ACCOUNTING TECHNICIAN DIPLOMA

LEVEL I

INTRODUCTION TO FINANCIAL ACCOUNTING

STUDY TEXT
KASNEB SYLLABUS

PAPER NO.1: INTRODUCTION TO 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 and prepare financial statements.

1.0 LEARNING OUTCOMES
A candidate who passes this paper should be able to:

- Apply accounting concepts in preparation of financial statements
- Apply the double entry aspects of accounting
- Account for assets and liabilities
- Prepare financial statements of a sole trader, partnership and company

CONTENT

1.1 Introduction to accounting
- Nature and purpose of accounting
- Objectives of accounting
- Users of accounting information and their information needs
- Qualities of useful accounting information
- Accounting concepts/principles
- Accounting standards and their importance
- The accounting equation

1.2 Double entry bookkeeping and books of original entry including manual and computerised systems
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- Accounting for accounts receivables, bad debts and allowance for doubtful debts
- Property plant and equipment including capital revenue and expenditure, depreciation, acquisition and disposal
- Inventory - recognition, measurement and valuation using specific cost method (FIFO and weighted average cost only)
- Accounting for cash and cash equivalents, bank reconciliation
- Accounting for accounts payable including control account

1.4 Correction of accounting errors and the suspense account

1.5 Financial statements of a sole trader

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- Statement of financial position

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- Types of share capital - ordinary shares and preference shares
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- Income tax - Accounting treatment and presentation (exclude computation)
- Income statement
- Statement of financial position

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</table>

Revised on: June 2016
TOPIC 1

INTRODUCTION TO ACCOUNTING

NATURE AND PURPOSE OF ACCOUNTING

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

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

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

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

The first definition emphasizes the following:

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

The second definition emphasizes the following:

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

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

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

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

**OBJECTIVES OF ACCOUNTING**

The objectives of accounting can be given as follows:

- **Systematic recording of transactions** - Basic objective of accounting is to systematically record the financial aspects of business transactions i.e. book-keeping. These recorded transactions are later on classified and summarized logically for the preparation of financial statements and for their analysis and interpretation.

- **Ascertainment of results of above recorded transactions** - Accountant prepares profit and loss account to know the results of business operations for a particular period of time. If revenue exceeds expenses then it is said that business is running profitably but if expenses exceed revenue then it can be said that business is running under loss. The profit and loss account helps the management and different stakeholders in taking rational decisions. For example, if business is not proved to be remunerative or profitable, the cause of such a state of affair can be investigated by the management for taking remedial steps.

- **Ascertainment of the financial position of the business** - Businessman is not only interested in knowing the results of the business in terms of profits or loss for a particular period but is also anxious to know that what he owes (liability) to the outsiders and what he
owns (assets) on a certain date. To know this, accountant prepares a financial position statement popularly known as Balance Sheet. The balance sheet is a statement of assets and liabilities of the business at a particular point of time and helps in ascertaining the financial health of the business.

- **Providing information to the users for rational decision-making** - Accounting like a language of commerce communes the monetary results of a venture to a variety of stakeholders by means of financial reports. Accounting aims to meet the information needs of the decision-makers and helps them in rational decision-making.

- **To know the solvency position**: By preparing the balance sheet, management not only reveals what is owned and owed by the enterprise, but also it gives the information regarding concern's ability to meet its liabilities in the short run (liquidity position) and also in the long-run (solvency position) as and when they fall due.

**USERS OF ACCOUNTING INFORMATION AND THEIR NEEDS**

Users of accounting information could be divided into 7 major groups which could be easily be remembered using the acronym GESCLIP. This stands for Government, Employees, Suppliers (trade creditors), Customers/Clients/Consumers, Lenders, Investors, and Public. Let us then discuss each user and find out why they need accounting information.

1. **Government** – the government needs accounting information during its day-to-day operations. The government needs accounting information to assess the amount of tax to be paid by a business or an individual (like the Bureau of Internal Revenue or the Internal Revenue Service when assessing income tax, estate tax, donor’s tax or other taxes); accounting information is needed when determining the fees to be charged in acquiring a business permit or a mayor’s permit; when the Securities and Exchange Commission determines the legality of the amount of share capital subscribed, accounting information is used; when the government deals with certain economic problems like inflation, still accounting information is used. Of course, this list could go on and on.

2. **Employees** – if you are an employee working in the accounting, finance or sales department, definitely, accounting information is essential. However, the use of accounting information is not delimited to employee working under accounting related departments. Employees need accounting information to know if the business could provide the necessary benefits that is due to them. Through accounting information, employees would not be in the dark with regards to the operations of the firm that they are working for.

3. **Suppliers and Other Trade Creditors** – suppliers and trade creditors are providers of merchandise on account to different business establishments. Some examples of suppliers are Coca-Cola and Pepsi. Coca-Cola and Pepsi products that are sold to different fast-food chains and supermarkets but are not paid in cash immediately. Before extending credit to customers, Coca-Cola and Pepsi should look into the accounting records of an entity to determine if they would sell their products on account or not. Telecommunication providers like Smart
Telecom, Globe, and At&t, could also be considered as suppliers. Before getting a plan from these telecommunication providers, they ask for different proofs of income from the clients availing of a plan. This is because suppliers could determine from the accounting information if a business or an individual has the ability to pay accounts on time.

4. **Customers/ Clients/ Consumers** - Customers need accounting information in order to determine the continuity of a business, most especially when there is a long-term engagement between the parties or if the customer is dependent on the enterprise. For instance, students have to go to a financially stable school that could continue to provide quality education until they graduate. Through accounting information, customers could also check if prices that are being charged are reasonable. Students could look into the financial statements of a school and determine if they are being charged the right tuition fees.

5. **Lenders** - Lenders have similar needs as suppliers wherein they interested in accounting information that enable them to determine the ability of a client to pay their obligations and the interest attached when the loan becomes due. However, in contrast to suppliers, lenders are providers of money (like banks or lending institutions) while suppliers are providers of tangible goods.

6. **Investors and Businessmen** - Investors need accounting information in order to make relevant decisions. Through accounting information, they could determine whether to purchase stocks, sell stocks or hold the stock. Businessmen could determine which operations to continue or discontinue, which product line is profitable, and many more. They need to know about the financial performance, position, and cash flows of a business.

7. **Public** - All of us need accounting information. We want to know the status of the economy, we want to know what is happening with our favorite fast food chains, we want to know the status of retirement plants, families need to budget their money, monitor receipts and disbursements, and many more.

### QUALITIES OF USEFUL ACCOUNTING INFORMATION

In order for accounting information to be useful, it must contain certain qualities and meet certain standards. These qualities include:

1. **Relevance**

Relevance in accounting information is necessary for predictive and feedback value. If investors cannot review accounting information for a company and assess its financial worthiness, then the information is not relevant and fails the relevance test. If management cannot review accounting information and use it to make decisions concerning business operations, then the information fails the feedback test.

2. **Timeliness**

Timeliness is a quality subset of relevance. If you do not present accounting information in a timely manner, its usefulness to investors and managers is diminished or completely eliminated. The
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TOPIC 2

DOUBLE ENTRY BOOKKEEPING AND BOOKS OF ORIGINAL ENTRY INCLUDING MANUAL AND COMPUTERIZED SYSTEMS

INTRODUCTION

Double entry is the fundamental concept underlying present-day bookkeeping and accounting. Double-entry accounting is based on the fact that every financial transaction has equal and opposite effects in at least two different accounts. It is used to satisfy the equation Assets = Liabilities + Equity, in which each entry is recorded to maintain the relationship.

In the double-entry system, transactions are recorded in terms of debits and credits. Since a debit in one account will be offset by a credit in another account, the sum of all debits must therefore be exactly equal to the sum of all credits. The double-entry system of bookkeeping or accounting makes it easier to prepare accurate financial statements directly from the books of account and detect errors.

Bookkeeping and accounting are a way of recording business transactions in monetary terms. A business transaction is an exchange of financial interests between at least two economic entities that in bookkeeping and accounting are expressed as accounts. There are a total of seven different types of accounts that all business transactions can relate to: assets, liabilities, equities, revenue, expenses, gains and losses. In essence, bookkeeping and accounting track changes of the amount of money in each of the seven accounts as a company conducts its business activities.

Debit and Credit

The terms "debit" and "credit" in bookkeeping and accounting simply denote an increase or decrease to the balance of a referenced business account. Using "debit" and "credit" to record increases or decreases of account balances conforms with the underlying occurrence in business transactions. The exchange of financial interests involving two or more business accounts inevitably leads to increases and/or decreases among those accounts. Rules in bookkeeping and accounting dictate that a debit to the accounts of assets, expenses or losses and a credit to the accounts of liabilities, equities, revenue or gains both increase the balance of each of those accounts. A debit decreases the account balance for liabilities, equities, revenue or gains, and a credit decreases the asset, expense or loss account balances.

The simplest account structure is shaped like the letter T. The T-account describes the appearance of the bookkeeping entries. If a large letter T were drawn on the page, the account title would appear just above the T, debits would be listed under the top line of the T on the left side and the credits
would be listed under the top line of the T on the right side, with the middle line separating the debits from the credits.

Below is the structure

<table>
<thead>
<tr>
<th>Debit side (Dr)</th>
<th>Account title</th>
<th>Credit side (Cr)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Date</td>
<td>Details</td>
<td>Amount Sh.</td>
</tr>
<tr>
<td>Date</td>
<td>Details</td>
<td>Amount Sh.</td>
</tr>
</tbody>
</table>

**SOURCE DOCUMENTS**

Source Documents are the original sources of information that provide documentation (proof) that a transaction has occurred such as sales invoices (tickets), invoices from suppliers, contracts, checks written and checks received, promissory notes, and various other types of business documents. These documents provide us with the information needed to record our financial transactions in our bookkeeping records. If you recall, a transaction is any event or condition that must be recorded in the books of a business because of its effect on the financial condition of the business, such as buying and selling.

Source documents detail the particulars of transactions that include the date, name, address, terms, and product description among other relevant pieces of information. Types of source documents include cash receipts, canceled checks and invoices. Source documents may be paper-based business forms or electronic documents.

- They are used for initial input to the accounting system. The transactions they record can be entered into the first of the accounting records – the journals.
- They assist internal control of the resources of the business – making sure that there is documentary evidence that a transaction took place such as the purchase or sale of items and the receipt and payment of money (that is, it makes it more difficult for people to misappropriate or steal cash or other items).
- They are part of the audit trail for as long as those documents are required to be kept by law or policy. Of such, they are a part of the record keeping process.

Here is a summary of some types of sources documents and their uses:

**Sales Invoice**
This document is sent to request payment for monies owed, for goods that were delivered, or services that were rendered.
Features of invoice
Invoices are numbered to keep track of sent invoices

Invoice usually includes the following information:

- Name, address of seller and purchaser
- Date of sale
- Description of sale (goods or services)
- Quantity and unit price of what has been sold
- Details discount if it is provided
- Total amount of invoice plus sales tax if applicable
- Other (date of payment, terms of sale)

Purchases Invoice

This document is received in request payment for monies owed, for goods that were delivered, or services that were rendered. It is identical to The Sales Invoice but is called a Purchases Invoice when the purchaser receives it.

Credit Note

This document is sent by a supplier to a customer to reduce the liability of the customer. In essence it is a negative invoice that is issued when goods are returned, when there was an overpayment, or when some other event has occurred that has the effect of reducing the amount that the customer owes to the supplier.
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REVISION EXERCISE

QUESTION 1

The following transactions relate to Kanja Hotel for the month of April 2007:

April 1 Bought fixtures on credit from Kamau Sh. 18,000
   4 Kanja took goods worth Sh5,000 for personal use.
   10 Onyango, a debtor for Sh. 15,000 was declared bankrupt. The debt was written off
   15 Some of the fixtures bought on 15th April worth Sh. 1,500 were found unsuitable and
       were returned to Kamau
   18 Purchased office equipment on credit from Super Ltd for Sh, 21,900
   25 Sold some of the old kitchen equipment for Sh. 25,000 on credit to Wanyanga.
   28 The proprietor brought in personal furniture ofSh. 25,000 for business use.
   30 Received a loan from ASK Bank of sh.800,000 by cheque

Prepare a:

i. Purchase daybook
ii. Sales daybook

Solution:

<table>
<thead>
<tr>
<th>DATE</th>
<th>Journal Entries April 2007</th>
<th>DR</th>
<th>CR</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1</td>
<td>Fixture a/c</td>
<td>18,000</td>
<td>18,000</td>
</tr>
<tr>
<td></td>
<td>Kamau a/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 4</td>
<td>Drawings a/c</td>
<td>5,000</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>Stock a/c -</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 10</td>
<td>Bad debt a/c</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td>Debtor Onyango a/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 15</td>
<td>Kamau a/c</td>
<td>1,500</td>
<td>1,500</td>
</tr>
<tr>
<td></td>
<td>Fixtures a/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 18</td>
<td>Office Equipment a/c</td>
<td>21,900</td>
<td>21,900</td>
</tr>
<tr>
<td></td>
<td>Super Ltd a/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 25</td>
<td>Wanyanga a/c</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td></td>
<td>Kitchen Equipment a/c</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 28</td>
<td>Furniture</td>
<td>80,000</td>
<td>80,000</td>
</tr>
<tr>
<td></td>
<td>Capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>April 1</td>
<td>Bank</td>
<td>800,000</td>
<td>800,000</td>
</tr>
<tr>
<td></td>
<td>ABK bank</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
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ACCRUED EXPENSES AND PREPAID EXPENSES

ACCRUED EXPENSES

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

Illustration

JKT Enterprises prepares its financial statements for periods ending 31st December. On 31st December 2015 a bill for electricity amounting to Sh 27 000 had been received by the accountant. Other bills received for the period amounted to Sh 210 000. These had been paid for as at 31st December 2015.

Required:

Show the necessary entries with regard to electricity:

i) Dr. Electricity expense a/c 210 000
   Cr. Cash/ bank 210 000

(To record electricity expense for the year paid for)

ii) Dr. Electricity expense 27 000
    Cr. Accrued electricity for the period 27 000

(To record accrued electricity expense for the period.)

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

<table>
<thead>
<tr>
<th>Sh</th>
<th>P &amp; L</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sh</td>
<td>Sh</td>
</tr>
<tr>
<td>Cash/bank/</td>
<td>210 000</td>
</tr>
<tr>
<td>Accrued electricity</td>
<td>27 000</td>
</tr>
</tbody>
</table>

Cash/bank

<table>
<thead>
<tr>
<th>Sh</th>
<th>Sh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electricity expense</td>
<td>210 000</td>
</tr>
</tbody>
</table>

Accrued electricity expense

<table>
<thead>
<tr>
<th>Sh</th>
<th>Sh</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance c/d</td>
<td>27 000</td>
</tr>
<tr>
<td>Electricity expense</td>
<td>27 000</td>
</tr>
<tr>
<td>Balance b/d</td>
<td>000</td>
</tr>
</tbody>
</table>

The total of Sh 237 000 will be taken to the expenses account in the statement of comprehensive income.
The balance b/d in the accrued expenses account is taken as a current liability to the balance sheet. Once the payment is made in the following period:

Dr. accrued expenses a/c 27 000
Cr. Cash/ bank 27 000

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

Accrued expense a/c

<table>
<thead>
<tr>
<th>2016</th>
<th>Sh</th>
<th>2016</th>
<th>Sh</th>
</tr>
</thead>
<tbody>
<tr>
<td>05/01</td>
<td>Cash/bank</td>
<td>27000</td>
<td>b/d</td>
</tr>
</tbody>
</table>
PREPAID EXPENSES

For some businesses expenses may tend to be prepaid in nature. An example would be insurance premiums or, rent and rates. This are usually paid for one year upfront. However the period for which the expenses relate may not match with the accounting year. Take for instance a business that commences operations on 1st January 2006. Beginning 1st April 2006 they pay for insurance for one year. The premiums would thus cover the period 1st April 2006 to 31st March 2007. On the other hand the business accounting period would cover from 1st January 2006 to 31st December 2006. Therefore by the end of the accounting period, premiums with respect to three months would not have been expensed, yet they have already been paid for. This is what results to a prepayment which is an asset to the business at the end of the accounting period.

Example:

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

Show the entries as they would appear in the accounts on 31st December 2006.

<table>
<thead>
<tr>
<th>Bank a/c</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>1/5</td>
</tr>
<tr>
<td>Sh</td>
<td>Sh</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Insurance a/c</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>31/12</td>
</tr>
<tr>
<td>Sh</td>
<td>Sh</td>
</tr>
<tr>
<td>1/5</td>
<td>Bank</td>
</tr>
<tr>
<td>31/12</td>
<td>800000</td>
</tr>
</tbody>
</table>
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When there is no accrual or prepayment of expenses, the amount shown in the cashbook as paid for the period will amount to total expenses for the period. However, in case there are accruals, or prepayments, we would need to prepare the specific expenses accounts that would help us get the actual expenses for the period.

REVISION EXERCISE

QUESTION 1

a) Citing an example in each case, briefly explain four types of bookkeeping errors which are not disclosed by a trial balance

b) The trial balance extracted from the books of Benard Masita as at 30 September 2010 failed to agree. The debit difference of Sh. 442,000 was posted to a suspense account. An income statement was prepared which showed a gross profit and a net profit of Sh. 1,985,000 and Sh. 1,229,000 respectively. Upon investigations, the following errors were discovered:

1. A purchase of Sh 150,000 on credit was correctly posted to the suppliers account but was completely omitted from the purchases day book.
2. Sales amounting to Sh. 250,000 to Samuel Njuguna were erroneously credited to his account. The sales account had been correctly posted.
3. Salaries paid for the month of September 2010 amounting to Sh. 230,000 were recorded in the salaries account as Sh 320,000.
4. Purchases of office stationery for Sh. 125,000 were erroneously debited to purchases account.
5. A payment of Sh. 45,000 to Daniel Olunya, a creditor, was erroneously debited to the account of Alois Olunya, another creditor.
6. An entry of Sh. 21,000 for returns outwards was made in error in the sales day book instead of in the purchases return day book.
7. A bad debt of Sh 22,500 is yet to be written off.
8. Goods valued at Sh .220,000 were taken for personal use but no entry had been made in the books.
9. A discount received of Sh. 59,000 was correctly entered in the cashbook but posted to the discounts allowed account.

Required:

i. A fully balanced suspense account.
ii. Statement of corrected gross profit.
iii. Statement of corrected net profit.
Solution:

a) A bank reconciliation explains the difference between balance at the bank as per cashbook and balance at bank as per the bank statement.

The function is:

i. To update the cashbook with transactions that have gone through the bank e.g. bank charges.
ii. To check and correct any errors in the cashbook.
iii. To detect and prevent any frauds that relate to the cashbook and bank transactions.

b)

<table>
<thead>
<tr>
<th></th>
<th>Shs '000'</th>
<th></th>
<th>Shs '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance b/d</td>
<td>2,366,500</td>
<td>Bank charges</td>
<td>3,000</td>
</tr>
<tr>
<td>Receipts</td>
<td>26,500</td>
<td>Standing order</td>
<td>62,000</td>
</tr>
<tr>
<td>Overcast in payment</td>
<td>4,500</td>
<td>Overcast in opening bal.</td>
<td>658,500</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Dishonoured cheque</td>
<td>15,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Cheque paid by bank</td>
<td>44,000</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Balance c/d</td>
<td>1,615,000</td>
</tr>
<tr>
<td></td>
<td>2,397,500</td>
<td></td>
<td>2,397,500</td>
</tr>
</tbody>
</table>

Bank statement as at 30 June 2001

<table>
<thead>
<tr>
<th></th>
<th>Shs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance as per cashbook</td>
<td>1,615,000</td>
</tr>
<tr>
<td>Add:</td>
<td></td>
</tr>
<tr>
<td>Unpresented cheques</td>
<td>22,500</td>
</tr>
<tr>
<td></td>
<td>1,637,500</td>
</tr>
<tr>
<td>Less: Uncredited cheques</td>
<td>(98,500)</td>
</tr>
<tr>
<td>Error</td>
<td>(832,500)</td>
</tr>
<tr>
<td>Bal as per bank statement</td>
<td>706,500</td>
</tr>
</tbody>
</table>
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TOPIC 4
CPRRECTION OF ACCOUNTING ERRORS AND SUSPENSE ACCOUNT

TYPES OF ACCOUNTING ERRORS AND THEIR CORRECTION

A Trial Balance is said to be a statement of proof done arithmetically to prove that proper double was observed in making accounting entries. The assumption is that the Trial balance totals will not agree whenever there is an accounting error. There are several errors in fact which will not affect the agreement of the trial balance totals. This means that there are two basic types of accounting errors:

- Errors which do not affect the Trial balance totals
- Errors which do affect the trial balance totals

The correction of all accounting errors must be journalized by way of the General Journal.

Errors which do not affect the Trial balance totals

1. Errors of Omission

This is an error that occurs when a transaction is completely omitted from the books of accounts. For example if we bought a motor van shs Sh 90 000 cash and we neither debit the motor vehicle account nor credit the cash account the trial balance would not be affected and it would still balance.

2. Errors of Principle

This occurs when we enter a transaction in the wrong class of account, but still observe double entry. For example we purchase furniture (fixed asset) worth shs Sh 200 000 for cash. We debit purchases account instead of debiting the furniture account and crediting the cash account. In such an instance the trial balance would still balance.

3. Errors of Commission

These types of errors occur when the correct amount is entered but in the wrong persons personal account though the account is in the same class of accounts. For example sales of Sh 20 000 sold to D. Waithaka but posted to P. Waithaka’s account in the sales ledger. The transaction would be as follows.

<table>
<thead>
<tr>
<th>Dr. P. Waithaka</th>
<th>20 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr. Sales</td>
<td>20 000</td>
</tr>
</tbody>
</table>

The correct entry would have been

<table>
<thead>
<tr>
<th>Dr. D Waithaka</th>
<th>20 000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cr sales</td>
<td>20 000</td>
</tr>
</tbody>
</table>
To correct such an error, the following entry will be passed in the books.

Dr. D. Waithaka 20 000
CR. D Waithaka 20 000

This is just a reversing transaction that transfers the amount from P. Waithaka to the correct account of D Waithaka. You will note that the sales entry is no affected by the reversal and since both P. Waithaka and D. Waithaka are in the sales ledger, the trial balance would still balance.

4. Compensating Errors

These are errors that cancel out each other e.g. an error that overstates both the credits and the debits or an error that understates both the debits and the credits by the same amount. E.g. if the purchases returns was overstated by shsSh2000 and the sales return overstated by Sh 2000. Since the purchases returns appear on the credit side and the sales returns appear on the debit side of the trial balance, the two would cancel out each other.

To correct the above error
Dr. Purchases returns Sh 2 000
Cr. Sales returns Sh 2 000

Another example would be overstating purchases as well as sales by the same amount; overstating both sides of a particular account by the same amount e.t.c.

5. Errors of Original Entry

These are errors that occur when the original figure is incorrect and yet double entry is still observed using the incorrect figure. The figure could either be understated or overstated.

Example
Purchases worth shs20 000 recorded as Sh 200 000 in both the purchase account and the cash account.

The incorrect entry would appear as follows

Dr. Purchases 200 000
Cr. Cash/ bank 200 000

The correct entry should have been
Dr. Purchases account 20 000
CR. Cash/bank 20 000
To correct the error, we make the following entries.

Dr. Cash at bank Sh 180 000
Cr. Purchases Sh 180 000

6. Complete Reversal of Entries
This is an error that occurs when the correct amount is posted in the correct account but in the wrong side of the account. For example: if we sold goods on credit to D. Kameme worth Sh 100 000 the wrong entry would appear as follows.

Dr. Sales 100 000
Cr. P. Kameme 100 000

The correct entry would have been

Dr P. Kameme 200 000
Cr. Sales 200 000

Correcting the above error is done in two stages:

- Canceling the initial recording
- Recording the correct entry.

This is done as follows:

Dr P. Kameme 100 000
Cr. Sales 100 000

(To cancel the initial entry in the accounts)

Dr. P Kameme shsSh 100 000
Cr. Sales 100 000

(To Record the correct entry)
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Adjusted Net Profit

<table>
<thead>
<tr>
<th>Item</th>
<th>Shs '000'</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net profit</td>
<td>85 800</td>
</tr>
<tr>
<td><strong>Adjustments:</strong></td>
<td></td>
</tr>
<tr>
<td>Overcast sales</td>
<td>(25 700)</td>
</tr>
<tr>
<td>Overcasted Purchases</td>
<td>40 000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>(2 000)</td>
</tr>
<tr>
<td>Telephone expenses overcast</td>
<td>900</td>
</tr>
<tr>
<td>Discount allowed</td>
<td>(2 500)</td>
</tr>
<tr>
<td>Discount received</td>
<td>2 500</td>
</tr>
<tr>
<td>Purchases under cast</td>
<td>(28 000)</td>
</tr>
<tr>
<td><strong>ADJUSTED NET PROFIT</strong></td>
<td><strong>71,000</strong></td>
</tr>
</tbody>
</table>

REVISION EXERCISE

QUESTION I

a. Citing an example in each case, briefly explain four types of bookkeeping errors which are not disclosed by a trial balance

b. The trial balance extracted from the books of Benard Masita as at 30 September 2010 failed to agree. The debit difference of Sh. 442,000 was posted to a suspense account. An income statement was prepared which showed a gross profit and a net profit of Sh. 1,985,000 and Sh. 1,229,000 respectively. Upon investigations, the following errors were discovered:

1. A purchase of Sh 150,000 on credit was correctly posted to the suppliers account but was completely omitted from the purchases day book.
2. Sales amounting to Sh. 250,000 to Samuel Njuguna were erroneously credited to his account. The sales account had been correctly posted.
3. Salaries paid for the month of September 2010 amounting to Sh. 230,000 were recorded in the salaries account as Sh 320,000.
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8. Goods valued at Sh '220,000 were taken for personal use but no entry had been made in the books.
9. A discount received of Sh. 59,000 was correctly entered in the cashbook but posted to the discounts allowed account.

Required:

i. A fully balanced suspense account.
ii. Statement of corrected gross profit.
iii. Statement of corrected net profit.
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TOPIC 5
FINANCIAL STATEMENTS OF A SOLE TRADER

INTRODUCTION

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

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

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

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

Financial statements of a sole trader involve the following:-

- Income statement.
- Statement of financial position.

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

THE INCOME STATEMENT

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

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

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

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

ITEMS TO BE DEBITED

I. Opening Stock:

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

2. Purchases:

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

a) Purchase of capital asset should not be added with the purchases. If it is already included in purchases, it should be deducted immediately.

b) If goods are purchased for personal consumption and Lliey acc added with 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...
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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>
<th>Sh.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>1,352,000</td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>990,000</td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>177,800</td>
<td></td>
</tr>
<tr>
<td>Creditors</td>
<td>83,400</td>
<td></td>
</tr>
<tr>
<td>Stock in trade (I January 2005)</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>Machinery (cost)</td>
<td>112,500</td>
<td></td>
</tr>
<tr>
<td>Furniture</td>
<td>17,000</td>
<td></td>
</tr>
<tr>
<td>Rent for building</td>
<td>19,200</td>
<td></td>
</tr>
<tr>
<td>Cash in hand</td>
<td>8,500</td>
<td></td>
</tr>
<tr>
<td>Cash at bank</td>
<td>34,738</td>
<td></td>
</tr>
<tr>
<td>Drawings</td>
<td>24,000</td>
<td></td>
</tr>
<tr>
<td>Capital</td>
<td>180,000</td>
<td></td>
</tr>
<tr>
<td>Salaries</td>
<td>37,820</td>
<td></td>
</tr>
<tr>
<td>Bad debts</td>
<td>2,400</td>
<td></td>
</tr>
<tr>
<td>Suspense account</td>
<td>6,000</td>
<td></td>
</tr>
<tr>
<td>Provision for bad debts</td>
<td>6,400</td>
<td></td>
</tr>
<tr>
<td>Printing expenses</td>
<td>4,600</td>
<td></td>
</tr>
<tr>
<td>Postage</td>
<td>3,000</td>
<td></td>
</tr>
<tr>
<td>Travelling expenses</td>
<td>15,800</td>
<td></td>
</tr>
<tr>
<td>Telephone expenses</td>
<td>3,200</td>
<td></td>
</tr>
<tr>
<td>Miscellaneous expenses</td>
<td>83,612</td>
<td></td>
</tr>
<tr>
<td>Insurance premiums</td>
<td>2,080</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,621,800</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.
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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 1962 (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.
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Statement of financial position as at 31 December 2001

<table>
<thead>
<tr>
<th>Fixed Assets</th>
<th>Cost</th>
<th>Accum. Depre</th>
<th>Net Book Value</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Sh.000</td>
<td>Sh.000</td>
<td>Sh.000</td>
</tr>
<tr>
<td>Premises (+10,000)</td>
<td>110,000</td>
<td>-</td>
<td>110,000</td>
</tr>
<tr>
<td>Delivery van</td>
<td>15,000</td>
<td>1,500</td>
<td>13,500</td>
</tr>
<tr>
<td></td>
<td>125,000</td>
<td>1,500</td>
<td>123,500</td>
</tr>
</tbody>
</table>

Current Assets

| Stock 31 Dec 2001    | 4,600  |
| Cash at bank         | 3,500  |
| Cash in hand         | 60     |
| Insurance prepaid    | 90     |
|                       | 10,700 |

Financed By:

| Capital               |        |
| Jack                  | 90,000 |
| Richard               | 45,000 |
|                       | 135,000|

Current

| Jack                  | (1,950)|
| Richard               | 2,470 |
|                       | (4,420)|

Current Liabilities

Creditors

|                        | 1,170  |
|                        | 131,750|

QUESTION 7

Munyaka and Opiyo commenced trading on 1 May 2002 as wholesalers, sharing profits and losses in the ration 2:1, after allowing interest on the capital introduced by the partners at the rate of 10% per annum. Opiyo was to receive a salary of Sh. 440,000 per annum. Munyaka and Opiyo do not operate a complete set of accounting records.

The following summary of the bank statements for the year ended 30 April 2003 has been provided:

Receipts: Cash introduced as capital on 1 May 2002: Munyaka Sh. 3,500,000 and Opiyo Sh. 2,000,000. Balance of receipts from customers amounted to Sh. 12,700,000.

Payments: Equipment Sh. 2,500,000; Pick-up Sh. 1,000,000; furniture and fittings Sh. 375,000; go-down rental Sh. 375,000, wages Sh. 1,772,000; salary of Sales Manager Sh. 1,200,000; purchases for resale Sh. 9,900,000; rates Sh. 200,000; repairs Sh. 62,500; insurance Sh. 55,000; motor expenses Sh. 186,500.
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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
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### Johnston Ltd
#### Appropriation Account for year ended 31 December 2001

<table>
<thead>
<tr>
<th></th>
<th>Shs.000</th>
<th>Shs.000</th>
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<tbody>
<tr>
<td>Profit for the year before tax</td>
<td></td>
<td>56,784</td>
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<tr>
<td>Less corporation tax</td>
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<td>12,546</td>
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<tr>
<td>Profit for the year after tax</td>
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<td>44,238</td>
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<tr>
<td><strong>Less:</strong> Proposed dividends</td>
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<tr>
<td>Preference dividends</td>
<td>3,000</td>
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<tr>
<td>Ordinary dividends</td>
<td>13,500</td>
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<tr>
<td>Retained profit carried forward to next year</td>
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<td>16,500</td>
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<tr>
<td></td>
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<td>27,738</td>
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</tbody>
</table>

### Johnston Ltd
#### Appropriation Account for year ended 31 December 2002

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<th>Shs.000</th>
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<td>Profit for the year after tax</td>
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<td><strong>Less:</strong> Proposed dividends</td>
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<td></td>
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<tr>
<td>Preference dividends</td>
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<tr>
<td>Ordinary dividends</td>
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</tr>
<tr>
<td>Transfer to general reserves</td>
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<tr>
<td>Retained profit carried forward to next year</td>
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<td>55,000</td>
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<tr>
<td></td>
<td></td>
<td>23,948</td>
</tr>
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### Johnston Ltd
#### Appropriation Account for year ended 31 December 2003

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<tr>
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<th>Shs.000</th>
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<td>Profit for the year before tax</td>
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<td>Profit for the year after tax</td>
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<td>27,731</td>
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<tr>
<td>Add retained profit from last year</td>
<td></td>
<td>23,948</td>
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<td><strong>Less:</strong> Proposed dividends</td>
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<tr>
<td>Preference dividends</td>
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<tr>
<td>Ordinary dividends</td>
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<tr>
<td>Transfer to general reserves</td>
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<td>Retained profit carried forward to next year</td>
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<td>27,500</td>
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