscription income prepaid		47,000			
Accumulated Fund	1,091,400				

Annual	subscri	ntion	income	alc
/ WILLIAM	CUNCULI	<b>V</b> • • • • • • • • • • • • • • • • • • •		<b>u</b> , u

Arrear b/d Income and Expenditure Prepaid C/d	7,400 310,600 47,000	Cash	371,000
	371,000		371,000

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**School Subscription income** 

	School Subs	cription in	COME
		Prepaid	
Income and expenditure	202,400	b/d	47,600
Prepaid c/d	37,000	Cash	191,800
	239,400		239,400

School Statement of comprehensive income

Expenditure	Sh.	<u>Income</u>	Sh.
School stationery	207,000	School subscription	202,400
Books School staff salary Surplus	21,800 13,000 57,200		96,600
	299,000		299,000
	Genera Income	and Expenditure	
Expenditure	Sh-	Income	Sh
Salaries	180,000	Surplus from school	57,200
Seminar costs	47,000	Annual subscription	316,600
Postage and stationery Telephone Sundry expenses rent and rates  Depreciation Surplus	35,600 14,400 57,800 41,000 22,000 41,800		65,800
	439,600		439,600

FINANCIA	LACCOUNTIN	G			on asomansingi.com
STATE			N WANAUME SOCIETY SITION AS AT 31ST DE	- 1/2	of Masolnion
Non-Current				17.	
assets Equipment cost Less	220,000		Accumulated Fund Surplus	1,091,400 41,800	
accumulated					
depreciation	22,000	198,000	Current liabilities Prepaid school		1,133,200
Investment		878,000	subscription Annual subscription	37,000	
Current assets			prepaid School stationery	47,000	
Adverts owing Bank	22,000 190,000		owing Salaries	55,800 15,000	
		212,000			_154,800
		1,288,000			1,288,000

#### **Question 5 answer**

#### a) Users of accounting information.

- (i) Management – management of business entities need accounting information to assistfor planning and decision making. They will need the information to prepare budgets and compare with the actual results of operations. They will also be interested in the cost consequences of a particular course of action to assist them in making decisions
- (ii) Present and potential investors they need accounting information to assess therisk inherent in, and the return provided by their investments. They need information to decide whether they should maintain, increase, Decrease of dispose altogether their investments.
- (iii) Employees are interested about the stability and profitability of their employer. It is asource of sustainability for them and they need to know whether to start searching for employment elsewhere or keep their current postings. They are also concerned about the ability to provide remuneration, retirement benefits and employment opportunities.

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the loans and the corresponding interests will be paid when due.

- (v) Customers. They require financial data in order to anticipate price changes and toseek alternative sources of supplies when necessary.
- (vi) The government. Governments and their agencies require information to regulate theactivities of the enterprises. They also need the financial information to determine level of taxation and also in preparation of national statistics.

### b) Advantages of historical cost accounting

- a. They can be determined with greater precision than those of other bases of measurements. Their verifiability makes them more reliable.
- b. If current value accounting were to be adopted, a firm's assets and liabilities would have to be revalued each time the financial statements were prepared. This would be expensive and time consuming.
- c. Historical accounting is closely related to objectivity and revenue realization principle. Historical costs are regarded as relatively objective measurements and that accountants normally ignore increases in the values of recorded assets until the increases have been validated by a sale.
- d. Historical cost figures provide a basis for comparison with the other enterprises of similar periods

c)

A general ledger usually records the nominal accounts while the other ledgers, including sales ledger and purchases ledger records personal accounts.

The general ledger will keep such nominal accounts such as purchases account, sales accounts, expenses accounts.

Sales ledger on the other hand contained personal accounts such as the individual debtor accounts. It generates its data from the books of original entry.

### Test paper 3 answers

#### **Question 1**

#### Overview of accounting

#### process 1. Recording phase

1) Appropriate business documents are prepared or received. The documentation provides the basis for making an initial record of each transaction. Examples of such documents are sales invoices, cash register, cheques etc

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- 2) Basing upon the supporting document, each transaction is recorded in a chronological order in the books of original entry or journals.
- 3) Each transaction, as classified and recorded in the journals, is posted to the appropriate accounts in the ledgers.

#### 2. Summarizing phase

- 4) A trial balance of the accounts in the ledger is taken. It provides a summary of the information as classified in the ledger, as well as a general check on the accuracy of the recording and posting.
- 5) The data required to bring the accounts up to date are compiled. This is done through the adjusting entries.
- 6) Accounts are closed. Balances in the nominal accounts are closed and transferred to the income statement. Balances of the real accounts are carried forward to the next period.
- 7) Financial statements are prepared. At this stage, the two main statements are prepared; the statement of comprehensive income and the Statement of financial position.
- 8) A post-closing trial balance is prepared
- 9) Reversing entries are made for accruals and prepayments to start a new accounting period.

#### b)

i) Purchased goodwill and non purchased goodwill.

Non purchased goodwill is the goodwill inherent in the business. It is extremely difficult to measure such goodwill because the business is a going concern. It is a goodwill not yet paid for and therefore has a no objective value. It keeps on changing. One bad act by an employee might damage it instantly.





Purchased goodwill on the other hand occurs when the business is being sold. When a buyer purchases an existing business, he will buy not only the existing tangible assets but also the goodness the existing business has ploughed to itself over the period of existence. It appears in the statement of financial position as a long-term intangible (fictitious) asset.

#### Bonus and rights issue. ii)

A bonus issue is one in which a proportional distribution of additional shares to the company's existing shareholders. Also called a script issue, it is a way of issuing dividends without giving soft cash. It can be termed as being issue of capital to the exiting shareholders for free.

A rights issue on the other hand is an issue of shares for cash to the existing shareholders. The rights are offered to the existing shareholders who may decide to sell them, exercise them or do nothing. Rights issues give the shareholder an option to acquire a specified number of shares under specified conditions within a specified period.

iii) Interim dividends and proposed dividends. Interim dividends are issued during the period for which they are payable and an actual payment in cash is made to the shareholders.

Proposed dividends represent the proportion of the year's dividends that the directors indicate will be transferred from the retained earnings. This proposal is made during the annual general meeting and there fore they are not payable by the year end. They are shown in the statement of financial position alongside other payables within a year.

¢

### question 2

3 (a)

	Ф
Opening capital	128,000
Capital introduced	50,000
	178,000
Less: Drawings	48,000
	130,000
Closing capital	184,000
Profit is therefore	54,000

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(b)	Purchases Co	ontrol Account	www.masomon	
Payments to suppliers Discounts received	888,400 11,200	Balance brought forward Goods taken by Senji	130,400 1,000 2,400 937,050	
Balance carried forward	171,250 ——— 1,070,850 ———		1,070,850	

(c)

#### Cost of sales:

Opening inventory	243,000	
Purchases	595,400	
Less: Returns	41,200	554,200
		797,200
Less: Closing inventory		261,700
		535,500

Sales figure is therefore  $$535,500 \times 3/2 = $803,250$ 

### question 3

(a)

- Reserves are balances in a company's statement of financial position forming part of (i) the equity interest and representing surpluses or gains, whether realized or not.
- Share premium account (ii) The surplus arising when shares are issued at a price in excess of their par values.
- (iii) Revaluation reserve The unrealized gain when the amount at which non-current assets are carried is increased above cost.





(b)

A bonus issue is the conversion of reserves into share capital, with shares being issued to existing members in proportion to their shareholdings, without any consideration being given by the shareholders.

A rights issue is again an issue of shares to existing members in proportion to their shareholdings, but with payment being made by the shareholders for the shares allotted to them. The fundamental difference between them is that the rights issue raises funds for the company whereas the bonus issue does not.



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STUDY TEXT

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## **GLOSSARY**

**Accounting** - the process of identifying, measuring, recording and communicating financial

information in order to permit users to make informed decisions

Sales - this term is used to refer to the transfer of goods in return for money

**Purchases** - these are goods bought by a business in order to be resold

**Journal** - this is the first record of a transaction that is made in a firm's books

**Ledger** - this is an account in which transactions initially recorded in journals are

transferred (or posted) to

**Business** - an organisation that exists in order to make profit

**Debtor** - a person that owes the business money

**Creditor** - a person that the business owes money

**Cashbook** - an account in which transactions concerning cash are recorded, such as

payments made or amounts received from debtors

**Carriage in** - the cost of transporting goods from a supplier to the business

**Carriage out** - the cost of transporting goods from the business to a customer who has

bought them

**Returns inwards** - goods returned by customers to the business

**Returns outwards** - goods returned by the business to the supplier

**Transactions** - activities of buying and selling that the business engages in

**Profit** - the excess of incomes made over expenditure

**Loss** - the excess of expenditure over income

**Assets** - things of value to the business

**Liabilities** - amounts owed by the business to external parties

Capital - the amount of money or other assets introduced by the owner of the business

**Partnership** - a business venture whereby two or more persons run a business together

with the objective of making profit

**Company** - an organization that is a legal person and has limited liability

**Sole proprietorship** - a business run by a single individual with an aim of making profit

**Financial statements** - a business run by two or more people together in order to make a profit





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