

NEW REVISED SYLLABUS

FINANCIAL
ACCOUNTING
STUDY TEXT

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FINANCIAL ACCOUNTING

FOUNDATION LEVEL

NEW REVISED SYLLABUS

STUDY TEXT

SYLLABUS

PAPER NO. 1 FINANCIAL ACCOUNTING

UNIT DESCRIPTION

This paper is intended to introduce the candidate to the overall purpose of accounting, applicable regulations, the accounting treatment and presentation of basic transactions and preparation and analysis of financial statements.

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Prepare books of original entry and basic ledger accounts under the double entry system
- Prepare basic financial statements of soletraders, partnerships, companies, manufacturing entities and not for profit organisations
- Comply with the regulatory framework in the accounting field
- Analyse financial statements by use of ratios and statement of cash flows
- Demonstrate basic understanding of public sector accounting framework

CONTENT

1. Introduction to Accounting

- Nature and Purpose of Accounting
- The objective of Financial Accounting
- The Elements of Financial Statements
- The Accounting Equation
- The Users of Accounting Information

2. The Accounting Process and Systems

- The Source documents such as receipts and invoices
- The Books of Prime entry/Original Entry from the journals, cashbooks, Petty cash books and registers
- The Ledger and the concept of double entry
- The Trial Balance
- The Financial Statements

3. Regulation and other principles guiding the accounting profession

- The legal sources of regulation
- The professional sources of regulation (local and international bodies) and ethical requirements
- Accounting Standards

- Common accounting principles/concepts
- Qualities of useful financial information

4. Accounting for Assets and Liabilities

- Property, Plant and Equipment (depreciation, acquisition, disposal, exchange, excluding revaluations)
- Intangible Assets
- Financial Assets and Financial Liabilities (Definition, Examples and Classification only)
- Inventory
- Cash in hand and cash at bank (bank reconciliation statements)
- Trade Receivables (Measurement and credit Losses)
- Trade payables
- Accrued Incomes/Expenses and Prepaid Incomes/Expenses

5. Financial Statements of a sole trader

- Statement of Profit or Loss
- Statement of Financial Position

6. Financial Statements of a partnership

- The partnership deed/agreement
- The statement of Profit or Loss and appropriation
- Partners' capital and current accounts
- The statement of financial position
- Accounting treatment and presentation when there is a change in profit/loss sharing ratio, admission/retirement of a partner, dissolution of a partnership

7. Financial Statements of a company

- Important concepts of a company (Ordinary and Preference share capital, issuing new shares by way of full market price, bonus shares and rights issue, Reserves, retained profits and corporation tax)
- Statement of Profit or Loss
- Other comprehensive incomes
- Statement of Financial Position
- Statement of Cash flows

8. Financial Statements of a manufacturing entity

- Manufacturing Statement of production
- Statement of Profit or Loss

- Statement of Financial Position

9. Statements of a not-for-profit entity

- Objectives of Not-for-profit organisations
- Statement of Income and Expenditure
- Statement of Financial Position

10. Correction of errors and preparing financial statements with incomplete records

- Types and causes of errors
- Correcting errors in source documents, the books of prime entry, the ledger, the trial balance and financial statements
- Reasons for incomplete information
- Preparation of financial statements from incomplete information

11. Analyzing Financial Statements

- The objective of analysing financial statements
- Analysing financial statements using financial ratios (Liquidity, Profitability, Solvency, Efficiency, Investor/Value and Cash Flow categories)

12. Accounting in the Public Sector

- Features of public sector entities (as compared to private sector)
- Structure of the public sector (National and county governments, State Corporations, Departments and Agencies)
- Regulation and oversight (International Public Sector Accounting Standards Board, Director of Accounting Services, National Treasury, Parliamentary Committees, Accounting Officers at national and county levels)
- Objectives of public sector financial statements and Standards (IPSAS)
- Accounting techniques in public sector such as budgeting, cash, accrual, commitment and fund accounting)

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TOPIC 1

INTRODUCTION TO ACCOUNTING

1.1 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 be useful in making economic decisions.

The first definition emphasizes the following:

- **Identifying** - in accounting, this is the process of recognition or non-recognition of business activities as accountable events. Stated differently, this is the process which determines if an event has accounting relevance.
- **Measuring** - in accounting, this is the process of assigning monetary amounts to the accountable events.

- **Communicating** - As we could notice with the above definitions, one main similarity between the three is the impact of communication. In order to be useful, accounting information should be communicated to the different decision makers. Communicating accounting information is achieved by the presentation of different financial statements.

The second definition emphasizes the following:

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

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

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

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

1.2 OBJECTIVES OF ACCOUNTING

The objectives of accounting can be given as follows:

- **Systematic recording of transactions** - Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.
- **Ascertainment of results of above recorded transactions** - Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue exceeds expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not

proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.

- **Ascertainment of the financial position of the business** - Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.
- **Providing information to the users for rational decision-making** - Accounting like a language of commerce communes the monetary results of a venture to a variety of stakeholders by means of financial reports. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.
- **To know the solvency position:** By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

1.3 ELEMENTS OF FINANCIAL STATEMENTS

The elements of financial statements are the general groupings of line items contained within the statements. These groupings will vary, depending on the structure of the business. Thus, the elements of the financial statements of a for-profit business vary somewhat from those incorporated into a nonprofit business (which has no equity accounts).

Examples of the Elements of Financial Statements

The main elements of financial statements are as follows:

- **Assets.** These are items of economic benefit that are expected to yield benefits in future periods. Examples are accounts receivable, inventory, and fixed assets.
- **Liabilities.** These are legally binding obligations payable to another entity or individual. Examples are accounts payable, taxes payable, and wages payable.
- **Equity.** This is the amount invested in a business by its owners, plus any remaining retained earnings.

- **Revenue.** This is an increase in assets or decrease in liabilities caused by the provision of services or products to customers. It is a quantification of the gross activity generated by a business. Examples are product sales and service sales.
- **Expenses.** This is the reduction in value of an asset as it is used to generate revenue. Examples are interest expense, compensation expense, and utilities expense.

Of these elements, assets, liabilities, and equity are included in the balance sheet. Revenues and expenses are included in the income statement. Changes in these elements are noted in the statement of cash flows.

1.4 THE ACCOUNTING EQUATION

The Accounting Equation

Initially when a business enterprise starts operating, it owns property in form of assets that are equivalent to the start up capital. Later on after continuance in the business, obligations in form of liabilities are incurred hence the equation changes. The total assets are now equivalent to the capital plus the liabilities in the business.

$$\text{ASSETS} = \text{LIABILITIES} + \text{CAPITAL}$$

The accounting equation is summarized in the balance sheet as illustrated below;

(Horizontal Format)		Balance sheet as at 31.12.20x3	
<u>ASSETS</u>		<u>CAPITAL AND LIABILITIES</u>	
Non Current Assets		Capital	xxx
Land and buildings	xxx	Long term liabilities	
Furniture and fittings	xxx	5 year loan from ABC ltd	xxx
Less Acc Depreciation	<u>(xx)</u>		
	xxx		
Motor vehicles	xxx		
Less Acc Depreciation	<u>(xx)</u>		
	xxx		
Current Assets		Current Liabilities	
Debtors (A/c Receivable)	xxx	Creditors (A/c Payable)	xxx
Stock (Closing Inventory)	xxx	Bank overdraft	xxx
Prepaid Expenses	xxx	Accrued expenses	<u>xxx</u>
Bank	xxx		xxx
Cash	<u>xxx</u>		
	<u>xxx</u>		
	<u>xxx</u>		<u>xxx</u>

Activity 3.1

The following transactions demonstrate the application of the accounting equation in a balance sheet.

1.) Introduction of Capital for a New Business

01/01/20x3; XYZ traders started business by depositing Ksh 90,000 in a business bank account

Balance sheet as at 01/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL</u>	Kshs
Cash at bank	90,000	Capital	90,000
	<u>90,000</u>		<u>90,000</u>

2.) Purchase of a Non Current Asset via Cheque

04/01/20x3; XYZ bought a motor vehicle for the business worth Ksh 40,000 paying by cheque

Balance sheet as at 04/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL</u>	Kshs
Motor vehicle	40,000	Capital	90,000
Cash at bank	50,000		
	<u>90,000</u>		<u>90,000</u>

3.) Purchase of a Current Asset on Credit

07/01/20x3; XYZ purchased goods for Ksh 13,000 on credit terms.

Balance sheet as at 07/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL & LIABILITIES</u>	Kshs
Motor vehicle	40,000	Capital	90,000
Stock	13,000	<u>Liability</u>	
Cash at bank	50,000	Creditor	13,000
	<u>103,000</u>		<u>103,000</u>

4.) Sale of a Current Asset on Credit Terms

11/01/20x3; XYZ made credit sales costing Ksh 5,000 to ABC enterprises.

Balance sheet as at 11/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL & LIABILITIES</u>	Kshs
Motor vehicle	40,000	Capital	90,000
Stock	8,000		
Debtor	5,000	<u>Liability</u>	
Cash at bank	50,000	Creditor	13,000
	<u>103,000</u>		<u>103,000</u>

5.) Sale of a Current Asset on Cash Terms

14/01/20x3; XYZ made cash sales costing Ksh 7,000 to KK enterprises

Balance sheet as at 14/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL & LIABILITIES</u>	Kshs
Motor vehicle	40,000	Capital	90,000
Stock	1,000		
Debtor	5,000	<u>Liability</u>	
Cash at bank	<u>57,000</u>	Creditor	<u>13,000</u>
	<u>103,000</u>		<u>103,000</u>

6.) Payment of a liability

16/01/20x3; XYZ paid Ksh 11,000 for the goods bought on credit.

Balance sheet as at 16/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL & LIABILITIES</u>	Kshs
Motor vehicle	40,000	Capital	90,000
Stock	1,000		
Debtor	5,000	<u>Liability</u>	
Cash at bank	<u>46,000</u>	Creditor	<u>2,000</u>
	<u>92,000</u>		<u>92,000</u>

7.) Collection of a current asset

30/01/20x3; ABC enterprises paid XYZ traders Ksh 3,500 being part settlement of the account.

Balance sheet as at 30/01/20x3

<u>ASSETS</u>	Kshs	<u>CAPITAL & LIABILITIES</u>	Kshs
Motor vehicle	40,000	Capital	90,000
Stock	1,000		
Debtor	1,500	<u>Liability</u>	
Cash at bank	<u>49,500</u>	Creditor	<u>2,000</u>
	<u>92,000</u>		<u>92,000</u>

Illustration 3.1

The following information relates to Alpha traders as at 31st December 20x3. You are required to prepare a balance sheet as at that date.

	Ksh
Land & Buildings	450,000
Furniture & Fittings	75,500
Motor Vehicles	95,800
Stocks	57,000
Debtor	17,600
Cash a bank	21,500
Cash in hand	9,000
Creditors	97,700
Capital	224,200
Loan	400,000

Solution using horizontal format

Alpha Traders			
Balance Sheet as at 31 December 20x3			
<u>Non Current Assets</u>	Ksh	<u>Capital & Liabilities</u>	
Land & Buildings	450,000	Capital	224,200
Furniture & Fittings	75,500		
Motor Vehicles	<u>95,800</u>	<u>Long term Liability</u>	
	621,300	Loan	400,000
<u>Current Assets</u>		<u>Current Liability</u>	
Stock	57,000	Creditors	97,700
Debtors	17,600	Accrued Electricity bill	4,500
Cash at bank	21,500		
Cash in hand	<u>9,000</u>		
	<u>105,100</u>		
	<u>726,400</u>		<u>726,400</u>

Solution using vertical format

Alpha Traders			
Balance Sheet as at 31 December 20x3			
<u>Non Current Assets</u>	Ksh	Ksh	Ksh
Land & Buildings			450,000
Furniture & Fittings			75,500
Motor Vehicles			<u>95,800</u>
			621,300
<u>Current Assets</u>			
Stock		57,000	
Debtors		17,600	
Cash at bank		21,500	
Cash in hand		<u>9,000</u>	
		105,100	
<u>Current Liabilities</u>			
Creditors	97,700		
Accrued Electricity bill	<u>4,500</u>		
		<u>(102,200)</u>	
Working Capital			<u>2,900</u>
NET WORTH			<u>624,200</u>
<u>Financed By:</u>			
Capital			224,200
Long term liability – Loan			<u>400,000</u>
			<u>624,200</u>

Illustration 3.2

The following assets and liabilities are owned by Jacob a sole trader as at 01/01/20x3.

	Ksh
Accounts payable	56,500
Machinery	150,000
Motor Vehicle	260,600
Stock	105,000
Accounts receivable	155,700
Bank	90,000
Cash	34,000

The following transactions were also captured during the financial period that ended 31/12/20x3.

- a) A new machine was purchased on credit worth Ksh 21,500.
- b) Additional stock for Ksh 64,000 was purchased via bank.
- c) Creditors were partly settled by payment of Ksh 20,000 by cheque.
- d) The current debtors paid their account by Ksh 72,000 on cash.
- e) Jacob deposited Ksh 5,000 into the bank account as capital.

Required:

- i. Determine the capital amount for the business at the beginning of the financial period.
- ii. Extract a trial balance that captures all the transactions reported.

Solution:

- i. **Capital can be derived using the accounting equation.**

ASSETS = LIABILITIES + CAPITAL

Therefore;

CAPITAL = ASSETS – CAPITAL

ASSETS	Ksh	LIABILITIES	Ksh
Accounts receivable	155,700	Accounts payable	<u>56,500</u>
Machinery	150,000		
Motor Vehicle	260,600		
Stock	105,000		
Bank	90,000		
Cash	<u>34,000</u>		
	<u>795,300</u>		

Capital = Assets – Liabilities

Capital = 795,300 – 56,500 = Ksh 738,800

- ii. **To Extract a balance sheet we need to consider the reported transactions**