ATD

ACCOUNTING TECHNICIAN DIPLOMA

LEVEL II

FINANCIAL ACCOUNTING

STUDY TEXT
SYLLABUS

PAPER NO 5: FINANCIAL ACCOUNTING

GENERAL OBJECTIVE

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to account for various basic financial transactions, prepare and analyse financial statements

LEARNING OUTCOMES

A candidate who passes this paper should be able to:

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

CONTENT

1. Introduction to Accounting

- The accounting framework
- Sources of regulations of National and global levels; the law (Companies Act), professional bodies, global regulational bodies
- Accounting standards (IAS/IFRS) (Importance and limitations)
- Professional ethics

2. Accounting for assets and liabilities

2.1 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
- Financial Assets – examples and categories

2.2 Liabilities

- Loans - accounting treatment of repayment of principal and interest

3. Financial statements of a sole trader

- Income statement
- Statement of financial position
- Preparing financial statements under incomplete information
4. Financial statements of a partnership
- Income statement
- Statement of financial position
- Changes in partnership – Admission of a new partner, retirement and change in profit sharing ratio

5. Financial statements of a company
- Financial statements - Income statement and statement of financial position
- Published financial statements (describe a complete set of published financial statements but not preparation)

6. 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

7. Financial statements of a not-for-profit organisation
- Features
- Types of funds and their accounting treatment
- Income and expenditure account
- Statement of financial position

8. 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

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

10. Emerging issues and trends
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Revised on: January 2017
TOPIC 1

INTRODUCTION TO ACCOUNTING

INTRODUCTION

Financial accounting is a system that accumulates, processes and reports information about an entity's performance (i.e. profit or loss), its financial position (i.e. assets, liabilities and shareholders' equity) and changes in financial position.

Every entity, whether for-profit or not-for-profit, aims at creating maximum value for its stakeholders. The goal of maximum value addition is best achieved when there is a mechanism to monitor the management and the board of directors. Financial accounting helps in such monitoring by providing relevant, reliable and timely information to the stakeholders.

Inputs to a financial accounting system include business transactions which are supported by source documents, such as invoices, board resolutions, management memos, etc. These inputs are processed using generally accepted accounting principles (GAAP). The processed information is reported through standardized financial statements.

Users of the Financial Statements

The most basic objective of financial accounting is preparation of general purpose financial statements, which are financial statements meant for use by stakeholders external to the entity, who do not have any other means of getting such information, i.e. people other than the management. These stakeholders include:

- **Investors and Financial Analysts**: Investors need the information to estimate the intrinsic value of the entity and to decide whether to buy, hold or sell the entity's shares. Equity research analysts use financial statements to conduct their research on earnings expectations and price targets.
- **Employee groups**: Employees and their representative groups are interested in information about the solvency and profitability of their employers to decide about their careers, assess their bargaining power and set a target wage for themselves.
- **Lenders**: Lenders are interested in information that enables them to determine whether their loans and the interest earned on them will be paid when due.
- **Suppliers and other trade creditors**: Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due and whether the demand from the company is going to increase, decrease or stay constant.
- **Customers**: Customers want to know whether their supplier is going to continue as an entity, especially when they have a long-term involvement with that supplier. For example, Apple is interested in long-term viability of Intel because Apple uses Intel processors in its computers.
and if Intel ceases operations at once, Apple will suffer difficulties in meeting its own demand and will lose revenue.

- **Governments and their agencies:** Governments and their agencies are interested in financial accounting information for a range of purposes. For example, the tax collecting authorities, such as IRS in USA, are interested in calculating taxable income of the tax-paying entities and finding their tax payable. Antitrust authorities, such as Federal Trade Commission, are interested in finding out whether an entity is engaged in monopolization. The governments themselves are interested in efficient allocation of resources and they need financial accounting information of different sectors and industries to decide on federal and state budget allocation, etc. The bureaus of statistics are interested in calculating national income, employment and other measures.

- **Public:** the public is interested in an entity's contribution towards the communities in which it operates, its corporate social responsibility updates, its environmental track record, etc

THE ACCOUNTING FRAMEWORK

An accounting framework is a published set of criteria that is used to measure, recognize, present, and disclose the information appearing in an entity's financial statements. An organization's financial statements must have been constructed using a recognized framework, or else auditors will not issue a clean audit opinion for them.

The most commonly-used accounting frameworks are generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS). GAAP is used by entities in the United States, while IFRS is used in most other parts of the world. These two frameworks are designed to be broad-based and therefore applicable to most types of businesses. There are other accounting frameworks that are designed for special situations, and which are known as other comprehensive bases of accounting (OCBOA).

SOURCES OF REGULATIONS OF NATIONAL AND GLOBAL LEVELS; THE LAW (COMPANIES ACT), PROFESSIONAL BODIES, GLOBAL REGULATIONAL BODIES

PROFESSIONAL BODIES

INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANT (ICPAK)

The Institute of Certified Public Accountants of Kenya (ICPAK) was established in 1978. The Institute is a member of the Pan-African Federation of Accountants (PAFA) and the International Federation of Accountants (IFAC), the global umbrella body for the accountancy profession. The Vision of the Institute is ‘A world class professional accountancy institute’, while the Mission is ‘To develop and promote internationally recognised accountancy profession that upholds public interest through effective regulation, research and innovation’.
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TOPIC 2

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.
MEANING OF DEPRECIATION

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

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

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

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

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

THE BASIC FACTORS IN DEPRECIATION

For calculating depreciation, the basic factors are:

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

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

Objectives of Providing Depreciation

1. **To ascertain true value of assets and financial position:** The value of assets diminishes over a period of time on account of various factors. In order to present a true state of affairs of the business, the assets should be shown in the Balance Sheet, at their trite and fair values. If the depreciation is not provided, the asset will appear in the Balance Sheet at the original
value. So, in order to show the true financial position of a business, it is imperative to charge depreciation on the assets. If depreciation is not provided, the value of assets will be shown at inflated value in the Balance Sheet. By this means, fixed assets will not represent true and correct state of affairs of business.

2. **To make provision for replacement of worn out assets:** All the fixed assets used in the business require replacement after the expiry of their useful life. The need for replacement can be due to many reasons like change in technology, taste, fashion or demand, which makes a particular asset useless causing permanent loss in its value. To provide requisite amount for replacement of this depreciating asset, annual depreciation is charged to Profit & Loss Account. The amount so provided may be retained in business by ploughing back or invested in outside securities to make the funds available for replacement purposes. Practically, the provisions so provided for depreciation help to recoup the expired cost of the assets used, depleted or exhausted.

3. **To calculate correct amount of profits or loss:** Matching principles states that the expenses or costs incurred to earn revenue must be charged to Profit & Loss Account for the purpose of correct computation of profit. When an asset is purchased, it is nothing more than a payment in advance for the use of asset. Depreciation is the cost of using a fixed asset. To determine true and correct amount of profit or loss, depreciation must be treated as revenue expenses and debited to Profit & 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;

\[
\text{Cost minus Estimated Scrap Value} \div \text{Estimated Life}
\]

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.
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REVISION EXERCISE

QUESTION 1

Pata Transport Limited (PTL) was incorporated on 1 June 2006 and on the same day bought its first lorry; KB099S for Sh. 9,000,000.

On 1 April 2007, the company bought its second lorry KB 120T FOR Sh 12,000,000. On 1 June 2008, the company bought a third lorry KB 340X for Sh. 6,000,000.

On 1 October 2008, lorry KB 099S was involved in an accident and was written off. The insurance compensation paid to PTL by the insurers was Sh. 2,600,000.

On 31 December 2009, lorry KB 340X broke down and was traded in with a new lorry registration KB 419Y valued at Sh. 8,000,000. PTL; paid cash amounting to Sh. 5,400,000 for the lorry.

On 1 April 2010, a van KB 890B was purchased for Sh 4,800,000.

Depreciation on motor vehicles is to be provided at the rate of 10% per annum on a straight line basis. The policy of the company is to provide depreciation on a pro rata basis.

On 1 January 2009, the company decided to change its depreciation rate from 10% to 15% per annum. The change was effected on motor vehicles that were in use retrospectively; that is from the year of purchase. An adjusting entry was to be made in the accounts for the year ended 31 December 2009. All lorries were comprehensively insured.

Assume the year end for PTL IS 31 December.

Required:


ii. Provision for depreciation account for the same years stated in (b) (i) above

iii. Disposal of motor vehicles account

Solution:

i) 

Motor vehicles account

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<td>1st April bank (KB 120T)</td>
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2008

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<td>1st October disposal (KB 099S)</td>
<td>9,000,000</td>
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</table>
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TOPIC 3

FINANCIAL STATEMENTS OF A SOLE TRADER

INTRODUCTION

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

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

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

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

Financial statements of a sole trader involve the following:

- Income statement.
- Statement of financial position.

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

THE INCOME STATEMENT

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

1. Finding out the gross profit (or gross loss)
2. Finding out the net profit (or loss)
DETERMINATION OF GROSS PROFIT (OR GROSS LOSS)

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

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

ITEMS TO BE DEBITED

1. 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 Llley 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.

Therefore the following entry is used to incorporate the effect of closing stock in the income statement;
To Closing Stock A/c Dr
To income statement A/c Cr
However, if closing stock forms a part of Trial Balance, it will not be transferred to

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

**Ascertain 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)**

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

**INTR TRADING ACCOUNT (VERTICAL FORMAT)**

<table>
<thead>
<tr>
<th>Sh</th>
<th>Sh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>XXX</td>
</tr>
<tr>
<td>Less: Returns Inwards</td>
<td>(XX)</td>
</tr>
<tr>
<td>Net sales</td>
<td>XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Sh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening stock</td>
</tr>
<tr>
<td>Purchases</td>
</tr>
<tr>
<td>Add: Carriage Inwards</td>
</tr>
<tr>
<td>Less: Returns Outwards</td>
</tr>
<tr>
<td>Cost of stock available for sale</td>
</tr>
<tr>
<td>Less: Closing stock</td>
</tr>
<tr>
<td>Cost of sales</td>
</tr>
<tr>
<td>Gross Profit</td>
</tr>
</tbody>
</table>
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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Sh. &quot;000&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carriage inwards</td>
<td>13,400</td>
</tr>
<tr>
<td>Returns outwards</td>
<td>9,900</td>
</tr>
<tr>
<td>Returns inwards</td>
<td>17,800</td>
</tr>
<tr>
<td>Sales</td>
<td>774,840</td>
</tr>
<tr>
<td>Purchases</td>
<td>666,660</td>
</tr>
<tr>
<td>Stock of goods: 31 December 2010</td>
<td>149,780</td>
</tr>
</tbody>
</table>

Mr. Karanja

Trading Account for the year ended 31 Dec 2010

<table>
<thead>
<tr>
<th>Description</th>
<th>Sh. &quot;000&quot;</th>
<th>Sh. &quot;000&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td></td>
<td>774,840</td>
</tr>
<tr>
<td>Less: Returns Inwards</td>
<td></td>
<td>17,800</td>
</tr>
<tr>
<td>Less: Cost of sales</td>
<td></td>
<td>757,040</td>
</tr>
<tr>
<td>Purchases</td>
<td>666,660</td>
<td></td>
</tr>
<tr>
<td>Add: Carriage Inwards</td>
<td>13,400</td>
<td></td>
</tr>
<tr>
<td>Less: Returns Outwards</td>
<td>(9,900)</td>
<td></td>
</tr>
<tr>
<td>Less: Closing stock</td>
<td>(149,780)</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
<td>(520,380)</td>
</tr>
<tr>
<td>Gross Profit</td>
<td></td>
<td>236,660</td>
</tr>
</tbody>
</table>

Illustration

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Sh. &quot;000&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stocks: 1 April 2009</td>
<td>16,523</td>
</tr>
<tr>
<td>Returns inwards</td>
<td>1,372</td>
</tr>
<tr>
<td>Returns 'outwards'</td>
<td>2,896</td>
</tr>
<tr>
<td>Purchases</td>
<td>53,397</td>
</tr>
<tr>
<td>Carriage inwards</td>
<td>1,122</td>
</tr>
<tr>
<td>Sales</td>
<td>94,600</td>
</tr>
<tr>
<td>Stocks: 31 March 2010</td>
<td>14,323</td>
</tr>
</tbody>
</table>
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REVISION EXERCISE

QUESTION 1

The following balances were extracted from the books of Patel and Sons in respect of the year ended 31 December 2005:

<table>
<thead>
<tr>
<th>Description</th>
<th>Sh.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,352,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>990,000</td>
</tr>
<tr>
<td>Debtors</td>
<td>177,800</td>
</tr>
<tr>
<td>Creditors</td>
<td>83,400</td>
</tr>
<tr>
<td>Stock in trade (I January 2005)</td>
<td>80,000</td>
</tr>
<tr>
<td>Machinery (cost)</td>
<td>112,500</td>
</tr>
<tr>
<td>Furniture</td>
<td>17,000</td>
</tr>
<tr>
<td>Rent for building</td>
<td>19,200</td>
</tr>
<tr>
<td>Cash in hand</td>
<td>8,500</td>
</tr>
<tr>
<td>Cash at bank</td>
<td>34,738</td>
</tr>
<tr>
<td>Drawings</td>
<td>24,000</td>
</tr>
<tr>
<td>Capital</td>
<td>180,000</td>
</tr>
<tr>
<td>Salaries</td>
<td>37,820</td>
</tr>
<tr>
<td>Bad debts</td>
<td>2,400</td>
</tr>
<tr>
<td>Suspense account</td>
<td>6,000</td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>6,400</td>
</tr>
<tr>
<td>Printing expenses</td>
<td>4,600</td>
</tr>
<tr>
<td>Postage</td>
<td>3,000</td>
</tr>
<tr>
<td>Travelling expenses</td>
<td>1,800</td>
</tr>
<tr>
<td>Telephone expenses</td>
<td>3,200</td>
</tr>
<tr>
<td>Miscellaneous expenses</td>
<td>83,612</td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>2,080</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,621,800</strong></td>
</tr>
</tbody>
</table>

Additional information:
1. Old furniture which stood in the books (as at I January 2005) at Sh.2,400,000 was disposed of at Sh.1,160,000 during the year in part exchange for new furniture costing Sh.2,080,000. A net invoice of Sh.920,000 in respect of this transaction was erroneously passed through the Purchases Day Book.
2. The suspense account represented money advanced to a sales team detailed to undertake a sales campaign in the Rift Valley Province. On returning, the sales team disclosed that Sh.2,400,000 was used for travelling, Sh.1,000,000 for legal fees and Sh.1,800,000 for miscellaneous expenses. The balance was yet to be refunded by 31 December 2005.
3. The business is conducted in a rented building and 50% or the building is used for accommodation of the business owner's family.
4. Depreciation is to be provided on the straight line basis at 10%) per annum on machinery and 5% per annum on furniture. Depreciation is to be applied for the whole year regardless of date of purchase of the asset.

5. Total bad debts for the year amounted to Sh.4,000,000. Provision for doubtful debts is to be maintained at 5% of the outstanding debtors

6. Closing stock amounted to Sh100,000,000

7. Insurance premiums cover the one year period ended 31 January 2006.

**Required:**

a) Trading and profit and loss account for the year ended 31 December 2005.
b) Balance sheet as at 31 December 2005

**Solution:**

<table>
<thead>
<tr>
<th>Patel and Sons</th>
<th>Shs '000'</th>
<th>Shs '000'</th>
<th>Shs '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Trading and Profit and Loss Account for the Year Ended 31 December 2005</strong></td>
<td></td>
<td></td>
<td>1,352,000</td>
</tr>
<tr>
<td>Sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening stock</td>
<td>80,000.00</td>
<td></td>
<td>1,069,080.00</td>
</tr>
<tr>
<td>Purchases (w1)</td>
<td>989,080.00</td>
<td></td>
<td>(969,080.00)</td>
</tr>
<tr>
<td>Closing stock</td>
<td>(100,000.00)</td>
<td></td>
<td>382,920.00</td>
</tr>
<tr>
<td>Gross profit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rent (w2)</td>
<td>9,600.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>37,820.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bad debts</td>
<td>4,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase in provision for bad debts (w3)</td>
<td>2,410.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Printing expenses</td>
<td>4,600.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Postage</td>
<td>3,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Travelling expenses (w4)</td>
<td>18,200.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telephone expenses (w5)</td>
<td>3,200.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Miscellaneous</td>
<td>85,412.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance Premium (w6)</td>
<td>1,906.67</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Legal fees</td>
<td>1,000.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation (w7) - Furniture</td>
<td>834.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Machinery</td>
<td>11,200.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loss on disposal — Furniture (w8)</td>
<td>1,240.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net profit</td>
<td></td>
<td>198,497.33</td>
<td></td>
</tr>
</tbody>
</table>

Note: Values are approximate due to rounding.
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INTRODUCTION

There are a number of ways in which a partnership may be defined, but there are four key elements.

**Two or more individuals**

A partnership includes at least two individuals (partners). In certain jurisdictions, there may be an upper limit to the number of partners.

**Business arrangement**

A partnership exists to carry on a business.

**Profit motive**

As it is a business, the partners seek to generate a profit.

**Unincorporated business entity**

A partnership is an unincorporated business entity. That means:

- The reporting entity (business entity) principle applies to a partnership, so for accounting purposes, the partnership is a separate entity from the partners
- The partners have unlimited liability, and
- If the partnership is unable to pay its liabilities, the partners may be called upon to use their personal assets to clear unpaid liabilities of the partnership.

Therefore a partnership is an unincorporated association of two or more individuals, to carry on a business for profit.

A partnership, by the Kenya Partnership Act of 1962 Chapter, is defined as the relationship which exists between persons carrying on a business in common with a view of profit.

According to the definition there are the following essential elements:

a) There must be a business which would include trade, occupation or profession.

b) The business must be carried on for the purpose of making a profit.

c) The business must be carried on by all or any one of them acting on behalf of all partners.

d) There must be an association of two or more persons.

e) Common property or part ownership does not create a partnership. Sharing returns, loans offered, or debts do not create a partnership.
Types of partnerships

There are two main types of partnerships: General partnership and Limited Partnership.

General partnerships are governed by the Partnership Act of 1962 Cap 29. These are partnerships which consist of persons whose liability for the debts and obligations are unlimited, because they take part in management of the partnership business.

Limited partnerships are governed by the Limited Partnership Act of 1062 (Cap 30). They consist of one or more general partners whose liability is unlimited and one or more limited partners whose liability is limited to the amount of capital contributed by them to the firm.

He has no right to share in management of the firm and if he does so, his liability becomes unlimited for the firm's debts.

The purpose of a limited partnership is to give limited liability to some partners who did not wish to take an active part in the business.

However, the objective can be satisfied by forming a private company under the Companies Act. Very few limited partnerships exist.

PARTNERSHIP AGREEMENT

A partnership can be formed without any legal formalities by any two or more people. The maximum number of people who can form such a partnership under our laws is 20.

When two or more people decide to form a partnership, such an agreement, whether written or verbal or even inferred from the conduct of the parties, constitutes a contract and a partnership is automatically created.

However, it is generally strongly recommended that a partnership contract or agreement should be written in order to lessen the chances of misunderstanding and future disagreement because it can be easily referred to.

It is good practice to set out the terms agreed by the partners in a partnership agreement. While this is not mandatory, it can reduce the possibility of expensive and acrimonious disputes in the future. As a formal agreement is not mandatory, there is no definitive list of what it should contain. The agreement should identify the partners; their respective business-related duties and responsibilities; how income will be shared; the criteria for additional investments and withdrawals; and the guidelines for adding partners, the withdrawal of a partner, and liquidation of the partnership. For income tax purposes, the partnership files an information return only. Each partner shares in the net income or loss of the partnership and includes this amount on his/her own tax return.

When a partnership agreement is in written form it should cover the following areas:
a. The names of the firm and the location of the business.
b. The nature of the business to be carried on by the firm.
c. The amount of capital to be contributed and left in the business by each partner.
d. The ratio in which profits are to be shared — one partner may entitled to a greater share of the profits because he has more expenses or is doing a greater share of the work.
e. The rate of interest to be allowed on investment capital and the rate of interest to be charged on drawings. Interest on capital may be appropriate where one or more partners are contributing a materially greater sum than others. Interest on drawings is used to discourage withdrawal.
f. Salaries to be allowed to partners and other benefits such as commissions or bonuses. Some partners may be entitled to a salary because of the work they are performing.
g. Any variations in the usual rights of a partner
h. The method to be followed on admission or retirement of a partner
i. Method to be followed in the event of dispute among partners
j. Duration of partnership
k. Manner in which accounts are to be prepared and inspected.

Rights of Partners

a) Every partner has a right to take part in the conduct and management of business.
b) Every partner has a right to be consulted and heard in all matters affecting the business of the partnership.
c) Every partner has a right of free access to all records, books and accounts of the business, and also to examine and copy them.
d) Every partner is entitled to share in the profits equally.
e) A partner who has contributed more than the agreed share of capital is entitled to interest at the rate of six percent per annum. But no interest can be claimed on capital.
f) A partner is entitled to be indemnified by the firm for all acts done by him in the course of the partnership business, for all payments made by him in respect of partnership debts or liabilities and for expenses and disbursements made in an emergency for protecting the firm from loss provided he acted as a person of ordinary prudence would have acted in similar circumstances for his own personal business.
g) Every partner is, as a rule, joint owner of the partnership property. He is entitled to have the partnership property used exclusively for the purposes of the partnership.
h) A partner has power to act in an emergency for protecting the firm from loss, but he must act reasonably.
i) Every partner is entitled to prevent the introduction of a new partner into the firm without his consent
j) Every partner has a right to retire according to the Deed or with the consent of the other partners. If the partnership is at will, he can retire by giving notice to other partners.
k) Every partner has a right to continue in the partnership.
l) A retiring partner or the heirs of a deceased partner are entitled to share in the profits earned with the aid of the proportion of assets belonging to such outgoing partner or interest at six per cent per annum at the option of the outgoing partner (or his representative) until the accounts are finally settled.

Duties of partners

a) Every partner is bound to diligently carry on the business of the firm to the greatest common advantage. Unless the agreement provides, there is no salary.
b) Every partner must be just and faithful to the other partners.
c) A partner is bound to keep and render true, proper, and correct accounts for the partnership and must permit other partners to inspect and copy such accounts.
d) Every partner is bound to indemnify the firm for any loss caused by his willful neglect or fraud in the conduct of the business.
e) A partner must not carry on a competing business, nor use the property of the firm for his private purposes. In both cases he must hand over to the firm any profit or gains made by him but he must himself suffer any loss that might have occurred.
f) Every partner is bound to share the losses equally with the others.
g) A partner is bound to act within the scope of his authority.
h) No partner can assign or transfer his partnership interest to any other person so as to make him a partner in the business.

Powers of Partners

The above relates to relations among the partners themselves. When it comes to dealings with outsiders or third parties, the partners are supposed to have the power to act in certain matters and not to have such power in others.

In other words, unless a public notice has been given to the contrary, certain contracts entered into by a partner on behalf of the partnership, even without consulting other partners, will be binding on the firm.

In the case of a trading firm, the implied powers of the partners are as follows:

a) Buying and Selling goods
b) Receiving payments on behalf of the firm and giving valid receipts
c) Drawing cheques and drawing, accepting and endorsing hills of exchange and promissory notes in the name of the firm
d) Borrowing moneys on behalf of the firm with or without pledging the stock in trade
e) Engaging servants for the business of the firm.

In the following cases, a partner has no powers. This is to say, the third parties cannot bind the firm unless the partners have agreed to be so bound.
a) Submitting a dispute relating to the firm to arbitration
b) Opening a bank account on behalf of the firm in the name of a partner
c) Compromise or relinquishment of any claim or portion of claim by the firm.
d) Withdrawal of a suit or proceedings filed on behalf of the firm.
e) Admission of any liability in a suit or proceedings against the firm
f) Acquisition of immovable property belonging to the firm
g) Transfer of immovable property belonging to the firm.
h) Entering into partnership on behalf of the firm

The rights, duties and powers of partners can be changed by mutual consent.

Types of Partners

Besides the usual partners who contribute to the capital of the firm and take part in its business, the following special types of partners may be noted.

**Sleeping or Dormant** partner is one who is in reality a partner, but whose name does not appear in any way as partner, and who is not known to outsiders as partner.

He is liable to those third parties who subsequently discover that he was or is a partner. He has no duties to perform but he has the right of access to the books of account and of examining and copying them.

**Nominal partner** is a person whose name is used as if he was a member of the firm, but who, in reality, is not a partner. He is liable to those third parties who give credit to the firm on the strength of his being a partner.

Partner in profit only is one who gets a share of the profits and does not share losses. He is liable to outsiders. He does not take part in the management of the business.

**Partner by estoppel or holding out** is one, who without really being a partner, so conducts himself as to lead others to believe him to be a partner. Similarly, if one is declared to be a partner and does not disclaim the partnership, one will be treated as partner by holding out. Such persons are liable to those third parties who extend credit to the firm on the belief that such persons are partners.

**Sub-partner** gets a share of profits of the firm from one of the partners. A sub-partner has no rights against the firm and he is not liable for its debts.

An **incoming partner** is one who is newly admitted to the firm. He is not liable for the debts and obligations of the firm incurred before his joining the firm unless he so agrees.

A **retiring or outgoing partner** continues to be liable for obligations incurred before his retirement, and will continue to be liable even for future obligations, if he does not give public notice of his retirement.
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REVISION EXERCISE

QUESTION 1

Aisha, Birdi and Wafula are partners. They share profits and losses in the ratio of 3:2:1. In the first year of trading, ending 31 December 2004, the partnership earned a net profit of Shs.15,800,000. They have agreed interest should be allowed on fixed capital balances at 10% per annum. Also, it has been agreed that Birdi should receive a partnership salary of sh.4,500,000 per annum. Capital - account balances are as follows: Aisha Shs.8,000,000, Birdi Shs.6000,000 and Wafula Shs.6,000,000

You are required to draw up the appropriation account of the partnership for the year ended 31 December 2004.

Solution:

<table>
<thead>
<tr>
<th>Aisha, Birdi &amp; Wafula</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Appropriation Account for year ended 31 December 2004</td>
<td>Shs.000</td>
<td>Shs.000</td>
</tr>
<tr>
<td>Net profit</td>
<td></td>
<td>15,800</td>
</tr>
<tr>
<td>Less: interest on capital</td>
<td>800</td>
<td></td>
</tr>
<tr>
<td>Hirst</td>
<td>600</td>
<td>2,000</td>
</tr>
<tr>
<td>Bright</td>
<td></td>
<td>4,500</td>
</tr>
<tr>
<td>Warhurst</td>
<td>600</td>
<td>9,300</td>
</tr>
<tr>
<td>Salary: Bright</td>
<td></td>
<td>6,500</td>
</tr>
<tr>
<td>Balance of profits shared:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hirst</td>
<td>4,650</td>
<td></td>
</tr>
<tr>
<td>Bright</td>
<td>3,100</td>
<td></td>
</tr>
<tr>
<td>Warhurst</td>
<td>1,550</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>9,300</td>
</tr>
</tbody>
</table>

QUESTION 2

Stewart and Armstrong are in partnership sharing profits and losses equally. The following balances have been extracted from the books as at 31 December 2006.

<table>
<thead>
<tr>
<th>Capital a/c: Sh.000</th>
<th>Current a/c: Sh.000</th>
<th>Salaries: Sh.000</th>
<th>Drawings: Sh.000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stewart, Shs.15,000</td>
<td>Stewart, Shs.3,200</td>
<td>Stewart, Shs.6,000</td>
<td>Stewart, Shs.8,000</td>
</tr>
<tr>
<td>Armstrong, Shs.20,000</td>
<td>Armstrong, Shs.800</td>
<td>Armstrong, Shs.4,000</td>
<td>Armstrong, Shs.5,000</td>
</tr>
</tbody>
</table>

The firm's net profit for the year to 31 December 2Q06 was Shs.26,750,000. Interest is to be allowed on capital at 10% per year.
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TOPIC 5

FINANCIAL STATEMENTS OF A COMPANY

INTRODUCTION

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

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

Types of companies

There are 2 principle types of companies:

Private companies

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

Public companies

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

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

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

The term capital structure refers to the percentage of capital (money) at work in a business by type. Broadly speaking, there are two forms of 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 it's "cost" is the return the firm must earn to attract investment. A speculative mining company that is looking for silver in a remote region of Africa may require a much higher return on equity to get investors to purchase the stock than a firm such as Procter & Gamble, which sells everything from toothpaste and shampoo to detergent and beauty products.

**Debt Capital**

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

**TYPES OF SHARE CAPITAL**

**ORDINARY SHARES**

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

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

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

On the other hand, ordinary share on average perform better than preferred shares or bonds over time. Ordinary share usually carries with it the right to vote on certain matters, such as electing the board of directors. However, a company can have both a "voting" and "non-voting" class of ordinary share.
Holders of ordinary share are able to influence the corporation through votes on establishing corporate objectives and policy, stock splits, and electing the company's board of directors. Some holders of ordinary share also receive preemptive rights, which enable them to retain their proportional ownership in a company should it issue another stock offering. There is no fixed dividend paid out to ordinary shareholders and so their returns are uncertain, contingent on earnings, company reinvestment, and efficiency of the market to value and sell stock.

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

PREFERENCE SHARES

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

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

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

ISSUE OF SHARES

Shares can be issued being payable for:

a) Immediately on application 

b) By installments 

Issue of shares take place on the following terms:

(Connected with the price of shares)

1) Shares issued at par value

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

2) Shares issued at a premium

Shares are issued at a price higher than the nominal value
3) Shares issued at a discount

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

**Accounting entries**

To recognize the amount expected on issue:

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

Being the nominal value expected on application.

On receipt of amount

- **DR**- bank account
- **CR**- share application

Being the amount received on application

**Issue at a premium**

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

Being the amount expected on issue

On receipt

- **DR**- bank
- **CR**- share application

Being the amount received on application

**Issue at discount**

- **DR**- share application
- **CR**- share application

Being the amount expected on application

On receipt

- **DR**- bank
- **DR**- discount on share issue
- **CR**- share application

Being the amount received on application and discount
Over and under subscription

Often, when a company invites investors to apply or subscribe for its shares, the number of applications will not equal the number of shares issued.

When more shares are applied for than are actually available for issue, then the issue is said to be oversubscribed.

When fewer shares are applied for than are available for issue, then the issue is said to be undersubscribed.

When the issue is under subscribed, there is no problem since accounting entries will only be in respect of the applied shares as the unapplied portion does not represent a transaction (there is no transaction for the unapplied portion)

If however the shares are oversubscribed, the company must come up with a policy on how the shares are to be allocated.

Any excess application money will be refunded by the company.

Rights Issue

A right issue is an option on the part of the shareholder given by the company to existing shareholders at a price lower than the market price.

It involves selling ordinary shares to existing shareholders of the company on a prorata basis. When the rights are issued the shareholders have 2 options available.

Buy the new shares and exercise their rights

Sell the rights in the market,

Ignore the rights.

A rights issue therefore gives the shareholder the right (but not an obligation) to buy the new shares issued by the company.

Example

A Ltd has a share capital of Shs.200,000 trade up of 100,000 shares of Shs.2 each. The balance on the share premium is Shs.60,000. Additional capital is raised by way of a right issue. The terms are For every 5 shares held in the company, a shareholder can buy 2 shares at a price of Shs.2.5 per share.

Required;
The journal entries to reflect the above transaction assuming that all the shareholders exercise their rights and the relevant balance sheet extract.
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REVISION QUESTIONS

QUESTION 1

From the following trial balance of M Fry, you are asked to draw up an income statement for the year ended 31 December 2007 and a statement of financial position as at that date

<table>
<thead>
<tr>
<th>Description</th>
<th>Shs.000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and loss account 31 December 2006</td>
<td>23,000</td>
</tr>
<tr>
<td>Sales</td>
<td>52,000</td>
</tr>
<tr>
<td>Purchases</td>
<td>33,000</td>
</tr>
<tr>
<td>Stock in trade 31 December 2006</td>
<td>9,660</td>
</tr>
<tr>
<td>Premises</td>
<td>135,000</td>
</tr>
<tr>
<td>Equipment</td>
<td>25,000</td>
</tr>
<tr>
<td>Vehicles</td>
<td>16,000</td>
</tr>
<tr>
<td>Bank</td>
<td>9,600</td>
</tr>
<tr>
<td>Wages</td>
<td>14,500</td>
</tr>
<tr>
<td>Insurance</td>
<td>2,340</td>
</tr>
<tr>
<td>Preference share capital (shs 1 shares) 6%</td>
<td>50,000</td>
</tr>
<tr>
<td>Ordinary share capital (shs 1)</td>
<td>120,000</td>
</tr>
<tr>
<td>Provision for bad debts.</td>
<td>450</td>
</tr>
<tr>
<td>General reserve</td>
<td>7,800</td>
</tr>
<tr>
<td>Debtors</td>
<td>12,400</td>
</tr>
<tr>
<td>Creditors</td>
<td>7,000</td>
</tr>
<tr>
<td>Rent</td>
<td>3,250</td>
</tr>
</tbody>
</table>

Total: 260,750

Additional Information:

- Stock in trade at 31 December 2007 was shs 10,660,000
- Prepaid wages shs 320,000
- Insurance owing shs 45,000
- The provision for debtors is to be maintained at 5%
- Corporation tax is to be provided for at shs 1,600,000
- The preference dividend is to be provided for and an ordinary dividend of 5% is also to be provided for.
Solution:

M Fry
Trading, profit & loss Appropriation Account
For year ended 31 December 2006

<table>
<thead>
<tr>
<th></th>
<th>Shs.000</th>
<th>Shs.000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>52,000</td>
<td></td>
</tr>
<tr>
<td><strong>Less cost of goods sold</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening stock</td>
<td>9,660</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>33,000</td>
<td>42,660</td>
</tr>
<tr>
<td>Less Closing stock</td>
<td>10,660</td>
<td></td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td></td>
<td>32,000</td>
</tr>
<tr>
<td><strong>Less expenses</strong></td>
<td></td>
<td>20,000</td>
</tr>
<tr>
<td>Wages</td>
<td>14,180</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>2,385</td>
<td></td>
</tr>
<tr>
<td>Rent</td>
<td>3,250</td>
<td></td>
</tr>
<tr>
<td>Vehicle depreciation</td>
<td>1,600</td>
<td></td>
</tr>
<tr>
<td>Equipment depreciation</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Provision for doubtful debts</td>
<td>170</td>
<td></td>
</tr>
<tr>
<td><strong>Profit for the year before tax</strong></td>
<td></td>
<td>26,585</td>
</tr>
<tr>
<td>Less corporation tax</td>
<td></td>
<td>1,600</td>
</tr>
<tr>
<td><strong>Profit for the year after tax</strong></td>
<td></td>
<td>(6,185)</td>
</tr>
<tr>
<td>Add retained profit b/f</td>
<td></td>
<td>23,000</td>
</tr>
<tr>
<td><strong>Less Appropriations:</strong></td>
<td></td>
<td>14,815</td>
</tr>
<tr>
<td>Ordinary divindeds</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Preference divindeds</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Transfer to general reserves</td>
<td>4000</td>
<td></td>
</tr>
<tr>
<td><strong>Retained profit c/f</strong></td>
<td></td>
<td>13,000</td>
</tr>
</tbody>
</table>

M Fry
Statement of financial position as at 31 December 2007

<table>
<thead>
<tr>
<th>Fixed Assets</th>
<th>Cost Shs.000</th>
<th>Dep. Shs.000</th>
<th>NBV Shs.000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Premises</td>
<td>135,000</td>
<td>135,000</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>25,000</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td>Vehicles</td>
<td>16,000</td>
<td>14,400</td>
<td></td>
</tr>
<tr>
<td></td>
<td>176,000</td>
<td>169,400</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Current Assets</th>
<th>Stock</th>
<th>Debtors</th>
<th>Less provision</th>
<th>Prepayments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>12,400</td>
<td>620</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>11,780</td>
<td>320</td>
</tr>
</tbody>
</table>
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TOPIC 6

FINANCIAL STATEMENTS OF A MANUFACTURING ENTITY

FEATURES OF A MANUFACTURING ENTITY

it will be realized that the ordinary Trading Account is not capable of showing up the cost of manufacturing goods, because:

1. It deals with stocks (both opening and closing) of finished goods
2. Some of the expenses connected with production, such as, depreciation and repairs of machinery, are usually debited to the Profit and Loss Account.

Thus, for manufacturing organizations, manufacturing accounts will be needed in addition to a trading and profit and loss accounts. This will be for internal purposes/ use in the company.

In place of purchases we will instead have the cost of manufacturing the goods. A separate 'Manufacturing Account' to which will be debited all expenses incurred in the factory on the production of goods. This means that depreciation of and repairs to plant and machinery are also debited to the Manufacturing Account and not to the Trading Account.

The total of such expenses adjusted for value of stocks of raw materials and of semi-finished goods will show the total cost of the output during the financial period.

This figure is transferred to the debit of the Trading Account which will show the gross profit made in the usual manner.

In a manufacturing concern, at any time there will be some unfinished or semi-finished work. This is called work in process or work UN certified. It is an asset like stock of materials or finished goods. The Value of work in progress in the beginning is debited to the Manufacturing Account as opening stock. The value of work in process-is credited to this account, as closing stock, and then shown in the Balance Sheet.


CLASSIFICATION OF COSTS

Classification and apportioning costs between manufacturing and selling and administration

For a manufacturing the manufacturing costs are did into the following types:

i) Direct material costs

Direct material costs are those materials used directly in the manufacture of products i.e. materials that can be identified in the final products. E.g. in the manufacture of tables, direct materials consists of timber, nails, glue etc.

ii) Direct labour costs

These are wages paid to those who are directly involved in the manufacture of a product e.g in the manufacture of tables; direct labour consists of wage paid to those workers who saw. Shape of join the piece of timber into table.

iii) Direct expenses

These are expenses that must be incurred in the manufacturing of a product. That is, they can be directly allocated a particular unit of a product e.g. live changes for special equipment used in the process of manufacture, royalties

NB: The sum of all the direct costs is known as Prime costs

iv) Indirect manufacturing costs / fact

These are any other expenses (apart from the direct costs) for items being manufactured: e.g cleaners wages, factory rents, depreciation of plant and equipment, factory powder and lighting

NB: prime cost + indirect manufacturing costs=Production cost

v) Administrative Expenses

These are expenses that are administrative in nature, that is, expenses incurred in the process of planning, controlling and directing the organization. E.g. office rents, office electricity, depreciation of office machinery, secretarial salaries

vi) Selling and distribution expenses

These are expenses incurred in the process of selling, promoting and distributing the goods manufactured, E.g. advertising expenses, carriage outwards, depreciation of motor van, salesmen salaries etc.

vii) Finance Costs

These are expenses such as bank charges, discount allowed.
FINANCIAL STATEMENTS

Manufacturing account, income statement and statement of financial position

Manufacturing account part

Manufacturing account is an account prepared by manufacturing concerns to ascertain cost of goods manufactured during the period. All the expenses relating to manufacturing activity are debited.

The total represents cost of manufactures, which is transferred to trading account.

This is debited with the production cost of goods completed during the accounting period:

It consists of

- Direct materials
- Direct labour
- Direct expenses
- Indirect manufacturing costs.

It also includes adjustments for work in progress (goods that are partly completed at the end of a period)

STEPS

1. Add opening stock of raw materials to purchases and subtract the stock of raw materials. This is to get the cost of materials used during the period.
2. Add in all the direct costs to get the prime costs
3. Add all the indirect manufacturing costs.
4. Add the opening stock of WIP and subtract the closing stock WIP to get the production cost of all goods completed in the period. This is because WIP cannot be sold and therefore should not be included in the trading account.
5. The manufacturing account when completed shows the total that is available for sale during the period
   This will be used in trading account in place for purchases.

Final accounts of a manufacturer

1. Manufacturing accounts — used to determine the cost of production.
2. Income statement - Used to determine the gross profit on trading.
3. Statement of financial position
**Treatments of loose materials**

The cost of loose tools consumed during the year is considered as a factory overhead in the manufacturing account and is determined as follows:

\[
\text{shs} \\
\begin{align*}
\text{Opening stock of loose tools} & \quad \text{Xx} \\
\text{Add purchases of loose tools} & \quad \text{Xx} \\
\text{Less closing stock of loose tools} & \quad \text{Xx} \\
\text{Cost of loose tools consumed} & \quad \text{Xx}
\end{align*}
\]

**Manufacturing Accounts Format**

<table>
<thead>
<tr>
<th>XYZ Ltd</th>
<th>manufacturing account for the year ended 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening stock raw materials</td>
<td>xxx</td>
</tr>
<tr>
<td>Add: purchased raw materials</td>
<td>xxx</td>
</tr>
<tr>
<td>Carriage inwards (raw materials)</td>
<td>xxx</td>
</tr>
<tr>
<td>Less: return outwards (raw materials)</td>
<td>(xxx)</td>
</tr>
<tr>
<td>Cost of materials available for production</td>
<td>(xxx)</td>
</tr>
<tr>
<td>Less closing stock (R.M)</td>
<td>x xx</td>
</tr>
<tr>
<td>Cost of raw materials used</td>
<td>xxx</td>
</tr>
<tr>
<td>Add Direct labor</td>
<td>xxx</td>
</tr>
<tr>
<td>Direct expenses</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Prime costs</strong></td>
<td>xxx</td>
</tr>
<tr>
<td>Indirect labor</td>
<td>xxx</td>
</tr>
<tr>
<td>Indirect expenses</td>
<td>xxx</td>
</tr>
<tr>
<td>Heating expenses</td>
<td>xxx</td>
</tr>
<tr>
<td>Lighting expenses</td>
<td>xxx</td>
</tr>
<tr>
<td>Depreciation of factory equipment</td>
<td>xxx</td>
</tr>
<tr>
<td>Depreciation of factory van</td>
<td>xxx</td>
</tr>
<tr>
<td>Factory salaries/wages</td>
<td>xxx</td>
</tr>
<tr>
<td>Factory rent</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Total indirect expense</strong></td>
<td>Xxx</td>
</tr>
<tr>
<td>Add opening work in progress</td>
<td>Xxx</td>
</tr>
<tr>
<td>Less closing work in progress</td>
<td>(xxx)</td>
</tr>
<tr>
<td><strong>Total Cost of production for goods completed</strong></td>
<td>xxx</td>
</tr>
<tr>
<td>Manufacturing gross profit added</td>
<td>xxx</td>
</tr>
<tr>
<td><strong>Finished goods at transferred price</strong></td>
<td>xxx</td>
</tr>
</tbody>
</table>
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.

ii. The opening stock to be used in the statement of comprehensive income is the opening stock of finished goods.

iii. 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.

<table>
<thead>
<tr>
<th>XYZ Income statement for the year ended 31 December XX</th>
<th>Sh.</th>
<th>Sh.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td></td>
<td>XXX</td>
</tr>
<tr>
<td>Less cost of goods sold</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Opening stock of finished goods</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Add production cost of goods completed b/f</td>
<td>XXX</td>
<td></td>
</tr>
<tr>
<td>Less closing stock of finished goods</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of Sales</td>
<td></td>
<td>XXX</td>
</tr>
<tr>
<td>Gross Profit</td>
<td></td>
<td>XXX</td>
</tr>
</tbody>
</table>

Less Expenses

| Office Rent | XXX |
| Office Electricity | XXX |
| Depreciation of office machinery | XXX |
| Selling & distribution expenses | XXX |
| Advertising | XXX |
| Delivery Van expenses | XXX |
| Carriage outwards | XXX |
| Carriage Outwards | XXX |
| Salesmen salaries | XXX | XXX |
| Net Profit /loss | XXX |

Note:

Expenses should be appointed as follows:
Indirect manufacturing costs - charged in manufacturing account
Administrative expenses - Charged in the profit & loss account
Selling and distribution expenses - Charged in the profit & loss account
Financial charges - Charged in the profit & loss account

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REVISION EXERCISE

QUESTION 1
Mboymak limited manufacturer’s farm implements. The following list of balances was extracted from the books of account of the company as at 31 December 2012

<table>
<thead>
<tr>
<th></th>
<th>Shs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory as at 1 January 2012</td>
<td></td>
</tr>
<tr>
<td>Raw materials</td>
<td>1,270,000</td>
</tr>
<tr>
<td>Work in progress</td>
<td>1,555,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>1,163,000</td>
</tr>
<tr>
<td>Purchase of raw materials</td>
<td>4,576,750</td>
</tr>
<tr>
<td>Carriage of raw materials</td>
<td>98,000</td>
</tr>
<tr>
<td>Direct labour</td>
<td>4,210,400</td>
</tr>
<tr>
<td>office salaries</td>
<td>1,670,950</td>
</tr>
<tr>
<td>Rent</td>
<td>260,000</td>
</tr>
<tr>
<td>Electricity (office)</td>
<td>221,000</td>
</tr>
<tr>
<td>Depreciation expense</td>
<td>510,000</td>
</tr>
<tr>
<td>Machinery</td>
<td></td>
</tr>
<tr>
<td>Equipment (office)</td>
<td>115,000</td>
</tr>
<tr>
<td>Sales</td>
<td>15,931,100</td>
</tr>
<tr>
<td>Electricity (factory)</td>
<td>406,000</td>
</tr>
</tbody>
</table>

Additional information:-
1. Inventory as at 31 December 2012 was given as follows:-

<table>
<thead>
<tr>
<th></th>
<th>Shs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw materials</td>
<td>1,445,000</td>
</tr>
<tr>
<td>Work in progress</td>
<td>1,230,000</td>
</tr>
<tr>
<td>Finished goods</td>
<td>1,442,000</td>
</tr>
</tbody>
</table>

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

Required:-
   i) Manufacturing account for the year ended 31 December 2012
   ii) Income statement for the year ended 31 December 2012
Solution:

a) Manufacturing account

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct raw materials</td>
<td>1,270,000</td>
</tr>
<tr>
<td>Purchase of raw materials</td>
<td>4,576,750</td>
</tr>
<tr>
<td>Carriage inwards</td>
<td>98,000</td>
</tr>
<tr>
<td>Raw materials available for use</td>
<td>5,944,750</td>
</tr>
<tr>
<td>Less: Closing inventory</td>
<td>(1,445,000)</td>
</tr>
<tr>
<td>Direct raw materials used</td>
<td>4,499,750</td>
</tr>
<tr>
<td>Direct labour</td>
<td>4,210,400</td>
</tr>
<tr>
<td><strong>Prime Cost</strong></td>
<td>8,710,150</td>
</tr>
<tr>
<td><strong>Indirect factory expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Depreciation on machinery</td>
<td>510,000</td>
</tr>
<tr>
<td>Electricity</td>
<td>406,000</td>
</tr>
<tr>
<td>Rent (¾ × 260,000)</td>
<td>195,000</td>
</tr>
<tr>
<td><strong>Gross cost of production</strong></td>
<td>9,821,150</td>
</tr>
<tr>
<td>Add work in progress at start</td>
<td>1,555,000</td>
</tr>
<tr>
<td>Less work in progress at end</td>
<td>(1,230,000)</td>
</tr>
<tr>
<td>Cost of finished goods</td>
<td>10,146,150</td>
</tr>
<tr>
<td>Add profit mark up 20%</td>
<td>2,029,230</td>
</tr>
<tr>
<td>Cost of finished goods transferred to trading</td>
<td>12,175,380</td>
</tr>
</tbody>
</table>

b) Income statement

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>15,931,100</td>
</tr>
<tr>
<td>Less Cost of sales</td>
<td></td>
</tr>
<tr>
<td>Opening inventory</td>
<td>1,163,000</td>
</tr>
<tr>
<td>Cost of finished goods transferred</td>
<td>12,175,380</td>
</tr>
<tr>
<td>Cost of goods available for sale</td>
<td>13,338,380</td>
</tr>
<tr>
<td>Less: Closing inventory</td>
<td>(1,442,000)</td>
</tr>
<tr>
<td><strong>Gross profit</strong></td>
<td>4,034,720</td>
</tr>
<tr>
<td><strong>Less expenses</strong></td>
<td></td>
</tr>
<tr>
<td>Rent (¼ × 260,000)</td>
<td>65,000</td>
</tr>
<tr>
<td>Depreciation on office equipment</td>
<td>115,000</td>
</tr>
<tr>
<td>Office salaries</td>
<td>1,670,950</td>
</tr>
<tr>
<td>Office Electricity</td>
<td>221,000</td>
</tr>
<tr>
<td>Net profit</td>
<td>(2,070,950)</td>
</tr>
<tr>
<td><strong>Net profit</strong></td>
<td>2,962,770</td>
</tr>
</tbody>
</table>
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TOPIC 7
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 or members. Accountants differ on the treatment of entrance fees. Many feel that since the amount is collected only once and as it is o I non recurring in nature it should be capitalized and taken to the liability side of the balance sheet but others argue Mai though it is paid is each members only once, the clerk or institution receives fairly regularly every year because of regular entrance of members. So it should be shown as an income in the credit side of income and expenditure account. In the absence of specific instruction in the question, students may treat it any way but they must append a note justifying the choice made.

7) Sale of old assets

The amount realized from the sale of old assets should be treated as capital receipts and should be credited to asset account. But loss or profit on its sales should be treated as revenue and is taken to income and expenditure account:
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 vroat.mnet as is follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock of Stationery (opening)</td>
<td>XXX</td>
</tr>
<tr>
<td>Add purchase during the year</td>
<td>XXX</td>
</tr>
<tr>
<td>Less stock of stationery (closing)</td>
<td>XXX</td>
</tr>
<tr>
<td>Stationery item used during the year</td>
<td>XXX</td>
</tr>
</tbody>
</table>

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 be 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 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 abridged addition of cash book - it is, in effect, a summary of cash book.
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 it is 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.

<table>
<thead>
<tr>
<th>Date</th>
<th>References</th>
<th>Amount</th>
<th>Date</th>
<th>References</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td>2005</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Jan. 1</td>
<td>Balance b/d</td>
<td>250</td>
<td>Jan. 5</td>
<td>Rent</td>
<td>200</td>
</tr>
<tr>
<td>Feb. 2</td>
<td>Subscription</td>
<td>600</td>
<td>Fed. 12</td>
<td>Traveling expenses</td>
<td>15</td>
</tr>
<tr>
<td>Mar. 10</td>
<td>Admission fee</td>
<td>25</td>
<td>Mar. 17</td>
<td>Entertainment expenses</td>
<td>50</td>
</tr>
<tr>
<td>Apr. 5</td>
<td>Subscription</td>
<td>250</td>
<td>Apr. 20</td>
<td>Electric charges</td>
<td>20</td>
</tr>
<tr>
<td>May 20</td>
<td>Sale of old newspapers</td>
<td>10</td>
<td>May 5</td>
<td>Furniture</td>
<td>300</td>
</tr>
<tr>
<td>July 15</td>
<td>Admission fee</td>
<td>30</td>
<td>June 3</td>
<td>Stationary</td>
<td>120</td>
</tr>
<tr>
<td>Aug. 20</td>
<td>Sale of old newspaper</td>
<td>15</td>
<td>July 12</td>
<td>Electric charges</td>
<td>30</td>
</tr>
<tr>
<td>Oct. 1</td>
<td>Donation</td>
<td>150</td>
<td>Aug. 3</td>
<td>Newspaper</td>
<td>25</td>
</tr>
<tr>
<td>Nov. 15</td>
<td>Donation</td>
<td>50</td>
<td>Sep. 15</td>
<td>Salaries</td>
<td>320</td>
</tr>
<tr>
<td>Dec. 28</td>
<td>Subscription</td>
<td>250</td>
<td>Sep. 20</td>
<td>Newspaper</td>
<td>65</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Oct. 3</td>
<td>Traveling expenses</td>
<td>25</td>
</tr>
</tbody>
</table>
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**Gym Equipment Account**

<table>
<thead>
<tr>
<th></th>
<th>Shs ‘000’</th>
<th>Shs ‘000’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance b/d</td>
<td>250,000</td>
<td>Depreciation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Balance c/d</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>250,000</strong></td>
<td><strong>250,000</strong></td>
</tr>
</tbody>
</table>

### REVISION EXERCISE

#### QUESTION 1

The following are the balances of assets and liabilities extracted from the books of Jenga Afya Sports Club as at 30 June 2012 and 30 June 2013:

<table>
<thead>
<tr>
<th></th>
<th>2012 Shs’000’</th>
<th>2013 Shs’000’</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sports pavilion at cost</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>Gym equipment at cost</td>
<td>6,000</td>
<td>?</td>
</tr>
<tr>
<td>Furniture and fittings at cost</td>
<td>4,000</td>
<td>?</td>
</tr>
<tr>
<td>Accumulated depreciation:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gym equipment</td>
<td>1,400</td>
<td>?</td>
</tr>
<tr>
<td>Furniture and fittings</td>
<td>1,200</td>
<td>?</td>
</tr>
<tr>
<td>Subscriptions received in advance</td>
<td>600</td>
<td>1,800</td>
</tr>
<tr>
<td>Subscriptions in arrears</td>
<td>1,200</td>
<td>1,500</td>
</tr>
<tr>
<td>Coach's fees outstanding</td>
<td>400</td>
<td>500</td>
</tr>
<tr>
<td>Restaurant payables</td>
<td>500</td>
<td>600</td>
</tr>
<tr>
<td>Pre-paid electricity</td>
<td>125</td>
<td>150</td>
</tr>
<tr>
<td>Restaurant inventory</td>
<td>1,100</td>
<td>1,900</td>
</tr>
</tbody>
</table>

The club's receipts and payments for the year ended 30 June 2013 were as follows:

<table>
<thead>
<tr>
<th></th>
<th>Sh. ‘000’</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Receipts</strong></td>
<td></td>
</tr>
<tr>
<td>Cash balance:</td>
<td></td>
</tr>
<tr>
<td>Cash in hand</td>
<td>2,400</td>
</tr>
<tr>
<td>Bank balance</td>
<td>1,650</td>
</tr>
<tr>
<td>Subscriptions</td>
<td>12,000</td>
</tr>
<tr>
<td>Restaurant sales</td>
<td>6,250</td>
</tr>
<tr>
<td>Gym services income</td>
<td>6,200</td>
</tr>
<tr>
<td>Sale of gym equipment</td>
<td>400</td>
</tr>
<tr>
<td><strong>Payments</strong></td>
<td></td>
</tr>
<tr>
<td>Restaurant purchases</td>
<td>4,250</td>
</tr>
<tr>
<td>Electricity bills</td>
<td>400</td>
</tr>
<tr>
<td>Restaurant wages</td>
<td>1,360</td>
</tr>
<tr>
<td>Coach's fees</td>
<td>3,100</td>
</tr>
</tbody>
</table>
Honoraria to secretary 4,600
Club maintenance expenses 200
Travelling expenses 420
Purchase of gym equipment 3,000
Purchase of furniture and fittings 1,100
Gym expenses 1,500
Salaries and wages 1,470
Purchase of office computers 1,000
Cash balance - Cash in hand 1,500
Bank balance 5,000

Additional information:
1. Goods worth Sh.75, 000 from the restaurant were consumed by members of staff during the year ended 30 June 2013, but were not paid for.
2. Depreciation is to be provided on cost of existing assets as follows:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Rate per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gym equipment</td>
<td>15%</td>
</tr>
<tr>
<td>Furniture and fittings</td>
<td>10%</td>
</tr>
<tr>
<td>Sports pavilion</td>
<td>5%</td>
</tr>
<tr>
<td>Office computers</td>
<td>20%</td>
</tr>
</tbody>
</table>

3. Depreciation on furniture and fittings is to be apportioned between restaurant and office at 40% and 60% respectively.
4. 10% of the subscriptions in arrears at the beginning of the year were not received by the end of the financial year. The management decided to write them off.
5. Gym equipment sold during the year had a cost of Sh. 1,000,000 and had been used for 3 years.

Required:
a) The restaurant income statement for the year ended 30 June 2013,
b) The income and expenditure account for the year ended 30 June 2013.
c) Statement of financial position as at 30 June 2013.
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TOPIC 8

ANALYZING FINANCIAL STATEMENTS

STATEMENT OF CASH FLOW

Definition

"A statement of changes in the financial position of a firm on cash basis is called a cash flow statement."

The statement of cash flow describes the inflow (sources) & outflow (uses) of cash. It summarizes the causes of changes in cash position of a business enterprise between two balance sheets.

CATEGORIES OF CASH

1. Cash flows from operating activities
2. Cash flows from investing activities
3. Cash flows from financing activities

Cash flows from Operating Activities

Operating activities are the basic revenue producing activities of the enterprise. The amount of cash flows arising from operating activities is an indicator of a firm's operating capability to generate sufficient funds to meet its operating needs, pay dividends, repay loans, etc. without depending on external sources of finance.

Examples of cash flow from operating activities

1. Cash receipts from sale of goods & rendering of services
2. Cash receipts from royalties, fees, commissions, etc
3. Cash payment to suppliers of goods & services
4. Cash payment to & on behalf of employees
5. Cash receipts & payments of an insurance company for premiums, claims, annuities and other policy benefits
6. Cash payments or refunds of income tax relating to operating activities
7. Cash receipts and payments from contracts held for dealing or trading purposes.

Cash flows from Investing Activities

Investing activities are the acquisition & disposal of long term assets & investments. A separate disclosure of cash flows arising from investing activities is important because cash flows represent the extent to which expenditure have been made for resources to generate future incomes.
Examples of cash flow from investing activities

1. Cash payments to acquire fixed assets (including intangibles).
2. Cash receipts from disposal of fixed assets (including intangibles)
3. Cash receipts from disposal of shares, warrants, debt instruments, etc
4. Cash advances & loans made to third parties.
5. Cash receipts from the repayment of advances & loans made to third parties.

Cash flows from financing Activities

Financing activities are activities that result in changes in the size & composition of the owners' capital (including preference share capital in the case of a company) & borrowings of the enterprise.

Examples of cash flows from financing activities

1) Cash proceeds from issuing shares or other similar instruments
2) Cash proceeds from issuing debentures, loans, bonds & other short or long term borrowings
3) Cash repayments of amounts borrowed such as redemption of debentures, bonds, preference shares.

METHODS OF PREPARING STATEMENTS OF CASH FLOW

An enterprise should report cash flow from operating activities using either:

- The direct method, whereby major classes of gross cash payments are disclosed; or
- The indirect method, whereby net profit or loss is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of post or future operating cash receipts or payments, and items of income or expense associated with investing or financing cash flows.

DIRECT METHOD

Enterprises are encouraged to report cash flows from operating activities using the direct method. Under the direct method information about major classes of gross cash receipts and gross cash payments may be obtained either:

a. From the accounting records of the enterprise; or
b. By adjusting sales, cost of sales (interest and similar income and interest expense and similar charges for a financial institution) and other items in the income statement for:

i. Changes during the period in inventories and operating receivables and payables
ii. Other non-cash items and
iii. Other items for which the cash effects are investing or financing cash flows.
INDIRECT METHOD

Under the indirect method, the net cash flow from operating activities is determined by adjusting a net profit or loss for the effects of:

a. Changes during the period in inventories and operating activities receivables and payables
b. Non-cash items such as depreciation, provisions, deferred taxes, unrealized minority interest
c. All other items for which the cash effects are investing or financing cash flows.

Alternatively, the net cash flow from operating activities may be presented under the indirect method by showing the revenue and expenses disclosed in the income statement and the changes during the period in inventories and operating receivables and payable.

REPORTING CASH FLOWS FROM INVESTING AND FINANCIAL ACTIVITIES

An enterprise should report separately major classes of gross cash receipts and gross cash payments arising from investing and financing activities, except to the extent that cash flows described below are reported on a net basis.

REPORTING CASH FLOWS ON NET BASIS

Cash flow arising from the following operating, investing or financing activities may be reported on a net basis:

a. Cash receipts and payments on behalf of customers when the cash flow reflect the activities of the customer rather than those of the enterprise; and
b. Cash receipts and payments for items, in which the turnover is quick, the amounts are large, and the maturities are short.

Examples of cash receipts and payments referred to in (a) above are:

1. The acceptance and repayment of demand deposits of a bank
2. Funds held for customers by an investment enterprise
3. Rents collected on behalf of and paid over to the owners of properties. Examples of cash receipts and payments referred to in (b) above are advances made for, and repayment of:
   4. Principal amount relating to credit card customers
   5. The purchase and sale of investments
   6. Other short-term borrowing for example, those which have a maturity period of three months or less

Cash flows arising each of the following activities of a financial institution may be reported on a net basis:

a) Cash receipts and payments for the acceptance and repayment of deposits with fixed maturity date.
b) The placement of deposits with and withdrawal of deposits from other financial institutions
c) Cash advances and loans made to customers and repayment of those advances and loans
INTEREST AND DIVIDENDS

Cash flows from interest and dividends received and paid should each be disclosed separately. Each should be classified in a consistent manner from period to period either as operating, investing or financing activities.

The total amount of interest paid during a period is disclosed in the cash flow statement whether it has been recognized as an expense in the income statement or capitalized.

Interest paid and interest and dividend received are usually classified as operating cash flows for a financial institution. However, there is no consensus on the classification of these cash flows for other enterprises. Interest paid and interest and dividends received may constitute operating cash flow because they enter into the determination of net profit or loss alternatively, interest paid and interest dividends received may be classified as financing cash flow and investing cash flows respectively, because they are costs of obtaining financial resources or returns on investment.

Dividends paid may be classified as a financing cash flow because they are a cost of obtaining financial resources. Alternatively, dividends paid may be classified as a component of cash flow from operating activities in order to assist users to determine the ability of an enterprise to pay dividends out of operating cash flows.

TAXES ON INCOME

Cash flows arising from taxes on income should be separately disclosed and should be classified as cash flow from operating activities unless they can be specifically identified with financing and investing activities.

Taxes on income arises on transactions that give rise to cash flow that are classified as operating, investing or financing activities in a cash flow statement. While tax expense may be readily identifiable with investing or financing activities the relating tax cash flow are often impracticable to identify and may arise in a different period from the cash flows of the underlying transaction. Therefore, taxes paid are usually classified as cash flow from operating activities. However, when it is practicable to identify the tax cash flows with an individual transaction that gives rise to cash flows that are classified as investing or financing activities the tax cash flow is then classified as an investing or financing activity as appropriate. When tax cash flows are allocated over more than one class of activity, the total amount of taxes paid is disclosed.

NON-CASH TRANSACTIONS

Investing and financing transactions that do not require the use of cash or cash equivalents should be excluded. From a cash flow statement, such transactions should be disclosed elsewhere in the financial statements in a way that provides all the relevant information about these investing and financing activities.

Many investing and financing activities do not have a direct impact on current cash flows although they do affect the capital and asset structure of a company. The exclusion of non-cash transactions from the cash flow statement is consistent with the objective of a cash flow statement as these items do not involve cash flows in the current period. Examples of non-cash transactions are:
i. The acquisition of asset or assets either by assuming directly related liabilities or by means of a finance lease:

ii. The acquisition of a company by means of an equity issue; and

iii. The conversion of debt to equity.

COMPONENTS OF CASH AND CASH EQUIVALENTS

An enterprise should disclose the components of cash and cash equivalents and should present a reconciliation of the amounts in its cash flow statement with the equivalent items reported in the balance sheet.

OTHER DISCLOSURES

A company should disclose, together with a commentary by management, the amount of significant cash and cash equivalent balances held by the company.

Additional information may be relevant to users in understanding the financial position and liquidation of a company. Disclosure of this information, together with a commentary by management, is encouraged and may include:

a. The amount of undrawn borrowing facilities that may be available for future operating activities and to settle capital commitments, indicating any restrictions on the use of these facilities.

b. The aggregate amounts of cash flows that represent increase in operating capacity separately from those cash flows that are require maintaining operating capacity.

The separate disclosure of cash flows that represent increases in operating capacity and cash flows are required to maintain operating capacity is useful in enabling the user to determine whether the company is investing adequately in the maintenance of its operating capacity. A company that does not invest adequately in the maintenance of its operating capacity may be prejudicing future profitability for the use of current liquidity and distribution to owners.
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TOPIC 9
INTRODUCTION TO PUBLIC SECTOR ACCOUNTING

DEFINITION OF TERMS
State Corporation is an entity incorporated under the Companies Act, which is solely or partly owned by the national government for commercial purposes.

State agency is an entity howsoever incorporated by the government to undertake a specific strategic government objective in delivering public service and includes any entity classified as:

- a) An executive agency;
- b) An independent regulatory agency; or
- c) A research institution, public university, tertiary education and training institution; County Corporation is an entity howsoever incorporated, that is solely or partly owned by the county government for commercial purposes:

Commercial purpose means a function;

- (a) Whose dynamics are governed by a competitive profit making and market driven; or
- (b) That can be performed commercially but serves a strategic socio-economic objective.

FEATURES OF PUBLIC SECTOR ENTITIES AS COMPARED TO PRIVATE SECTOR

There is an important difference between private sector accounting and governmental accounting. The main reasons for this difference are the environment of the accounting system. In the government environment, public sector entities have differing goals, as opposed to the private sector entities' one main goal of gaining profit. Also, in government accounting, the entity has the responsibility of fiscal accountability which is demonstration of compliance in the use of resources in a budgetary context. In the private sector, the budget is a tool in financial planning and it isn't mandatory to comply with it.

Government accounting refers to the field of accounting that specifically finds application in the public sector or government. It is a special field of accounting because;

- (a) The objectives to which accounting reports to differ significantly from that for which generally accepted accounting practice has been developed for in the private (business) sector; &
(b) The usage of the results of accounting processes of government differs significantly from the use thereof in the private sector.

An exception exists on the above-mentioned differences in the case of public utility businesses (for example Electricity Services) that may be intended to produce a net income or profit, but a significant debate exists over whether there should be such an exception. Nationalization includes, amongst others, the argument that entities should be either private or public, and that the objectives of public entities should differ significantly from that of private entities. In other words, is the generation and reticulation of electricity with the objective to generate a profit in the public interest or not? And if it is the best way, shouldn't it then be completely private instead of having access to putnie funds and monopolies?

The unique objectives of government accounting do not preclude the use of the double entry accounting system. There can, however, be other significant differences with private sector accounting practices, especially those that are intended to arrive at a net income result. The objectives for which government entities apply accountancy can be organized in two main categories:

a. The accounting of activities for accountability purposes.

In other words, the representatives of the public, and officials appointed by them, must he accountable to the public for powers and tasks delegated. The public, who have no other choice but to delegate, are in a position that differs significantly front that of shareholders and therefore need financial information, to be supplied by accounting systems, that is applicable and relevant to them and their purposes.

b. Decision-making purposes.

The relevant mole-players, especially officials and representatives, need financial information that is accounted; organized and presented for the objectives of their decision-making. These objectives hear, in many instances, no relation to net income results but are rather about service delivery and efficiency. The taxpayer, a very significant group, simply wants to pay as little as possible taxes for the essential services for which money is being coerced by law.

Governmental accounting standards are currently being dominated by the accounting standards (internationally sometimes referred to as IFRS) originally designed for the private sector. The so-called Generally Recognised Accounting Practices (GRAP) that are being enforced in the punkt, Sector of countries such as South Africa, one of the front-runners in this regard is based nil the Generally Accepted Accounting Practices originally developed for the private sector. The above and common sense raises the question of whether this is the best solution. It is of course Cheaper and it iti alleged that the history-Of separate development of accounting practices for government has not beo successful. Even at the onset of the current fiscal crisis in Europe and other partS of the world it was argued authoritatively that the sometimes inapplicable accounting practices of the private sector being used, have contributed to the origination of, and belated reaction to, the fiscal crisis.
Examples of Entities in Public Sector

The following example of some of the entities in the public sector according to the Public Pittance Management Act:-

a) the Government or any department of the Government;
b) the courts;
c) the commissions established under the Constitution;
d) a local authority uncle-r the Local Government Act

e) a state corporation within the meaning of the State Corporations Act
f) the Central Bank of Kenya established under the Central Bank of Kenya Act

g) a co-operative society established under the Co-operative Societies Act
h) a public school within the meaning of the Education Act-
i) a public university within the meaning of the Universities Act
j) a college or other educational institution maintained or assisted out of public funds',

STRUCTURE OF THE PUBLIC SECTOR

Most government organizations are classic examples of vertical structure. Vertical organizational structures are characterized by few people at the top and increasing numbers of people in middle management and lower level positions. In other words, a few people make policy and decisions, and many people carry them out. Governments often lean toward them because they create much defined job scopes and powers--each person has a clear role to play. Vertical structure is the classic bureaucracy and is epitomized and originated in one of the oldest government functions: military command.

REGULATORY STRUCTURES AND OVERSIGHT IPSASB

The international Public Sector Accounting Standards Board (IPSASB)- formerly the Public Sector Committee - of the International Federation of Accountants focuses on the accounting, auditing, and financial reporting needs of national, regional, and local governments, related governmental agencies, and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance, conducting educational and research programs, and facilitating the exchange of information among accountants and those that work in the public sector or rely on its work.

The IPSASB's current activities are focused on the development of International Public Sector Accounting Standards (IPSAS) for financial reporting by governments and other public sector entities (the Standards Project).

The IPSASB's Standards Project was established in late 1996. The objectives of the initial stage of the project were to develop by the end of November 2001:
• A background paper identifying current practices and issues in public sector financial reporting.
• A core set of IPSAS based (to the extent appropriate) on the International Accounting Standards in place as at August 1997.
• An IPSAS on the cash basis of accounting,
• Guidance on the transition from the cash to the accrual basis of accounting.

The Preface to International Financial Reporting Standards issued by the International Accounting Standards Board explains that international Financial Reporting Standards (IFRSs) are designed to apply to the general purpose financial statements of all profit-oriented entities. Government Business Enterprises (GBEs) as defined by the IPSASB are profit-oriented entities. Accordingly, they are required to comply with IFRS.

(a) Present to the Senate, subject to the exceptions in the Constitution, the proposal for the basis of allocating revenue among the Counties and consider any Bill dealing with county Financial matters
(b) Introduce into the Senate a County Allocation of Revenue Bill and a Division of Revenue Bill in accordance with Article 218(1)(b) of the Constitution at least two months before the end of the financial year;
(c) Examine financial statements and other documents submitted to the Senate under Part IV of the Public Finance Management Act and make recommendations to the Senate for improving the management of government's public finances;
(d) Monitor adherence by the Senate to the principles of public finance set out in the Constitution, and to the fiscal responsibility principles of the Public finance Management Act.

In carrying out its functions in (a) and (b) the Committee shall consider recommendations from the Commission on Revenue Allocation, County Executive Committee member responsible for finance, the Intergovernmental Budget and Economic Council, the public and any other interested persons or groups.

The Role of Auditor General

The Kenya Constitution defines the duties of the Office of the Controller and Auditor General in broad terms, and more detailed responsibilities are provided in the Exchequer and Audit Act. Specifically, the Controller and Auditor General, who is appointed by the President, are charged with:

i. Reviewing proposed withdrawals from the Consolidated Fund and, if satisfied that they are authorized by law, approving the withdrawals;
ii. Examining disbursements of monies appropriated by Parliament to ensure that they have been applied to the purposes to which they were appropriated and that expenditures conform to the authorities that govern them; and
iii. Auditing and reporting on the public accounts of the Government of Kenya, the accounts of all government officers and authorities, the accounts of all courts and commissions, and the accounts of the Clerk of the National Assembly.

iv. Consider and approve the estimates for the Kenya National Audit Office; and

v. Determine the remuneration and other terms of appointment of the staff of the Kenya National Audit Office.

The exchequer and Audit Act further require that the Controller and Auditor General audit and report in all accounts of the local authorities.

The Role of Internal Audit

National government entity to maintain internal auditing arrangements

Every national government entity shall ensure that it complies with the Public Finance Management Act and-

a) Has appropriate arrangements in place for internal audit according to the guidelines of the Accounting Standards Board; and

b) Where any regulations are in force, those regulations are complied with.

Regulations may prescribe requirements to be complied with in conducting internal audits.

A national government entity shall ensure that its arrangements for conducting internal audits include;

a) reviewing the governance mechanisms of the entity and mechanisms for transparency and accountability with regard to the finances and assets of the entity;

b) conducting, risk-based, value-for-money and systems audits aimed at strengthening internal control mechanisms that could have an impact on achievement of the strategic objectives of the entity;

c) verifying the existence of assets administered by the entity and ensuring that there are proper safeguards for their protection;

d) providing assurance that appropriate institutional policies and procedures and good business practices are followed by the entity; and

e) Evaluating the adequacy and reliability of information available to management for making decisions with regard to the entity and its operations.

A national government entity shall ensure that internal audits in respect of the entity are conducted in accordance with international best practices.

Every national government entity shall establish an audit committee whose composition and Functions shall be as prescribed by the regulations.
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REVISION EXERCISE:

QUESTION 1

(a) Highlight purposes of public sector accounting.

Solution:

i. To create a standard expectation of ethics and accountability for a nation’s financial information.

ii. It assists in public sector budgeting.

iii. It helps in the establishment of a public governance system which enhances discipline decision making by those in charge of state affairs.

iv. It enables the public assess whether there is value for money submitted as a result of the taxes paid to the state.

QUESTION 2

The following were the approved estimates and actual expenditure for the Ministry of health for the financial year ended 30 June 2013:

<table>
<thead>
<tr>
<th>Item</th>
<th>Details</th>
<th>Approved estimate</th>
<th>Actual expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>0300</td>
<td>Transport</td>
<td>Sh.&quot;000&quot;</td>
<td>76,500</td>
</tr>
<tr>
<td>0301</td>
<td>Travel and subsistence</td>
<td>88,400</td>
<td>86,700</td>
</tr>
<tr>
<td>0500</td>
<td>Personal emoluments</td>
<td>102,000</td>
<td>96,900</td>
</tr>
<tr>
<td>0700</td>
<td>Electricity</td>
<td>81,600</td>
<td>76,500</td>
</tr>
<tr>
<td>0240</td>
<td>Staff development</td>
<td>15,980</td>
<td>17,510</td>
</tr>
<tr>
<td>0900</td>
<td>Purchase of equipment</td>
<td>166,600</td>
<td>166,600</td>
</tr>
<tr>
<td>0400</td>
<td>Other allowances</td>
<td>116,960</td>
<td>113,390</td>
</tr>
<tr>
<td>1000</td>
<td>Appropriations- in-aid</td>
<td>133,960</td>
<td>125,800</td>
</tr>
</tbody>
</table>

Drawings from the Exchequer during the financial year ended 30 June 2013 amounted to Sh.127,500,000.

Required:

i) General account of vote.

ii) Exchequer account.

iii) Paymaster general account.
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