

FOUNDATIONS OF ACCOUNTING

DICT

DCM

LEVEL 3

STUDY NOTES

SYLLABUS

PAPER NO. 10

OBJECTIVE

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

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

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

CONTENT

1. Introduction to Accounting

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

2 Recording transactions

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

3. Accounting for assets and liabilities

3.1 Assets

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

3.2 Liabilities

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

4. Correction of errors and suspense account

5. Financial statements of a sole trader

- Income statement
- Statement of financial position

6. Financial statements of a partnership

- Partnership agreement
- Distinction between current and fixed capital
- Income statement
- Statement of financial position

7. Financial statements of a company

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

8. Financial statements of a manufacturing entity

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

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

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

10. Analysing financial statements

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

11. Emerging issues and trends

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TOPIC 1

INTRODUCTION TO ACCOUNTING

NATURE AND PURPOSE OF ACCOUNTING

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

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

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

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

The first definition emphasizes the following:

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

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TOPIC 3

ACCOUNTING FOR ASSETS AND LIABILITIES

ASSETS

PROPERTY, PLANT AND EQUIPMENT - IAS 16,

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

Property, plant and equipment are tangible items that:

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

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

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

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

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

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

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

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

revaluation, the decrease shall be recognised in profit or loss. However, the decrease shall be debited directly to equity under the heading of revaluation surplus to the extent of any credit balance existing in the revaluation surplus in respect of that asset.

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

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

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

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

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

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MEANING OF DEPRECIATION

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

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

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

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

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

THE BASIC FACTORS IN DEPRECIATION

For calculating depreciation, the basic factors are:

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

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

Objectives of Providing Depreciation

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

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

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

METHODS FOR PROVIDING DEPRECIATION

The following are the various methods for providing depreciation —

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

(a) Fixed Percentage on Original Cost

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

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

$$\frac{\text{Cost minus - Estimated Scrap}}{\text{Value estimated life}}$$

In the case of companies, the scrap value is assumed to be five percent of the original cost of the asset. In other words, ninety five percent of the cost of an asset is to be written off over its life. The tile oldie asset is to be reckoned by reference to the rate recognized by the Income-tax Rules. The Rules lay down that depreciation is to be provided by applying the prescribed rate to the reducing book figure or the asset as a result of the depreciation charge

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

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

(b). Fixed Percentage on Diminishing Balance

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

In the first year, depreciation is written off proportionate to the actual period in use. The depreciation on Shs.20. 000 - the cost of the asset - at the rate of ten percent will be Shs.2, 000 in the first year.

This will reduce the book value of the asset to Shs.18, 000. Depreciation in the second year will be Shs.1, 800, i.e, ten percent of Shs.18, 000.

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

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

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

Later years will show heavier expense. This is not proper because the asset gives

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

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

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

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

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

a) Sum of the Digits Method

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

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

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

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

In the second year, it will be:

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

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

b) Annuity Method

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

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

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

c) Revaluation Method

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

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

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

d) Depletion Method

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

Depreciation is calculated per tonne of output. For example, if a mine is purchased for Shs.200,000 and it is estimated that the total quantity of mineral in the mine is 500,000 tonnes, the depreciation per tonne output comes to 40%. i.e.

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

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

e) Machine hour Rate Method

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TOPIC 5

FINANCIAL STATEMENTS OF A SOLE TRADER

INTRODUCTION

A sole trader - also known as a sole proprietorship is a type of business entity which is owned and run by one individual and where there' is no legal distinction between the owner and the business.

As a sole trader, your business is owned entirely by you, grown by you and ultimately succeeds or fails by you. This also means you are entitled to all profit that the business makes.

Becoming a sole trader is simple. All you have to do is register your business name and you can start trading.

There are huge incentives to becoming a sole trader but with them come terrifying or - depending on your personality - gratifying, side effects.

Financial statements of a sole trader involve the following:-

- Income statement.
- Statement of financial position.

Trial balance provides the essential input for the preparation of these accounts or statements. These accounts / statements provide necessary information to various interested groups e.g. shareholders, investors, creditors, employees, management and government agencies etc. Therefore, these financial statements are prepared to serve the information needs of these diverse groups to enable them to make appropriate decisions.

THE INCOME STATEMENT

At the end of the year, every business must ascertain its net profit (or loss). This is done in two stages:

1. Finding out the gross profit (or gross loss)
2. Finding out the net profit (or loss)

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DETERMINATION OF GROSS PROFIT (OR GROSS LOSS)

Gross profit is the difference between sale proceeds of a particular period and the cost of the goods actually sold. Since gross profit means overall profit, no deduction of any sort, i.e. general, administrative or selling and distribution expenses is made. Gross Profit is said to be made when the Sale proceeds exceed the cost of goods sold. On the contrary, if the cost price of the goods is more than the selling price, then we can say that there is a loss.

The entries / items that will appear in an income statement to ascertain the gross profit or loss will be;-

ITEMS TO BE DEBITED

I. Opening Stock:

It refers to the value of goods at hand at the end of the previous accounting year. Opening stock means the stock of an item at the beginning of a new inventory-keeping period. It becomes the opening stock for the current accounting year and contains the value of goods in which the business deals.

2. Purchases:

It refers to the value of goods (in which the concern deals) which are purchased either on cash or on credit for the purpose of resale. The balance of the purchase account, appearing in the Trial Balance, reflects the total purchases made during the accounting period. While dealing with purchases, we must bear in mind the following aspects:

- a) Purchase of capital asset should not be added with the purchases. If it is already included in purchases, it should be deducted immediately.
- b) If goods are purchased for personal consumption and account added with the purchases, they should be excluded. These types of purchases should be treated as drawings.
- c) If some of the goods purchased are still in transit at the year-end, it is better to debit Stock-in-transit Account and credit Cash or Supplier's Account.
- d) If the amounts of purchases include goods received on consignment, on approval or on hire purchase, these should be excluded from purchases.
- e) Cost of goods sent on consignment must be deducted from the purchases in case of a trading concern.

3. Purchases Returns/Returns Outwards:

It may come about that due to some reason; the goods are sent back to the supplier. In that case, the supplier is debited in the book of accounts and purchases returns or returns outwards are credited. It appears on the credit side in the Trial Balance. There are two ways of showing the purchases returns in the income statement. It may be shown by way of deduction from purchases in the income

statement. An alternative way is to show the purchases returns in the credit side of the income statement.

4. Direct Expenses:

These types of expenses are incurred in connection with purchase, procurement or production of goods. These expenses are directly related to the process of production. It also includes expenses that bring the goods up to the point of sale.

ITEMS TO BE CREDITED

I. Sales

It refers to the sale of goods in which the business deals and includes both cash and credit sales. It does not include sale of old, obsolete or depreciated assets, which were acquired for utilization in business. However, goods sent to customers on approval basis, free samples and sales tax, if any, included in the sales figure should be excluded.

2. Sales Returns / Returns Inward

When goods are returned by the buyers for some reason, it is called Sales Return or Returns Inward. In the books of account, "Returns

Inwards Account" or "Sales Returns Account" is debited and buyer's account is credited.

It appears on the debit side of Trial Balance. We can show the sales returns in the Trading Account in two ways. It may be shown by way of deduction from sales in the Trading Account. An alternative way to show the sales returns is in the debit side of the Trading Account.

3. Abnormal Loss

It refers to the abnormal loss of stock due to fire, theft or accident. If any abnormal loss is there, it is credited fully to the Trading Account because the Trading

Account is prepared under normal conditions of the business and has no place for abnormal instances.

4. Closing Stock

It refers to the value of goods lying unsold at the end of any accounting year. This stock at the end is called closing stock and is valued at either cost or market price, whichever is lower. The trial balance generally does not include closing stock.

To Closing Stock A/c Dr

To income statement A/c Cr

However, if closing stock forms a part of Trial Balance, it will not be transferred to

Income statement but taken only to the statement of financial position. In case of the goods that have been dispatched to customers on approval basis, such goods should be included in the value of closing stock.

Ascertaining the gross profit or loss

After recording the above items in the respective sides of the income statement, the balance is calculated to ascertain Gross Profit or Gross Loss. If the total of, credit side is more than, that of the debit side, the excess represents Gross Profit. Conversely, if the total of debit side is more than that of the credit side, the excess represents Gross Loss.

TRADING ACCOUNT (HORIZONTAL FORMAT)

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

INTR TRADING ACCOUNT (VERTICAL FORMAT)

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

Illustration

From the following details draw up the trading account of Mr. Karanja for the year ended 31 December 2010, which was his first year in business.

	Sh. "000"
Carriage inwards	13,400
Returns outwards	9,900
Returns inwards	17,800
Sales	774,840
Purchases	666,660
Stock of goods: 31 December 2010	149,780

Mr. Karanja

Trading Account for the year ended 31 Dec 2010

	Sh. "000"	Sh. "000"
Sales		774 840
Less: Returns Inwards		<u>17 800</u>
		757 040
Less: Cost of sales		
Purchases	666,660	
Add: Carriage Inwards	13,400	
Less: Returns Outwards	(9,900)	
Less: Closing stock	(149,780)	
Cost of sales		<u>(520,380)</u>
Gross Profit		236 660

Illustration

The following details for the year ended 31 March 2010 are available. Draw up the trading account of B. Osongo for that year.

	Sh. "000"
Stocks: 1 April 2009	16,523
Returns inwards	1,372
Returns outwards	2,896
Purchases	53,397
Carriage inwards	1,122
Sales	94,600
Stocks: 31 March 2010	14,323

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Solution

B. Osongo

Trading Account for the year ended 31 March 2010

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

DETERMINATION OF NET PROFIT (OR LOSS)

After ascertaining the gross profit, the subsequent step is to ascertain net profit or net loss during an accounting period. Here the revenues and expenses of an accounting period are summarized to reflect the alterations in various critical areas of the firm's operations. This step indicates how the revenue (money received from the sale of products and services before expenses are withdrawn) is transformed into the net income (the result after all revenues and expenses have been accounted for). It displays the revenues recognised for a specific period and the cost and expenses charged against these revenues, including write-offs (e.g. depreciation and amortization of various assets) and taxes. The objective of the income statement is to explain to the managers and investors whether the company made or lost money during the period being reported. As pointed out earlier, gross profit or gross loss ascertained in first step, which becomes the starting point of the ascertainment of net profit or loss. It takes into consideration all remaining indirect (normal and abnormal) expenses and losses related to or incidental to business. These operating and non-operating expenses are charged and shown to the debit side of the account. After transferring the Gross Profit or Gross Loss, the sources of other incomes like commission or discount received are shown on the credit side

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TOPIC 7

FINANCIAL STATEMENTS OF A COMPANY

INTRODUCTION

Limited companies come into existence because of the growth in size of business and the need to have many investors in the business.

Partnerships were not suitable for such businesses because the membership is limited to 20 persons.

Types of companies

There are 2 principle types of companies:

Private companies

These have the words limited at the end of the name. Being private, they cannot invite the members of the public to invest in their ownership.

Public companies

They are much larger in size as compared to private companies. They have the words public limited company at the end of their name.

They can invite the members of the public to invest in their ownership and the companies may be quoted on the stock exchange.

CAPITAL STRUCTURE OF A COMPANY INCLUDING INITIAL ISSUES OF SHARES AT FULL PRICE, RIGHTS ISSUES AND BONUS

The term capital structure refers to the percentage of capital (money) at work in a business by type. Broadly speaking, there are two forms of capital: equity capital and debt capital. Each has its own benefits and drawbacks and a substantial part of wise corporate stewardship and management is attempting to find the perfect capital structure in terms of risk / reward payoff for shareholders. This is true for companies and for small business owners trying to determine how much of their startup money should come from a bank loan without endangering the business.

Equity Capital

This refers to money put up and owned by the shareholders (owners). Typically, equity capital

consists of two types:

1. Contributed capital, which is the money that was originally invested in the business in exchange for shares of stock or ownership and
2. Retained earnings, which represents profits from past years that have been kept by the company and used to strengthen the fund growth, acquisitions, or expansion.

Many consider equity capital to be the most expensive type of capital a company can utilize because its "cost" is the return the firm must earn to attract investment. A speculative mining company that is looking for silver in a remote region of Africa may require a much higher return on equity to get investors to purchase the stock than a firm such as Procter & Gamble, which sells everything from toothpaste and shampoo to detergent and beauty products.

Debt Capital

This type of capital is infused into a business with the understanding that it must be paid back at a predetermined future date. In the meantime, the owner of the capital (typically a bank, bondholders, or a wealthy individual), agree to accept interest in exchange for you using their money. Think of interest expense as the cost of "renting" the capital to expand your business; it is often known as the cost of capital. For many young businesses, debt can be the easiest way to expand because it is relatively easy to access and is understood by the average American worker thanks to widespread home ownership and the community-based nature of banks. The profits for the owners is the difference between the return on capital and the cost of capital; for example, if you borrow Shs.100,000 and pay 10% interest yet earn 15% after taxes, the profit of 5%, or Shs 5,000, would not have existed without the debt capital infused into the business.

TYPES OF SHARE CAPITAL

ORDINARY SHARES

The terms "voting share" or "Common stock" are also used in other parts of the world; common stock being primarily used in the United States.

It is called "common" to distinguish it from preferred stock. If both types of stock exist, ordinary shareholders cannot be paid dividends until all preferred stock dividends (including payments in arrears) are paid in full.

In the event of bankruptcy, ordinary share investors receive any remaining funds after bondholders, creditors (including employees), and preferred stock holders are paid. As such, ordinary share investors often receive nothing after a bankruptcy.

On the other hand, ordinary share on average perform better than preferred shares or bonds over time. Ordinary share usually carries with it the right to vote on certain matters, such as electing the board of directors. However, a company can have both a "voting" and "non-voting" class of ordinary share.

Holders of ordinary share are able to influence the corporation through votes on establishing corporate objectives and policy, stock splits, and electing the company's board of directors. Some holders of ordinary share also receive preemptive rights, which enable them to retain their proportional ownership in a company should it issue another stock offering. There is no fixed dividend paid out to ordinary shareholders and so their returns are uncertain, contingent on earnings, company reinvestment, and efficiency of the market to value and sell stock.

Additional benefits from ordinary shares include earning dividends and capital appreciation.

PREFERENCE SHARES

Preferred stock (also called preferred shares, preference shares or simply preferreds) is an equity security which may have any combination of features not possessed by ordinary share including properties of both equity and a debt instruments, and is generally considered a hybrid instrument. Preferred stock are senior (i.e. higher ranking) to common stock, but subordinate to bonds in terms of claim (or rights to their share of the assets of the company).

Preferred stock usually carries no voting rights, but may carry a dividend and may have, priority over ordinary share in the payment of dividends and upon liquidation. Terms of the preferred stock are stated in a "Certificate of Designation".

Similar to bonds, preferred stocks are rated by the major credit-rating companies. The rating for preferred stock is generally lower, since preferred dividends do not carry the same guarantees as interest payments from bonds and they are junior to all creditors.

ISSUE OF SHARES

Shares can be issued being payable for:

- a) Immediately on application
- b) By installments

Issue of shares take place on the following terms:

(Connected with the price of shares)

1) Shares issued at par value

In this case shares are issued at a price equal to the nominal value

2) Shares issued at a premium

Shares are issued at a price higher than the nominal value

3) Shares issued at a discount

Shares are issued at a price lower than the nominal value In Kenya it is illegal for a company to issue shares at a discount

Accounting entries

To recognize the amount expected on issue:

DR- share application account at par value
CR- share capital at par value

Being the nominal value expected on application.

On receipt of amount

DR- bank account
CR- share application

Being the amount received on application

Issue at a premium

DR- share application
CR- share capital
CR- share premium

Being the amount expected on issue On receipt

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TOPIC 9

FINANCIAL STATEMENTS OF A NOT FOR PROFIT MAKING ORGANIZATION

INTRODUCTION

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

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

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

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

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

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

TYPES OF FUNDS AND THEIR ACCOUNTING TREATMENT

1) **Subscription**

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

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

2) **Donations**

The amount received from a person, firm or company by way of gift is called a donation. Donations

may be specific donation or general donations.

a) Specific donations

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

b) General donations

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

3) Grants

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

4) Legacy

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

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

5) Endowment fund

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

6) Entrance fees

This is the amount of fee collected on the admission of members. Accountants differ on the treatment of entrance fees. Many feel that since the amount is collected only once and as it is a non recurring in nature it should be capitalized and taken to the liability side of the balance sheet but others argue that though it is paid is each members only once, the clerk or institution receives fairly regularly every year because of regular entrance of members. So it should be shown as an income in the credit side of income and expenditure account. In the absence of specific instruction in the question, students may treat it any way but they must append a note justifying the choice made.

7) Sale of old assets

The amount realized from the sale of old assets should be treated as capital receipts and should be

credited to asset account. But loss or profit on its sales should be treated as revenue and is taken to income and expenditure account:

8) Sale of newspapers and periodicals etc.

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

9) Expenditure stock items

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

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

10) Sale of scraps, grass etc.

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

11) Life membership fee

.life membership may, sometime, be granted to members on their making a lump sum payment in lieu of annual subscription. As the service has to be rendered for a long time without further payment; it must he treated as capital receipts and should be capitalized.

12) Payment of honorarium

Amount paid to a person for the specific service rendered by him is called honorarium. For example payment made to singers, dancers etc. is shown on the expenditure side

13) Special purpose fund

If there is any special purpose fund example tournament fund, charity fund, prize fund, endowment fund etc. and there are certain items of expenses and incomes relating to that fund. Then income and expenses should not be shown in the income and expenditure account but income should be added to Ike fund and expenses deducted from such fund on the liability side of the balance sheet

RECEIPT AND PAYMENT ACCOUNT:

"A receipt and payment account is a summarized cash book (cash and bank) for a given period".

or

"This is simply a summary of the cash transactions as in the cash book, analyzed and classified under suitable headings, including the opening and closing balances".

Non-profit organizations (also called non-trading concerns) prepare a receipt and payment account at the end of year. With the help of this account and some additional information, an income and expenditure account is prepared to disclose the true results of non-profit organizations. Receipt and payment account cannot disclose the true result of non-trading concern.

All the information necessary for the preparation of this account is available from cash book. Various cash receipts and cash payments during the whole year find place in this account in a classified manner. Its closing balance indicates cash in hand and cash at bank at the year end.

Characteristics of Receipt and Payment Account:

Following are the features of receipt and payment account:

1. It is a bridged addition of cash book - it is, in effect, a summary of cashbook.
2. All cash receipts during the whole year are recorded on its left hand (i.e., debit) side. While all the cash payments during the whole year written on its right hand (i.e., credit) side, arranged in a classified form.
3. Cash receipts and cash payments of both capital and revenue nature are recorded here.
4. Only cash transactions are recorded in this account.
5. It generally shows a debit balance. In case of bank overdraft balance, however, its net balance may be credit. Again, it may also show nil balance but such occasion is rare.
6. Its closing balance indicates closing cash in hand and closing cash at bank.
7. It is not an account within the double entry system - it is a statement only.
8. It is prepared on the last day of the accounting year.

Advantages:

The following are the advantages of receipt and payment account:

1. Total receipts and total payments under various heads are available at a glance.
2. The amount of cash in hand at the year end can be ascertained.
3. The correctness of cash book can be verified through it. The total of debit side of cash book will agree with the total of receipt side of this account. On the other hand, the total of credit side of cash book will agree with that of payment of this account.

Method of Preparation:

Receipts and payment account is prepared with all the cash receipts and cash payments of the whole year. The net result of cash receipts and cash payments of a fixed time is determined through this account. So its heading will be:

Receipt and Payment Account For the Year Ended 31.12.2005

Its left hand side is called "Receipts" and right hand side "payments". On the left hand side all cash receipts are recorded, while on the right hand side all cash payments are recorded arranged in a classified form. It starts with last year's closing cash in hand and cash at bank and closes with current year's closing cash in hand and cash at bank. In other words, its opening balance indicates last year's closing cash in hand and cash at bank, while its closing balance means current year's closing cash in hand and cash at bank.

Example:

From the following cash book prepare receipts and payments account for the year ended 31 December 2005.

Cash Book

Date	References	Amount	Date	References	Amount
2005			2005		
Jan. 1	Balance b/d	250	Jan. 5	Rent	200
Feb. 2	Subscription	600	Jan. 16	Traveling expenses	15
Mar. 10	Admission fee	25	Fed. 12	Salaries	250
Apr. 5	Subscription	950	Mar. 17	Entertainment expenses	50
May 20	Sale of old newspapers	10	Apr. 20	Electric charges	20
June 3	Subscription	880	May 5	Furniture	300
July 15	Admission fee	30	May 10	Postage	18
Aug. 20	Sale of old newspaper	15	June 3	Stationary	120
Sep. 5	Donation	100	July 12	Electric charges	30
Oct. 1	Sale of old furniture	150	Aug. 3	Newspaper	25
Nov. 15	Donation	50	Sep. 15	Salaries	320
Dec. 28	Subscription	250	Sep. 20	Newspaper	65
			Oct. 3	Traveling expenses	25

			Oct. 12	Postage	12
			Nov. 5	Rent	300
			Nov. 16	Entertainment expenses	80
			Dec. 5	Books	450
			Dec. 12	Salaries	350
			Dec. 25	Rent	130
			Dec. 31	Balance c/d	550
		_____			_____
		3,310			3,310
		_____			_____
2006					
Jan. 1		550			

Solution:

ABC Club
Receipt and Payment Account
For the year ended 31st December, 2005

Receipts	\$	Payments	\$
Balance b/d	250	Rent [200+300+130]	630
Subscription [600+950+880+250]	2,680	Traveling expenses [15+25]	40
Admission fee [25+30]	55	Salaries [250+320+350]	920
Sale of old newspaper [10+15]	25	Entertainment expenses [50+80]	130
Donation [100+50]	150	Electric charges [20+30]	50
Sale of old furniture	150	Furniture [200+300+130]	300
		Postage [18+12]	30
		Stationary	120
		Newspaper [25+65]	90
		Books	450
		Balance c/d	550
	_____		_____
	3,310		3,310
	_____		_____
Balance b/d	550		

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