**Chapter One**

**Introduction to Accounting**

**1.1 The Nature and Purpose of Accounting**

**1.1.1 Definition of Accounting**

Accounting is the process of recording, summarizing, analyzing, and communicating financial transactions and information about an organization. It involves the systematic and comprehensive recording of financial activities, including purchases, sales, receipts, and payments, in order to produce financial statements such as the balance sheet, income statement, and cash flow statement.

Accounting serves several purposes, including providing information for decision-making, assessing the financial health of an organization, facilitating compliance with tax laws and regulations, and communicating financial performance to stakeholders such as investors, creditors, and management. There are various branches of accounting, including financial accounting, management accounting, tax accounting, and auditing, each serving specific functions within an organization.

**1.1.2 The Nature of Accounting**

The nature of accounting encompasses several key aspects that define its role and function within organizations and society. Here are some of the fundamental aspects of the nature of accounting:

**a) Recording Transactions**: At its core, accounting involves the systematic recording of financial transactions. This includes documenting all monetary exchanges, purchases, sales, expenses, and revenues in a structured manner.

**b) Summarizing Financial Data:** Accounting processes involve summarizing recorded transactions into meaningful financial reports. This includes preparing financial statements such as the balance sheet, income statement, and cash flow statement, which provide an overview of the organization's financial position and performance.

**c) Analyzing Financial Information:** Accountants analyze financial data to derive insights and make informed decisions. This analysis may involve assessing trends, identifying areas of strength or weakness, evaluating financial ratios, and projecting future outcomes based on historical data.

**d) Interpreting Results**: Interpretation of financial information is a crucial aspect of accounting. Accountants interpret financial statements to understand the financial health of an organization, assess its profitability, liquidity, and solvency, and communicate insights to stakeholders.

**e) Compliance and Regulation:** Accounting operates within a framework of laws, regulations, and accounting standards. Compliance with these regulations ensures transparency, accuracy, and reliability of financial reporting, thereby enhancing trust among stakeholders.

**f) Decision Support:** Accounting information serves as a basis for decision-making by providing relevant data to management, investors, creditors, and other stakeholders. It helps in evaluating performance, formulating strategies, allocating resources, and assessing risks.

**g) Communication:** Accounting serves as a language of business, facilitating communication of financial information to various stakeholders. Clear and accurate financial reporting enables effective communication and fosters trust among investors, creditors, employees, and regulatory authorities.

**h) Continuous Improvement:** The nature of accounting involves a continuous process of improvement and adaptation to changing business environments, technological advancements, and regulatory requirements. Accountants need to stay updated with emerging trends, best practices, and evolving standards to ensure relevance and effectiveness in their role.

Overall, the nature of accounting is multifaceted, encompassing both technical and analytical aspects, as well as ethical considerations and professional judgment in the pursuit of accurate and reliable financial reporting.

**1.1.3 The Purpose and Goals of Accounting**

The purposes of accounting are multifaceted, encompassing various objectives that serve the needs of different stakeholders within an organization and in the broader economic context. Here are some key purposes of accounting:

**1. Recording Transactions**

Accounting serves the fundamental purpose of systematically recording financial transactions. This includes documenting purchases, sales, expenses, revenues, and other monetary exchanges to maintain a comprehensive record of the organization's financial activities.

**2. Financial Reporting**

Accounting provides a framework for preparing financial reports such as balance sheets, income statements, and cash flow statements. These reports summarize the financial performance, position, and cash flows of the organization, enabling stakeholders to assess its financial health and make informed decisions.

**3. Decision-Making**

Accounting information supports decision-making by providing relevant data to management, investors, creditors, and other stakeholders. Managers use financial reports to evaluate performance, set goals, allocate resources, and formulate strategies, while investors and creditors use them to assess the profitability, liquidity, and solvency of the organization.

**4. Performance Evaluation**

Accounting facilitates the evaluation of organizational performance over time. By comparing financial data across different periods, stakeholders can analyze trends, identify areas of strength or weakness, and measure the effectiveness of management strategies and operational activities.

**5. Resource Allocation**

Accounting helps in the efficient allocation of resources within an organization. By providing insights into the costs and benefits of different options, accounting information assists management in prioritizing investments, optimizing expenditures, and maximizing returns on capital.

**6. Compliance and Regulation**

Accounting ensures compliance with legal and regulatory requirements governing financial reporting. By adhering to accounting standards and principles, organizations maintain transparency, accuracy, and integrity in their financial statements, thereby enhancing trust among stakeholders and mitigating legal risks.

**7. Taxation**

Accounting plays a crucial role in tax compliance and planning. By accurately recording financial transactions and preparing tax returns in accordance with tax laws and regulations, organizations fulfill their tax obligations and optimize their tax liabilities within the legal framework.

**8. Stakeholder Communication**

Accounting serves as a means of communication between the organization and its stakeholders. Financial reports communicate important information about the organization's financial performance, prospects, and risks to investors, creditors, employees, customers, suppliers, and regulatory authorities.

**9. Risk Management**

Accounting helps in identifying, measuring, and managing financial risks. By analyzing financial data and ratios, stakeholders can assess the organization's liquidity, solvency, creditworthiness, and exposure to various risks such as market risk, credit risk, and operational risk.

**10. Continuous Improvement**

Accounting supports continuous improvement by providing feedback on past performance and insights for future planning. Organizations use accounting information to learn from past experiences, adapt to changing market conditions, and enhance efficiency and effectiveness in their operations.

**1.2. The Objectives of Financial Accounting**

The objectives of financial accounting are fundamental principles that guide the practice of recording, summarizing, and reporting financial information. These objectives help ensure that financial statements provide relevant, reliable, and understandable information to users. Here are the main objectives of financial accounting:

**a) Provide Information to External Users**

Financial accounting aims to provide relevant financial information to external users, such as investors, creditors, regulators, analysts, and other stakeholders who are not directly involved in the day-to-day operations of the company. These users rely on financial statements to make investment decisions, assess the creditworthiness of the company, and evaluate its financial performance and position.

**b) Meet Regulatory Requirements**

Financial accounting aims to comply with legal and regulatory requirements governing financial reporting. Companies must adhere to accounting standards and regulations established by regulatory bodies such as the Financial Accounting Standards Board (FASB) in the United States or the International Financial Reporting Standards (IFRS) globally. Compliance with these standards ensures consistency, comparability, and transparency in financial reporting across industries and jurisdictions.

**c) Facilitate Decision Making**

Financial accounting provides information that helps internal and external stakeholders make informed decisions. Managers use financial statements to assess the financial health of the company, evaluate performance, and make strategic decisions. Investors and creditors rely on financial information to allocate resources, assess risk, and evaluate investment opportunities. Therefore, the objective of financial accounting is to provide timely and relevant information to support decision-making processes.

**d) Assess the Company's Financial Performance**

Financial accounting aims to measure and report the financial performance of a company over a specific period. This involves preparing financial statements such as the income statement, which shows revenues, expenses, and net income, and the statement of comprehensive income, which provides a broader view of the company's financial performance by including items not included in the income statement, such as gains and losses from investments.

**e) Evaluate the Company's Financial Position**

Financial accounting aims to assess the financial position of a company at a specific point in time. This involves preparing the balance sheet, which presents the company's assets, liabilities, and shareholders' equity. The balance sheet provides valuable information about the company's liquidity, solvency, and ability to meet its financial obligations.

**f) Ensure Accountability and Stewardship**

Financial accounting aims to promote accountability and stewardship by providing information about how resources are being used and managed. Financial statements serve as a tool for holding management accountable to shareholders and other stakeholders for the use of company resources and the results of their stewardship.

**g) Facilitate Comparison and Benchmarking**

Financial accounting aims to provide information that allows users to compare the financial performance and position of a company over time and with other companies in the same industry or sector. Consistent accounting principles and standards enable meaningful comparisons and benchmarking, which are essential for assessing competitiveness, identifying trends, and making strategic decisions.

Overall, the objectives of financial accounting are to provide relevant, reliable, and understandable financial information that meets the needs of external users, supports decision making, ensures compliance with regulatory requirements, and promotes accountability and transparency in financial reporting.

**1.3. The Elements of Financial Statements**

The elements of financial statements, also known as financial statement elements or financial reporting elements, are the building blocks used to prepare financial statements. These elements represent the various components of financial transactions and events that are recognized in financial reporting. The elements of financial statements are typically classified into two main categories: balance sheet elements and income statement elements. Here are the primary elements of financial statements:

**(a) Assets**

Assets are resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity. Examples of assets include cash, accounts receivable, inventory, property, plant, and equipment, investments, and intangible assets such as patents and trademarks.

**(b) Liabilities**

Liabilities are present obligations of the entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. Examples of liabilities include accounts payable, loans payable, bonds payable, accrued expenses, and deferred revenue.

**(c) Equity**

Equity, also known as shareholders' equity or net assets, represents the residual interest in the assets of the entity after deducting liabilities. It reflects the owners' claim on the assets of the company. Equity includes items such as common stock, retained earnings, additional paid-in capital, and accumulated other comprehensive income.

**(d) Income**

Income, also referred to as revenues or sales, represents increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases in liabilities that result in increases in equity, other than contributions from equity participants. Examples of income include sales revenue, service revenue, interest income, and gains from the sale of assets.

**(e) Expenses**

Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than distributions to equity participants. Examples of expenses include cost of goods sold, salaries and wages, rent expense, utilities expense, depreciation expense, interest expense, and income tax expense.

**(f) Gains**

Gains are increases in equity during the accounting period from peripheral or incidental transactions and other events and circumstances affecting the entity, except those that result from revenues or investments by owners. Gains typically arise from the sale of assets, investments, or other transactions resulting in an increase in the entity's net assets.

**(g) Losses**

Losses are decreases in equity during the accounting period from peripheral or incidental transactions and other events and circumstances affecting the entity, except those that result from expenses or distributions to owners. Losses typically arise from the sale of assets, write-offs of assets, or other transactions resulting in a decrease in the entity's net assets.

These elements serve as the foundation for preparing financial statements such as the balance sheet, income statement, statement of changes in equity, and statement of cash flows. They are used to classify and measure financial transactions and events, enabling users to assess the financial position, performance, and cash flows of the entity.

**1.4. The Accounting Equation**

The accounting equation, also known as the basic accounting equation or balance sheet equation, is a fundamental principle in accounting that illustrates the relationship between a company's assets, liabilities, and equity. The equation is expressed as:

*Assets* = *Liabilities* + *Equity*

This equation represents the fundamental principle of double-entry bookkeeping, which states that for every transaction recorded, there must be at least two accounts affected, with the total debits equaling the total credits.

Here's what each component of the equation represents:

**Assets:** Assets are economic resources owned or controlled by a company that have measurable value and are expected to provide future benefits. Examples of assets include cash, accounts receivable, inventory, property, plant, equipment, and investments.

**Liabilities:** Liabilities are obligations or debts owed by a company to external parties, such as creditors, suppliers, or lenders. Liabilities represent claims against the company's assets and must be settled or paid off in the future. Examples of liabilities include accounts payable, loans payable, bonds payable, and accrued expenses.

**Equity:** Equity, also known as owner's equity, shareholders' equity, or net worth, represents the residual interest in the assets of the company after deducting liabilities. Equity reflects the owners' claim on the company's assets and represents the amount of capital contributed by the owners plus retained earnings or accumulated profits. It can be further broken down into components such as common stock, additional paid-in capital, retained earnings, and accumulated other comprehensive income.

The accounting equation must remain in balance at all times, meaning that the total assets must equal the total liabilities and equity. This principle is essential for ensuring the accuracy of financial records and statements, as any changes to one side of the equation must be offset by corresponding changes to the other side.

For example, if a company borrows money (increasing assets through cash and increasing liabilities through a loan payable), the accounting equation remains balanced:

*Assets* (*Cash*) = *Liabilities* (*Loan Payable*) + *Equity* (*Owner*′*s Equity*)

In this case, the company's assets (cash) increase, but so do its liabilities (loan payable), maintaining the balance in the equation.

**1.5. The Users of Accounting Information**

Accounting information serves a wide range of users who rely on financial data to make informed decisions about various aspects of an organization's operations, financial performance, and prospects. These users can be broadly categorized into two groups: internal users and external users. Here's a breakdown of the primary users of accounting information:

**Internal Users:**

**a. Management:** Internal users primarily include management personnel within the organization, such as executives, managers, and department heads. They use accounting information for decision-making, planning, controlling, and evaluating the organization's performance. Management relies on financial reports to assess profitability, manage costs, allocate resources, set goals, and formulate strategies to achieve organizational objectives.

**b. Employees:** Employees at different levels of the organization may also use accounting information to understand the financial health of the company, assess their performance against targets, evaluate compensation and benefits, and make decisions about career development or job changes.

**c. Board of Directors:** The board of directors, as representatives of shareholders, relies on accounting information to oversee the company's financial management, governance, and strategic direction. They use financial reports to monitor performance, evaluate risks, approve major decisions, and ensure compliance with legal and regulatory requirements.

**d. Internal Auditors:** Internal auditors play a crucial role in evaluating the effectiveness of internal controls, risk management processes, and compliance with policies and procedures. They use accounting information to assess the reliability of financial reporting, identify weaknesses in internal controls, and recommend improvements to mitigate risks.

**e. Budgeting and Planning Departments:** Departments responsible for budgeting, forecasting, and planning use accounting information to develop budgets, set targets, allocate resources, and monitor performance against predetermined goals. They rely on financial data to make projections, assess variances, and adjust plans as needed to achieve financial objectives.

**External Users:**

**a. Investors and Shareholders:** External users include investors, shareholders, and potential investors who provide capital to the organization. They use accounting information to evaluate the company's financial performance, profitability, growth prospects, and potential risks before making investment decisions. Investors rely on financial statements to assess the company's ability to generate returns and dividends and to determine the value of their investment.

**b. Creditors and Lenders:** Creditors, such as banks, financial institutions, suppliers, and bondholders, use accounting information to assess the creditworthiness and financial stability of the organization before extending credit or lending money. They rely on financial statements to evaluate the company's ability to repay debts, manage liquidity, and honor financial obligations.

**c. Regulators and Government Agencies:** Regulators, government agencies, and tax authorities use accounting information to monitor compliance with legal and regulatory requirements, enforce financial reporting standards, and assess tax liabilities. They rely on financial reports to ensure transparency, accuracy, and accountability in financial reporting and to protect the interests of investors and the public.

**d. Customers and Suppliers:** Customers and suppliers may also use accounting information to assess the financial stability and reliability of the organization as a business partner. They may review financial statements to evaluate the company's ability to fulfill orders, deliver goods and services, manage supply chains, and maintain long-term relationships.

**e. Competitors and Industry Analysts:** Competitors and industry analysts may analyze accounting information to benchmark performance, assess market trends, and identify opportunities and threats in the industry. They use financial reports to compare the company's financial ratios, profitability, market share, and operating efficiency against industry peers and to make strategic decisions about market positioning and competitive advantage.

Overall, accounting information plays a critical role in facilitating communication, transparency, and accountability among various stakeholders, enabling them to make informed decisions and assess the financial health and performance of the organization.

**Chapter Two: The Accounting Process and Systems**

**2.1 Source Documents**

Accounting source documents are the original records that provide evidence of a transaction or financial event. These documents serve as the basis for recording transactions in accounting systems. Examples of accounting source documents include:

**a) Invoices:** These are issued by a seller to a buyer, detailing the items or services provided, their quantities, prices, and payment terms.

**b) Receipts:** Given to customers as proof of payment received for goods or services. They typically include details such as the date of the transaction, amount paid, and method of payment.

**c) Purchase Orders:** Generated by a buyer to request goods or services from a supplier. They outline the quantity, description, price, and terms of the purchase.

**d) Sales Orders:** Similar to purchase orders but issued by the seller to confirm the sale of goods or services to a buyer.

**e) Contracts:** Legal agreements between parties detailing the terms and conditions of a transaction or ongoing business relationship.

**f) Bank Statements**: Provide a record of transactions, including deposits, withdrawals, checks cleared, and other bank charges.

**g) Payroll Records:** Documents related to employee compensation, including time cards, pay stubs, and tax withholding forms.

**h) Credit Notes:** Issued by a seller to a buyer, indicating a reduction in the amount owed due to returned goods, discounts, or other adjustments.

**i) Shipping Documents:** Such as bills of lading or delivery notes, which confirm the shipment and receipt of goods.

**j) Expense Reports:** Submitted by employees to claim reimbursement for business-related expenses incurred during travel or other activities.

These documents serve as evidence to support the entries made in accounting records, ensuring accuracy and reliability in financial reporting.

**2.2 Books of Original Entry**

The accounting books of original entry, also known as primary books of accounting or subsidiary books, are where transactions are first recorded before being summarized and posted to the general ledger. These books provide a systematic way of organizing and recording various types of transactions. Common accounting books of original entry include:

**i) Cash Book:** Records all cash receipts and payments made by an organization. It typically has separate columns for different types of transactions such as cash receipts, cash payments, discounts allowed, and discounts received.

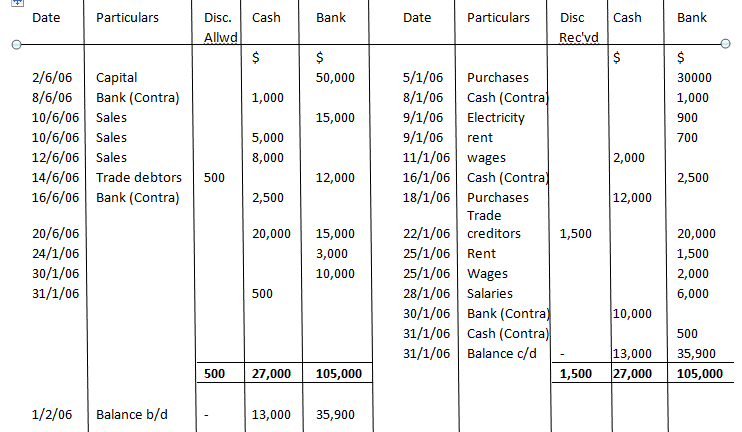


Figure : Sample Double Colum Cash Book

**ii) Sales Day Book (Sales Journal):** Records all credit sales transactions made by the business. It usually includes details such as the date of the sale, the name of the customer, the invoice number, and the amount of the sale.

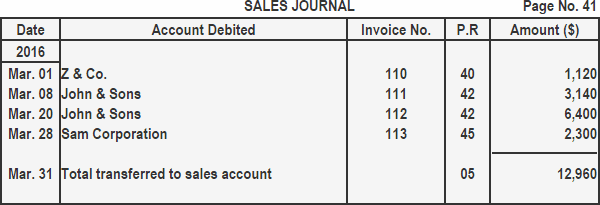


Figure : Sample Sales Journal or sales day book

**iii) Purchase Day Book (Purchases Journal):** Records all credit purchases of goods or services made by the business. Similar to the sales day book, it includes details such as the date of purchase, the name of the supplier, the invoice number, and the amount of the purchase.

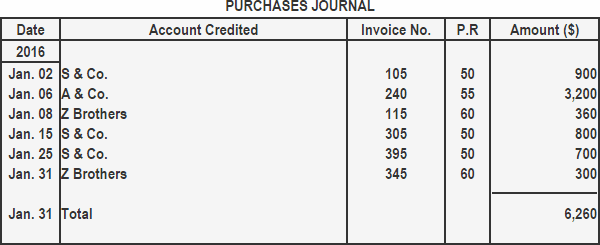


Figure : Sample purchases journal

**iv) Sales Returns Book:** Records all goods returned by customers. It includes details such as the date of the return, the name of the customer, the original invoice number, and the value of the goods returned.

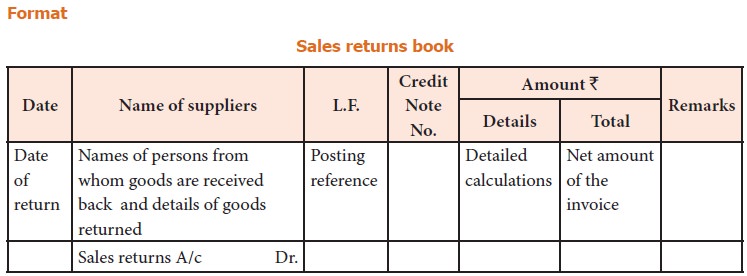


Figure : Sample sales returns book

**v) Purchase Returns Book:** Records all goods returned to suppliers. It includes details such as the date of the return, the name of the supplier, the original invoice number, and the value of the goods returned.

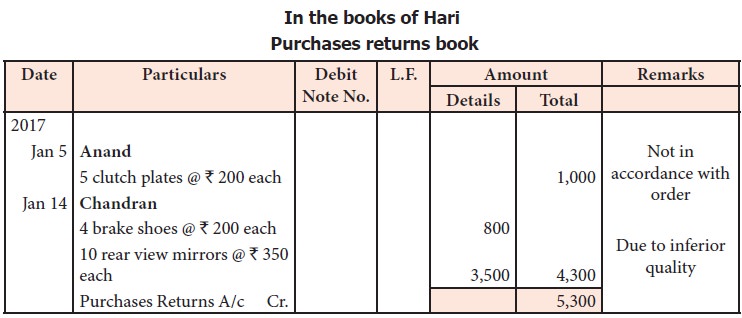


Figure : Sample purchases returns book

**vi) Journal Proper:** Records all transactions that do not fit into any of the specialized journals mentioned above. These may include adjusting entries, accruals, depreciation, and other miscellaneous transactions.

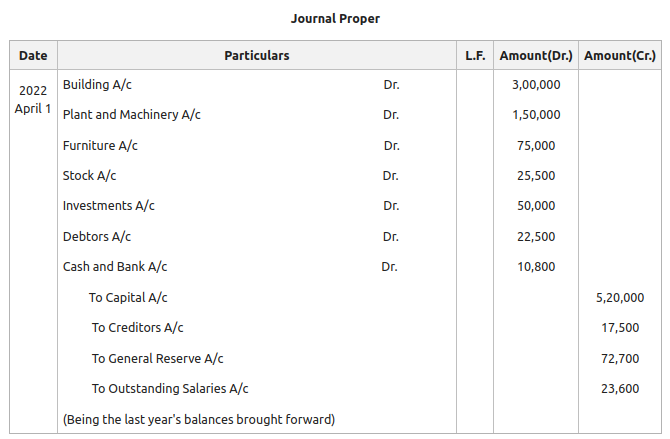


Figure : Sample journal proper

**vii) Petty Cash Book:** Records small, miscellaneous expenses paid out of petty cash. It includes details such as the date of the expenditure, the purpose of the expenditure, and the amount spent.

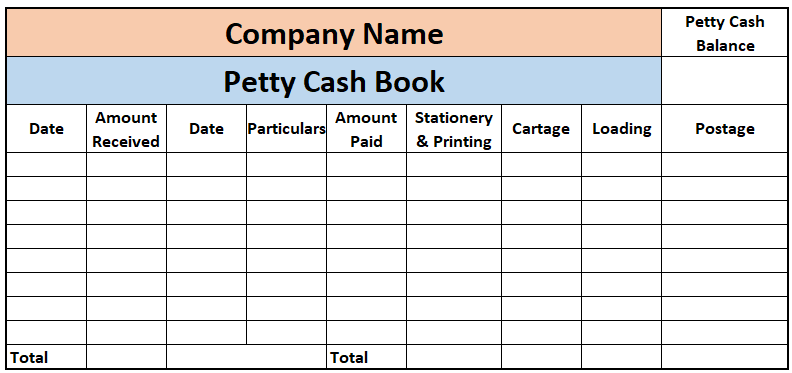


Figure : Sample petty cash book

These books of original entry serve as the primary records of financial transactions and provide a chronological record of the company's activities. Entries from these books are later summarized and posted to the general ledger accounts.

**2.3. The Ledger and the Concept of Double Entry**

The accounting ledger, also known as the general ledger, is a principal book or file that contains all the accounts used by a company to record transactions. Each account in the ledger represents a specific aspect of the company's financial transactions, such as assets, liabilities, equity, revenue, and expenses. Here's an overview of the accounting ledger:

**a) Chart of Accounts:** Before transactions are recorded in the ledger, a chart of accounts is established. This chart defines the categories or types of accounts the company will use to organize its financial information. Common account categories include assets, liabilities, equity, revenue, and expenses. Each account is assigned a unique account number and name for identification purposes.

**b) Recording Transactions:** When a business transaction occurs, it is initially recorded in a journal, such as the general journal or specialized journals like sales and purchases journals. These transactions are then posted to the appropriate accounts in the ledger. The ledger serves as the central repository for all transactions affecting the company's financial position.

**c) Account Structure:** Each account in the ledger typically follows a standardized structure. It includes:

Account Name: Describes the nature of the account, such as "Cash," "Accounts Receivable," or "Sales Revenue."

i) Account Number: A unique identifier assigned to each account for easy reference and organization.

ii) Debit and Credit Columns: Transactions are recorded as debits and credits, with each transaction affecting at least two accounts. Debits and credits are entered into their respective columns in the ledger.

iii) Balance: The ledger maintains a running balance for each account, representing the cumulative effect of all transactions recorded in that account.

**d) Posting Entries:** Posting involves transferring information from the journal entries to the appropriate accounts in the ledger. Each journal entry affects at least two accounts, with one account debited and another credited. The debits and credits are posted to the ledger accounts, ensuring that the accounting equation (Assets = Liabilities + Equity) remains in balance.

**e) Trial Balance:** Periodically, typically at the end of an accounting period, the ledger is used to prepare a trial balance. This report lists all the accounts and their balances (debit or credit) to ensure that total debits equal total credits, verifying the accuracy of the ledger entries.

**f) Financial Reporting:** The information stored in the ledger serves as the basis for preparing financial statements, such as the balance sheet, income statement, and cash flow statement. These statements provide stakeholders with an overview of the company's financial performance and position.

Overall, the accounting ledger is a fundamental tool for recording, organizing, and summarizing a company's financial transactions, providing essential information for decision-making and financial reporting purposes.

**The Concept of Double Entry**

The concept of double-entry accounting is a fundamental principle in accounting that states that for every transaction, there are at least two accounts involved, with one account debited and another credited. This system ensures that the accounting equation, Assets = Liabilities + Equity, remains in balance at all times.

Here's how the double-entry accounting system works:

**a) Every Transaction Involves Two Accounts:** In double-entry accounting, every financial transaction affects at least two accounts. One account is debited (recorded on the left side), and another account is credited (recorded on the right side). The total debits must always equal the total credits.

**b) Debits and Credits:** Debits and credits are not inherently positive or negative. Instead, they represent the increase or decrease in the balance of an account. The rules for debits and credits depend on the type of account:

i) Asset Accounts: Debits increase the balance, and credits decrease the balance.

ii) Liability and Equity Accounts: Credits increase the balance, and debits decrease the balance.

iii) Revenue Accounts: Credits increase the balance, and debits decrease the balance.

iv) Expense Accounts: Debits increase the balance, and credits decrease the balance.

The Accounting Equation: The double-entry system ensures that the accounting equation (Assets = Liabilities + Equity) remains in balance after every transaction. Each transaction affects both sides of the equation, maintaining the equality between assets, liabilities, and equity.

**c) Recording Transactions:** When a transaction occurs, it is initially recorded in a journal, such as the general journal. The journal entry includes the accounts affected, the amounts debited and credited, and a brief description of the transaction. These journal entries are then posted to the appropriate accounts in the general ledger.

**d) Trial Balance:** Periodically, typically at the end of an accounting period, a trial balance is prepared to verify the accuracy of the ledger accounts. The trial balance lists all the accounts and their balances (debit or credit), ensuring that total debits equal total credits.

**e) Financial Statements:** The information recorded using the double-entry system forms the basis for preparing financial statements, such as the balance sheet, income statement, and cash flow statement. These statements provide valuable insights into a company's financial performance and position.

Overall, the double-entry accounting system provides a systematic and reliable method for recording and summarizing financial transactions, ensuring accuracy, integrity, and consistency in financial reporting.

**2.4. The Trial Balance**

A trial balance is a financial statement that lists all the accounts in the general ledger along with their respective debit or credit balances. Its purpose is to ensure that the total debits equal the total credits, which helps to verify the accuracy of the recording and posting of transactions in the accounting system.

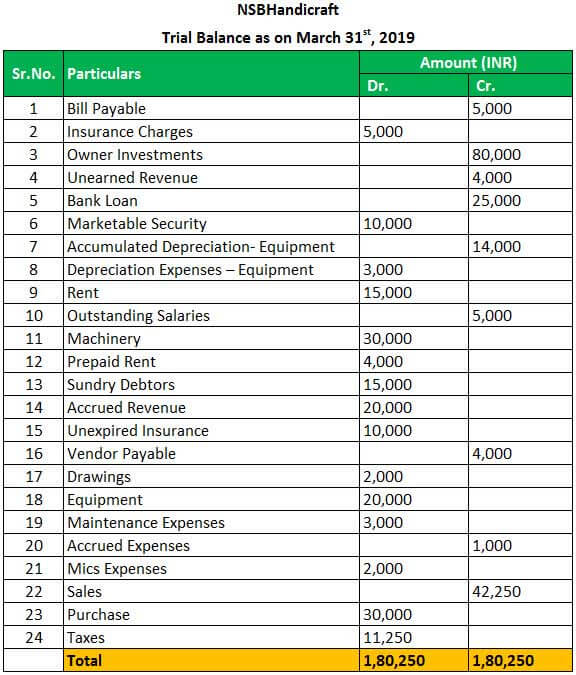


Figure : Sample trial balance

**Key Features of a Trial Balance**

**Listing of Accounts**: The trial balance includes a list of all accounts from the general ledger. Each account is listed along with its account number and balance.

**Debits and Credits:** The trial balance shows the balances of each account as either a debit or credit amount. Debit balances are listed in one column, and credit balances are listed in another column.

**Totaling of Balances:** The total of all debit balances is calculated and listed at the bottom of the debit column. Similarly, the total of all credit balances is calculated and listed at the bottom of the credit column.

**Equality Check:** The trial balance verifies that the total debits equal the total credits. If the accounting system is functioning correctly and all transactions have been recorded accurately, the total debits should equal the total credits.

**Identifying Errors:** If the trial balance does not balance (i.e., if the total debits do not equal the total credits), it indicates that there may be errors in the recording or posting of transactions. Common errors include:

i) Posting a transaction to the wrong account

ii) Omitting a transaction from the ledger

iii) Recording a transaction with incorrect amounts

iv) Errors in calculations

**Preparation Frequency:** Trial balances are typically prepared at the end of an accounting period, such as monthly, quarterly, or annually, as part of the closing process. They serve as an important step in preparing financial statements and ensuring the accuracy of the company's financial records.

It's important to note that while a balanced trial balance is a good indication of accuracy, it does not guarantee that the financial statements are error-free. Further analysis and review of individual transactions and account balances are necessary to ensure the integrity of the financial information.

**2.5. Financial Statements**

Accounting financial statements are formal records of a company's financial activities and position, typically prepared at the end of an accounting period (e.g., monthly, quarterly, or annually). These statements provide valuable insights into the financial health, performance, and position of a business. The main financial statements include:

i) The statement of financial position or the balance sheet

ii) The income statement

iii) Cash flow statement

iv) Statement of changes in equity

**The Balance Sheet**

The balance sheet, also known as the statement of financial position, is one of the primary financial statements that provides a snapshot of a company's financial position at a specific point in time. It presents the company's assets, liabilities, and equity, and it follows the fundamental accounting equation:

*Assets = Liabilities + Equity*

**Sample Statement of Financial Position**

**ABC Limited**

**Balance sheet as at 31 March 2000**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Sh.** | **Sh.** | **Sh.** |
| **Long Term Assets** |  |  |  |
| Freehold property (Net book value)  Plant and machinery (Net book value)  Motor vehicles (Net book value)  Furniture and fittings (Net book value)  Current Assets:  Stocks  Debtors  Investments  Current liabilities:  Trade creditors  Bank overdraft  Corporation tax  Dividends payable  Equity  Authorised share capital – 800,000  Sh.1 ordinary shares  Issued and fully paid: 400,000 Sh.1 Ordinary shares  Capital reserve  Revenue reserve  Loan capital: 400,000 10% Sh.1 Debentures | 238,400  878,400  176,000  107,200 | 1,000,000  400,000  120,000  1,500,000  (1,400,000) | 480,000  800,000  200,000  200,000  1,680,000  120,000  1,800,000  400,000  200,000  800,000  400,000  1,800,000 |

**Key Components of the Balance Sheet**

**a) Assets**

Assets represent what the company owns and can include tangible items like cash, inventory, property, plant, and equipment (PP&E), as well as intangible assets like patents and trademarks. Assets are typically classified into current assets and non-current assets.

**i) Current Assets:** These are assets expected to be converted into cash or used up within one year or the normal operating cycle of the business, whichever is longer. Examples include cash, accounts receivable, inventory, and short-term investments.

**ii) Non-current Assets:** Also known as long-term assets, these are assets expected to provide economic benefits beyond one year. Examples include property, plant, and equipment (PP&E), long-term investments, and intangible assets like patents and goodwill.

**b) Liabilities**

Liabilities represent what the company owes to external parties, such as creditors and suppliers. Liabilities are also classified into current liabilities and non-current liabilities.

**i) Current Liabilities:** These are obligations expected to be settled within one year or the normal operating cycle of the business, whichever is longer. Examples include accounts payable, short-term loans, and accrued expenses.

**ii) Non-current Liabilities:** Also known as long-term liabilities, these are obligations that are due beyond one year. Examples include long-term loans, bonds payable, and deferred tax liabilities.

**c) Equity**

Equity represents the ownership interest in the company. It is the residual interest in the assets of the entity after deducting liabilities. Equity is composed of several components, including:

**i) Share Capital:** The amount of capital contributed by shareholders through the issuance of shares.

**ii) Retained Earnings:** The accumulated profits or losses of the company that have not been distributed to shareholders as dividends.

**iii) Additional Paid-in Capital:** Any additional amount received from shareholders in excess of the par value of shares issued.

**iv) Accumulated Other Comprehensive Income (OCI):** Unrealized gains or losses that are not included in **net income but are reported directly in equity.**

**v) Treasury Stock:** Shares of the company's own stock that have been repurchased and are held in the company's treasury.

The balance sheet provides valuable insights into a company's liquidity, solvency, and overall financial health. It is an essential tool for investors, creditors, and other stakeholders to assess a company's financial position and make informed decisions.

**The Income Statement**

The income statement, also known as the profit and loss statement (P&L), is one of the primary financial statements that reports a company's financial performance over a specific period of time, typically a month, quarter, or year. It summarizes the company's revenues, expenses, gains, and losses, and ultimately shows whether the company has generated a profit or incurred a loss during the period.

Sample Income Statement

**ABC Limited**

**Income Statement**

**For the Year Ended 31st December 2023**

|  |  |  |
| --- | --- | --- |
|  | Sh”000” | Sh”000” |
| **Sales** |  | 400 |
| Less Cost of Sales |  |  |
| Opening Inventory | 50 |  |
| Add Purchases | 100 |  |
| Less Closing Inventory | (70) |  |
| **Cost of Goods Sold** | (80) | (80) |
| **Gross Profit** |  | 320 |
| **Less Expenses** |  |  |
| Salaries and Wages |  | (70) |
| Rent |  | (40) |
| Electricity |  | (30) |
| Insurance |  | (20) |
| Audit fees |  | (10) |
| Interest Expenses |  |  |
| Net Profit |  | 150 |

**Components of the Income Statement**

**a) Revenues**

Revenues, also known as sales or turnover, represent the income generated from the sale of goods or services. Revenue is recognized when goods are delivered, services are rendered, or other criteria for revenue recognition are met. Types of revenues include:

i) Sales Revenue: Income from the sale of goods or services to customers.

ii) Interest Revenue: Income earned from interest on loans, investments, or other financial instruments.

iii) Dividend Revenue: Income received from dividends on investments in stocks or other equity securities.

**b) Expenses**

Expenses represent the costs incurred by the company in the process of generating revenue and operating the business. Expenses are deducted from revenues to calculate the company's net income. Common types of expenses include:

i) Cost of Goods Sold (COGS): The direct costs associated with producing or purchasing the goods sold by the company.

ii) Operating Expenses: These are expenses incurred in the day-to-day operations of the business, such as salaries, rent, utilities, marketing, and administrative expenses.

iii) Interest Expenses: The cost of borrowing money, such as interest on loans or bonds.

iv) Depreciation and Amortization: The systematic allocation of the cost of long-term assets over their useful lives.

v) Income Tax Expenses: The taxes owed by the company on its taxable income.

**c) Gains and Losses**

Gains and losses represent income or expenses that are not directly related to the company's core operations. They are typically from non-operating activities and may include:

Gains: Income generated from non-operating activities, such as the sale of investments, assets, or subsidiaries at a profit.

Losses: Expenses incurred from non-operating activities, such as asset write-downs, impairments, or losses on the sale of investments or assets.

**Net Income (or Net Loss)**

Net income is the final line item on the income statement and represents the company's profit or loss for the period. It is calculated by subtracting total expenses (including losses) from total revenues (including gains). If revenues exceed expenses, the result is net income. If expenses exceed revenues, the result is a net loss.

The income statement provides valuable insights into a company's profitability and performance. It helps investors, creditors, and other stakeholders assess the company's ability to generate profits, manage expenses, and sustain its operations over time.

**The Cash Flow Statement**

The cash flow statement is one of the primary financial statements that provides information about a company's cash inflows and outflows over a specific period of time. It helps stakeholders understand how cash is generated and used by the company, providing insights into its liquidity, solvency, and ability to meet financial obligations.

The cash flow statement is divided into three main sections:

**1) Operating Activities:** This section reports cash flows from the company's primary business operations. It includes cash receipts from customers and cash payments to suppliers, employees, and other operating expenses. The operating activities section reflects the company's ability to generate cash from its core operations. Typical items included in this section are:

i) Cash received from customers for the sale of goods or services.

ii) Cash paid to suppliers and vendors for inventory and other operating expenses.

iii) Cash paid to employees for wages and salaries.

iv) Cash paid for operating expenses such as rent, utilities, and insurance.

v) Interest received and paid related to operating activities.

**2) Investing Activities:** This section reports cash flows from the buying and selling of long-term assets, investments, and other non-current assets. It reflects the company's investments in capital expenditures and other long-term assets. Typical items included in this section are:

i) Cash paid for the purchase of property, plant, and equipment (PP&E).

ii) Cash received from the sale of PP&E or other long-term assets.

iii) Cash paid for investments in securities such as stocks and bonds.

iv) Cash received from the sale of investments or collection of dividends.

v) Loans made to other entities or proceeds from the repayment of loans.

**3) Financing Activities:** This section reports cash flows related to the company's financing activities, such as raising capital and repaying debt. It reflects changes in the company's capital structure and financing arrangements. Typical items included in this section are:

i) Cash received from issuing stocks or bonds.

ii) Cash received from borrowing money through loans or lines of credit.

iii) Cash paid for the repurchase of company stock (buybacks).

iv) Cash paid for dividends to shareholders.

v) Cash proceeds from the repayment of debt or other financing arrangements.

At the end of each section, the net cash flow is calculated by summing the cash inflows and outflows. The net cash flow from each section is then added together to calculate the overall change in cash and cash equivalents for the period.

The cash flow statement is a valuable tool for investors, creditors, and other stakeholders to assess a company's ability to generate cash, manage liquidity, and fund its operations, investments, and financing activities. It complements the income statement and balance sheet by providing a more comprehensive view of a company's financial performance and position.

**The Statement of Changes in Equity**

The statement of changes in equity, also known as the statement of shareholders' equity or statement of retained earnings, is one of the financial statements that reports the changes in a company's equity over a specific period of time. It provides details about the factors that contributed to the change in the equity section of the balance sheet.

Here's a breakdown of the components of the statement of changes in equity:

**a) Beginning Equity:** The statement typically starts with the beginning balance of equity from the previous period, which is carried forward from the balance sheet.

**b) Contributions and Distributions**: This section includes any changes in equity resulting from transactions with shareholders, such as the issuance of new shares or the repurchase of existing shares. It also includes any distributions to shareholders, such as dividends.

i) Issuance of Shares: When a company issues new shares of common stock, the proceeds received from the issuance increase the equity section of the balance sheet.

ii) Repurchase of Shares: If a company repurchases its own shares (treasury stock), it reduces the equity section of the balance sheet.

iii) Dividends: Distributions to shareholders reduce the retained earnings portion of equity.

**c) Net Income or Loss:** This section represents the net income or loss generated by the company during the period. Net income increases equity, while net losses decrease equity. The net income or loss is transferred from the income statement to the statement of changes in equity.

**d) Other Comprehensive Income (OCI):** OCI includes gains and losses that bypass the income statement and are recorded directly in equity. Examples of items included in OCI are unrealized gains or losses on available-for-sale securities, foreign currency translation adjustments, and pension adjustments. OCI can have either a positive or negative impact on equity.

**e) Ending Equity**: The statement concludes with the ending balance of equity, which is the sum of the beginning equity, contributions and distributions, net income or loss, and other comprehensive income.

The statement of changes in equity helps stakeholders understand how a company's equity position has changed over time and the factors that contributed to those changes. It provides transparency into the company's capital structure, financing activities, and retained earnings. The statement of changes in equity is typically included in the set of financial statements along with the balance sheet, income statement, and cash flow statement.

Chapter Three: Regulations and Other Principles Guiding the Accounting Profession

**3.1. The Legal Sources of Regulation**

The accounting profession is subject to various regulations and standards to ensure transparency, accuracy, and ethical conduct. Legal laws are usually put in place by most countries that regulate the preparation and sharing of accounting information among the different stakeholders involved. In Kenya, key sources of legal regulation include the following:

**a) The Companies Act**

The companies act is a detailed section of the constitution that outlines the financial reporting guidelines for both public and private limited companies. Based on the provisions of the act, publicly listed companies are supposed to publish audited financial statements at least once every year. The act also outlines other aspects of the operations of companies such as the minimum number of directors and the tax rate applicable to each type of company.

**b) Stock exchanges**

Stock exchanges such as the Nairobi Stock exchanges also have reporting requirements that are meant to be met by companies. Firms must comply with these requirements if they are to remain listed on the exchange.

**3.2 Professional Sources of Regulation**

**Internal Sources of Regulation**

Several international bodies play significant roles in regulating accounting standards, ethics, and professional practices globally. Here are some of the key international bodies that regulate accounting:

**a) International Financial Reporting Standards Foundation (IFRS Foundation):** The IFRS Foundation is responsible for the governance and oversight of the International Accounting Standards Board (IASB), which develops International Financial Reporting Standards (IFRS). IFRS is widely adopted by countries around the world as the global standard for financial reporting.

**b) International Accounting Standards Board (IASB):** The IASB is an independent standard-setting body that develops and maintains International Financial Reporting Standards (IFRS). It works under the oversight of the IFRS Foundation to establish high-quality accounting standards that promote transparency, comparability, and reliability in financial reporting.

**c) International Federation of Accountants (IFAC):** IFAC is a global organization representing the accounting profession. It sets international standards on ethics, auditing, education, and public sector accounting through its independent standard-setting boards, such as the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA). IFAC also provides guidance and resources to support the development of the profession worldwide.

**d) The International Auditing and Assurance Standards Board (IAASB):** IAASB is an independent standard-setting body under IFAC responsible for developing International Standards on Auditing (ISAs) and other assurance standards. These standards guide auditors in conducting high-quality audits and provide a framework for ensuring the reliability of financial information.

**e) The International Ethics Standards Board for Accountants (IESBA):** IESBA is an independent standard-setting board under IFAC that develops the International Code of Ethics for Professional Accountants. The code establishes ethical requirements for accountants, including integrity, objectivity, professional competence, and confidentiality, to promote public trust in the profession.

**f) Basel Committee on Banking Supervision (BCBS):** The BCBS sets global standards for banking regulation, including accounting and financial reporting requirements for banks and financial institutions. Its standards, such as the Basel III framework, impact the accounting practices of banks worldwide.

**International Public Sector Accounting Standards Board (IPSASB):** IPSASB is an independent standard-setting board under IFAC that develops International Public Sector Accounting Standards (IPSAS) for government entities. IPSAS aim to improve the quality and transparency of public sector financial reporting, enhancing accountability and decision-making.

These international bodies collaborate with governments, regulators, professional organizations, and other stakeholders to promote consistent and high-quality accounting practices globally, contributing to financial stability, investor confidence, and economic development.

**Local Sources of Regulation**

In Kenya, accounting professionals are regulated by several professional bodies that set standards, provide certifications, promote ethical conduct, and offer professional development opportunities. Some of the key professional bodies that regulate accounting in Kenya include:

**i) Institute of Certified Public Accountants of Kenya (ICPAK):** ICPAK is the statutory body established under the Accountants Act of Kenya to regulate the accounting profession. It sets accounting and auditing standards, conducts examinations for certification, promotes professional development, and ensures compliance with ethical standards among its members.

**ii) Association of Chartered Certified Accountants (ACCA) Kenya:** ACCA is a global professional accounting body offering the Certified Chartered Accountant qualification. ACCA Kenya provides support, training, and resources to ACCA members in Kenya, promoting high ethical and professional standards in the accounting profession.

**iii) Institute of Certified Public Secretaries of Kenya (ICPSK):** ICPSK is the professional body responsible for regulating and promoting the practice of company secretaries in Kenya. While its primary focus is on company secretaries, ICPSK also oversees the governance and compliance aspects related to accounting and financial reporting within organizations.

**iv) Kenya Accountants and Secretaries National Examination Board (KASNEB):** KASNEB is a government agency responsible for overseeing professional examinations in accounting, finance, and related fields in Kenya. It conducts examinations for various qualifications, including Certified Public Accountant (CPA), Certified Secretaries (CS), and Certified Information Communication Technologists (CICT).

**v) The Institute of Internal Auditors Kenya (IIA Kenya):** IIA Kenya is a professional association dedicated to promoting internal auditing practices in Kenya. It provides training, certification, and networking opportunities for internal auditors and works to enhance the effectiveness of internal audit functions within organizations.

These professional bodies play a crucial role in regulating the accounting profession in Kenya by ensuring that accounting professionals adhere to high standards of professionalism, competency, and ethical behavior. They also contribute to the development and advancement of the accounting profession through education, training, and advocacy initiatives.

**3.3 Accounting Standards**

Accounting standards are a set of principles, rules, and guidelines that govern the preparation, presentation, and disclosure of financial information in financial statements. These standards ensure consistency, comparability, transparency, and reliability in financial reporting. The main accounting standards used internationally include:

**Generally Accepted Accounting Principles (GAAP)**

GAAP is a set of accounting standards and guidelines used globally for preparing financial statements. It encompasses various principles, conventions, and rules established by standard-setting bodies such as the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC).

**International Financial Reporting Standards (IFRS)**

IFRS is a set of global accounting standards developed and maintained by the International Accounting Standards Board (IASB). IFRS is used by companies in many countries around the world for preparing their financial statements. The aim of IFRS is to promote transparency, comparability, and understandability of financial information across borders.

**International Public Sector Accounting Standards (IPSAS)**

IPSAS are a set of accounting standards developed by the International Public Sector Accounting Standards Board (IPSASB) for use by governments and other public sector entities. IPSAS aim to improve the quality and consistency of financial reporting in the public sector, enhancing accountability and decision-making.

These accounting standards provide a framework for how financial transactions should be recorded, measured, and reported in financial statements. They help ensure consistency and comparability in financial reporting, enabling stakeholders to make informed decisions based on reliable and transparent financial information.

**3.4 Common Accounting Principles and Concepts**

Accounting principles and concepts provide a framework for recording, presenting, and interpreting financial information. While specific accounting standards may vary depending on the jurisdiction and the nature of the entity, there are several common accounting principles and concepts that form the foundation of financial accounting. Key accounting principles include:

**1. Accrual Basis Accounting:** Revenue and expenses are recognized when they are earned or incurred, regardless of when cash is exchanged. For example, if a company sells goods on credit in December, the revenue is recognized in December, even if the cash is received in January.

**2. Going Concern Concept:** Assumes that the entity will continue to operate indefinitely. For instance, when preparing financial statements, a company assumes it will continue to operate and won't be forced to liquidate or cease operations in the near future.

**3. Consistency:** Requires using the same accounting methods and principles from one period to another. For instance, if a company uses the straight-line method to depreciate its assets in one year, it should continue to use the same method in subsequent years.

**4. Materiality:** Refers to the significance of an item or event to the financial statements. For example, a company may expense a small repair cost immediately rather than capitalize it if the amount is immaterial to the overall financial picture.

**5. Prudence (Conservatism):** Calls for recognizing potential losses when they are certain, but recognizing gains only when they are realized. For example, if a company is involved in a lawsuit, it may recognize the potential loss immediately, but wait to recognize a gain until it is realized.

**6. Historical Cost Principle:** Assets are recorded at their original cost when acquired. For instance, if a company purchases a building for $500,000, it will record the building on its balance sheet at that cost, even if the market value of the building increases over time.

**7. Matching Principle:** Expenses should be recognized in the same period as the revenues they help generate. For example, if a company sells goods in January, but incurs advertising expenses to promote those goods in December, the advertising expenses should be recognized in January, when the revenue is earned.

**8. Objectivity Principle (Verifiability):** Financial information should be based on objective evidence and verifiable data. For instance, if a company purchases inventory, it should have invoices and receipts as evidence of the transaction.

**9. Conservatism:** When faced with uncertainty, accountants should err on the side of caution and recognize potential losses immediately. For example, if a company is unsure about the collectability of a receivable, it may recognize a bad debt expense to reflect the potential loss.

**10. Entity Concept:** Requires that the financial affairs of a business entity are kept separate from the personal affairs of its owners. For instance, if a business owner uses personal funds to purchase a vehicle, it should not be recorded as an asset of the business unless properly documented and accounted for.

These principles and concepts provide a framework for accounting professionals to prepare and analyze financial information in a consistent, reliable, and transparent manner, facilitating decision-making by users of financial statements.

**3.5 Qualities of Useful Accounting Information**

Useful accounting information possesses several key qualities that help ensure it is relevant, reliable, understandable, and comparable. These qualities are often summarized using the acronym "CARES" and include the following:

**Comparability**

Accounting information should be comparable over time (i.e., consistency in reporting from one period to another) and across different entities (i.e., consistency in reporting among similar businesses). This allows users to assess trends and make meaningful comparisons.

**Accuracy**

Accounting information should be free from material errors and faithfully represent the economic events and transactions it purports to depict. Accuracy ensures that financial statements provide a true and fair view of the entity's financial position and performance.

**Relevance**

Accounting information should be relevant to the needs of users and capable of influencing their decisions. Relevant information helps users assess the entity's ability to generate future cash flows, evaluate its financial health, and make informed decisions.

**Understandability**

Accounting information should be presented in a clear, concise, and understandable manner. Complex financial information should be communicated in a way that is accessible to users with varying levels of financial knowledge, enabling them to comprehend and interpret the information effectively.

**Timeliness**

Accounting information should be provided in a timely manner to be useful for decision-making purposes. Timeliness ensures that users have access to relevant information when they need it, allowing them to make timely decisions and take appropriate actions.

These qualities collectively contribute to the usefulness of accounting information by ensuring that it is reliable, relevant, understandable, and comparable, thereby enhancing its value to users in making informed economic decisions.

Chapter Four: Accounting for Assets and Liabilities

**Definition of Assets and Liabilities**

Assets and liabilities are fundamental concepts in accounting that act as the building block for financial statements. The general definition of each is provided below:

**Assets:** Assets are resources owned or controlled by a company as a result of past events and from which future economic benefits are expected to flow to the entity. In simpler terms, assets are things of value that a company owns. Assets can be tangible, such as cash, inventory, property, and equipment, or intangible, such as patents, trademarks, and goodwill. Examples of assets include:

* Cash and cash equivalents
* Accounts receivable (amounts owed to the company by customers)
* Inventory (goods held for sale)
* Property, plant, and equipment (land, buildings, machinery, etc.)
* Investments in stocks and bonds
* Intangible assets (patents, copyrights, trademarks, goodwill, etc.)

Assets are typically recorded on the balance sheet at their historical cost or fair market value and are classified as current (expected to be converted to cash or used up within one year) or non-current (expected to provide economic benefits beyond one year).

**Liabilities:** Liabilities are obligations or debts that a company owes to external parties as a result of past transactions or events. Liabilities represent claims against a company's assets, and they require future sacrifices of economic benefits. In simpler terms, liabilities are amounts owed by a company to others. Liabilities can include:

* Accounts payable (amounts owed to suppliers for goods or services)
* Loans and borrowings (such as bank loans or bonds payable)
* Accrued expenses (such as wages payable or interest payable)
* Deferred revenue (payments received in advance for goods or services not yet provided)
* Lease obligations
* Income taxes payable

Liabilities are also recorded on the balance sheet and are classified as current (due within one year) or non-current (due beyond one year). Like assets, liabilities are typically recorded at their historical cost or fair market value.

Assets and liabilities are essential components of the balance sheet, which is one of the primary financial statements used by investors, creditors, and other stakeholders to assess a company's financial health and performance.

**4.1 Accounting for Property Plant and Equipment**

Property, plant, and equipment (PP&E), also known as fixed assets, are tangible assets held by a company for use in its business operations to generate revenue. These assets are expected to be used for more than one accounting period and are not intended for resale. PP&E typically represents significant long-term investments made by a company to support its core business activities.

Key Components of PPE include the following:

**Property:** This component includes land and buildings owned by the company for use in its operations. Land represents the physical ground and any natural resources attached to it, while buildings encompass structures such as offices, factories, warehouses, and retail spaces.

**Plant:** The "plant" component refers to machinery, equipment, and other fixed assets used in manufacturing, production, or processing activities. This can include items such as manufacturing equipment, vehicles, tools, and computer systems.

**Equipment:** Equipment refers to movable assets used in business operations, typically with a finite useful life. This category may include items such as office furniture, computers, vehicles, and specialized tools. PP&E is vital for the production of goods or services and is considered a key indicator of a company's operational capabilities and long-term investment in its infrastructure.

**Accounting for PPE on Acquisition**

Acquisition is the stage where the item of PPE has been first bought by the business. At this point, the item of PPE is recorded at its historical cost, which is what the business paid to acquire it. For example, a business purchases a delivery van for KES 500,000, the van will be listed under long term assets at KES 500,000.

**Example**

|  |
| --- |
| ABC Limited bought a delivery van for KES 500,000 on credit to be paid for over five years. Create journal entries on how this transaction will be recorded in the general journal and provide a balance sheet excerpt.  **Solution**  **Journal Entries**  Debit (Dr) Delivery Van Account 500,000  Credit (Cr) Long term loan for delivery vans 500,000  (Being initial record of the purchase of a delivery van.  **Balance Sheet Excerpt:**  **Long Term Assets**  Delivery vans 500,000  **Liabilities and Equity**  **Long term liabilities**  Loan for delivery van 500,000 |

**Accounting for Depreciation**

Depreciation in accounting refers to the systematic allocation of the cost of tangible assets over their useful lives. Assets generally lose value as they are used in day to day operations. A delivery van for example will lose value over time and cannot be valued at the same price it was bought when preparing financial statements. A depreciation charge is therefore made each year that reduce the asset by a specific value that accurately captures the value it losses in a single year. When a company purchases a long-term asset such as machinery, buildings, vehicles, or equipment, it doesn't expense the entire cost in the year of purchase. Instead, it spreads the cost over the asset's estimated useful life.

In the balance sheet, an asset is listed at its **historical cost less any accumulated depreciation**. The value left after reducing depreciation is referred to as the carrying amount.

|  |
| --- |
| ABC Limited bought a delivery van for KES 500,000 on January 1st 2020. Depreciation is charged annually at 50,000. Determine the carrying amount that is reported in the balance sheet in December 2023, four years later.  **Solution**  Annual depreciation = 50,000  Total depreciation for four years = 50,000 \* 4 = 200,000  The accumulated depreciation is therefore 200,000 at 31st December 2023.  The carrying amount = Historical costs – Accumulated depreciation  Carrying amount = 500,000 – 200,000 = 300,000  The delivery van will therefore be listed at KES 300,000 under long term/non-current assets in the balance sheet of the company as at 31st December 2023. |

Depreciation is recorded as an expense on the income statement, which reduces the net income and reflects the portion of the asset's value that has been used up during the accounting period. It is also important to note that depreciation is a non-cash expense, meaning cash isn't actually leaving the company when depreciation is recorded.

**Example**

|  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- |
| ABC Limited charges annual depreciation worth KES 100,000 to its Factory machines that are valued at KES 5 million. Sales revenue for 2023 were KES 2 million. Other expenses included salaries worth 300,000 and administrative costs worth 500,000. Determine the net profit of the company for 2023.  **Solution**   |  |  | | --- | --- | | Sales Revenue | 2,000,000 | | **Less Expenses** |  | | Salaries | (300,000) | | Administrative expenses | (500,000) | | Depreciation expense | (100,000) | | Total Expenses | (900,000) | | Net Profit ( Sales – Total expenses) | 1,100,000 | |

**Methods of Calculating Depreciation**

The two main methods of calculating depreciation include the straight line method and the reducing balance method. Both are discussed in detail below.

**The Straight Line Method**

Is the most common method of charging depreciation. A uniform charge is applied every year for the asset that is based on its cost and expected useful lives. Its key components include:

**Cost of the Asset:** The cost of the asset, that includes any expenses incurred to acquire and prepare it for its intended use.

**Estimated Useful Life:** Useful life refers to the period over which the asset is expected to contribute to the company's operations. This could be based on factors such as wear and tear, technological obsolescence, or legal constraints.

**Residual/scrap Value**: This is the expected value of the asset at the end of its useful life.

Depreciation charged

**Example**

|  |
| --- |
| Safaricom Limited bought boosters for KES 20 million and spent an additional five million to set them up by buying land and installing them across the country. The boosters have a useful life of 10 years, after which they can be sold for KES 500,000. The company uses the straight line method of depreciation. Calculate the annual depreciation charge.  **Solution**  The cost of the asset = 20,000,000 plus the 5,000,000 spent to make the asset usable  The cost of the asset = 25,000,000  Residual value = 500,000  Useful life = 10 years  Depreciation charged  Depreciation charged = 2,450,000 per year |

**Reducing Balance Method**

The reducing balance method, also known as the declining balance method, is another common technique used to calculate depreciation. Unlike the straight-line method, which allocates the cost of an asset evenly over its useful life, the reducing balance method allows for a higher depreciation expense in the earlier years of an asset's life, with the depreciation expense decreasing over time. Here's how it works:

**Cost of the Asset:** The cost of the asset, that includes any expenses incurred to acquire and prepare it for its intended use.

**Estimated Useful Life:** Useful life refers to the period over which the asset is expected to contribute to the company's operations. This could be based on factors such as wear and tear, technological obsolescence, or legal constraints.

**Depreciation Rate**: This is a percentage representing the rate at which the asset's value is expected to decline each period. This rate is usually fixed and is typically higher than what would be used in the straight-line method to account for the accelerated depreciation in the early years.

Depreciation Expense Calculation: Calculate the depreciation expense for each period using the formula:

***Depreciation Expense = Book Value × Depreciation Rate***

Book value represents the written down value of the asset after deducting depreciation for the previous year. For example if an asset has an initial value of 1000, and depreciation for year one is determined to be 100, the book value to be used to calculate depreciation in year two will be 900.

**Example**

|  |
| --- |
| On 1 January 2016, XYZ Limited purchased a truck for KES 75,000. Depreciation is estimated at 20% per year on the book value.  **Required:** Calculate the truck's depreciation for 2016, 2017, and 2018 using the reducing balance method.  **Solution**  **2016**  The book value at the beginning of 2016 is $75,000. Depreciation for 2016 is KES 75,000 × 0.2 = 15,000.  **2017**  The book value at the beginning of 2017 is $75,000 - $15,000 = $60,000. Depreciation for 2017 is $60,000 × 0.2 = $12,000.  **2018**  The book value at the beginning of 2018 is $60,000 - $12,000 = $48,000. Depreciation for 2018 is $48,000 × 0.2 = $9,600. |

**Accounting for Asset Disposals**

Asset disposal in accounting refers to the process of removing a long-term asset from a company's books when it is no longer needed or has reached the end of its useful life. This disposal can occur due to various reasons, including sale, retirement, scrapping, or donation.

**Disposal of a Fully Depreciated Asset**

Assets that are fully depreciated have to be written off. This does not require major adjustments, as most depreciation methods will lead to a book value of zero at the end of the assets useful life.

**Disposal of an Asset by Sale Leading to a Profit**

A company may sell an asset that is still valuable for a profit. Adjusting entries are needed in this case to account for the profit made and remove the asset from the company’s books.

Example

ABC limited has an asset with an accumulated depreciation of 2000 after two years of operations. The asset originally cost 3000, and currently has a book value of 1000. ( 3000 – 2000). The company was however able to sell the machine for 1500, thereby making a profit of 500. Create journal entries for this transaction.

|  |  |  |
| --- | --- | --- |
| Debit Cash ( To account for the cash received on sale of asset) | 1,500 |  |
| Dr Accumulated Depreciation ( to remove the depreciation of the asset from the books of account of the business) | 2000 |  |
| Cr Gain on sale ( sales value less book value of asset) |  | 500 |
| Cr Machinery (with historical cost on purchase, which eliminates it from the company’s books) |  | 3000 |

**NB: All gains on sale are reported in the income statement under other incomes.**

**Disposal of an Asset by Sale Leading to a Loss**

Asset are sold for a loss if the sales price is less than the book value.

Example

ABC limited has an asset with an accumulated depreciation of 2000 after two years of operations. The asset originally cost 3000, and currently has a book value of 1000. ( 3000 – 2000). The company was however able to sell the machine for 500, thereby making a loss of 500. Create journal entries for this transaction.

|  |  |  |
| --- | --- | --- |
| Debit Cash ( To account for the cash received on sale of asset) | 500 |  |
| Dr Accumulated Depreciation ( to remove the depreciation of the asset from the books of account of the business) | 2000 |  |
| Dr. Loss on sale ( sales value less book value of asset) | 500 |  |
| Cr Machinery (with historical cost on purchase, which eliminates it from the company’s books) |  | 3000 |

**All losses on disposal are reported in the income statement as an expense.**

**Intangible Assets**

Intangible assets are non-physical assets that lack a physical substance but hold value for a company due to the rights or economic benefits they confer. These assets are long-term resources that are expected to provide future economic benefits to the company. Unlike tangible assets such as buildings or machinery, intangible assets cannot be touched or seen.

**Examples of Intangible Assets**

**Intellectual Property:** This includes patents, trademarks, copyrights, and trade secrets that provide legal protection for original ideas, inventions, artistic works, or brand names.

**Goodwill:** Goodwill represents the premium a company pays for acquiring another company above its net tangible assets. It encompasses factors such as brand reputation, customer relationships, and employee morale.

**Brand Recognition:** Brand recognition refers to the value associated with a well-known brand name that can attract customers and generate higher sales.

**Customer Relationships:** Customer relationships and contracts can be considered intangible assets, representing the value of established relationships with customers or contractual agreements that provide future revenue streams.

**Software:** Software developed internally or acquired from third parties is considered an intangible asset and is typically amortized over its useful life.

**Licenses and Permits:** Licenses and permits that grant exclusive rights or privileges, such as a broadcasting license or a regulatory permit, are intangible assets.

**Research and Development (R&D):** Costs associated with developing new products, processes, or technologies can be capitalized as intangible assets if they meet certain criteria, such as demonstrating future economic benefits.

Intangible assets are recorded on the balance sheet of a company and are typically amortized over their useful lives. Amortization is the process of systematically allocating the cost of an intangible asset over its estimated useful life. Intangible assets are subject to impairment testing to assess whether their carrying value exceeds their recoverable amount, in which case they would need to be written down. Proper recognition and valuation of intangible assets are important for providing a comprehensive picture of a company's financial position and performance.

4.3 Financial Assets and Financial Liabilities

**Financial Assets**  
Financial assets are tangible or intangible assets that represent ownership of value or a right to future benefits. These assets are typically liquid and tradable, meaning they can be easily converted into cash or traded in financial markets. Examples include stocks, bonds, cash, mutual funds, exchange-traded funds (ETFs), derivatives, and bank deposits. Financial assets serve as a means for individuals, businesses, and governments to store wealth, generate income, hedge against risks, and facilitate investment and economic activity.

**Financial Liabilities**

Financial liabilities are obligations or debts that an individual, business, or government owes to another party. These obligations require the debtor to make future payments or provide goods or services to settle the debt. Financial liabilities can arise from various sources, including borrowing money, issuing bonds or loans, or entering into contractual agreements. Examples of financial liabilities include bank loans, corporate bonds, mortgages, accounts payable, accrued expenses, and deferred revenue. These liabilities represent claims against an entity's assets and must be repaid or fulfilled according to the terms of the agreement.

**4.4 Inventory**

In accounting, inventory refers to the goods, raw materials, work-in-progress, or finished products that a business holds for the purpose of resale or use in its operations. Inventory represents one of the key components of a company's assets and is typically recorded on the balance sheet.

There are three main types of inventory:

**a) Raw Materials Inventory:** These are the materials and components that a company purchases to use in the production process. Examples include raw metals for manufacturing, fabrics for clothing production, or wood for furniture making.

**b) Work-in-Progress (WIP) Inventory:** This consists of partially completed goods that are still in the production process. WIP inventory includes items that have undergone some processing but are not yet finished products. For example, a partially assembled car in an automobile manufacturing plant would be considered work-in-progress inventory.

**c) Finished Goods Inventory:** These are products that have completed the production process and are ready for sale to customers. Finished goods inventory represents the final stage of production and includes items that are packaged, labeled, and ready for distribution.

Inventory is crucial for businesses because it ties up capital and affects cash flow. Therefore, effective inventory management is essential to optimize the balance between having enough inventory to meet customer demand and minimizing the costs associated with holding excess inventory, such as storage, insurance, and obsolescence.

**Accounting for Inventory**

Inventory is usually valued at the lower of cost or the net realizable value. Cost refers to the purchase price incurred by a firm to purchase inventory, including conversion cost and cost of transporting the inventory to a firm’s warehouse. The net realizable value on the other hand refers to the most likely selling price of the inventory. Cost is therefore compared to the net realizable value and the lower value used in valuing inventory.

Example

|  |
| --- |
| ABC Limited bought 5 tonnes of maize for 2 million shillings on the 1st of October. Changes in market demand however led to a reduction in value of maize to 200,000 per tonne, meaning ABC could sell its current inventory for just 1 million. What is the value used in recognizing inventory in the balance sheet of the company.  Solution  Inventory will be rcognized at 1 million as the net realizable value, since it is lower than the purchase cost. |

Chapter Five: Financial Statements of a Sole Trader

**5.1 Introduction**

A sole trader, also known as a sole proprietorship, is a type of business entity where an individual owns and operates the business alone. In this structure, the business and the owner are considered as one legal entity. Sole traders have complete control over the business and make all decisions regarding its operations. They are personally liable for all the debts and obligations of the business, meaning their personal assets are at risk in case of business losses or legal liabilities. This form of business is common among small businesses and freelancers due to its simplicity and ease of setup.

**Financial Statements of a Sole Trader**

Sole traders typically prepare several financial statements to assess the performance and financial health of their business. The main types of financial statements prepared by a sole trader include:

**a) Income Statement (Profit and Loss Statement):** This statement shows the revenues earned and expenses incurred over a specific period, usually monthly, quarterly, or annually. It calculates the net profit or loss by subtracting expenses from revenues.

**b) Balance Sheet**: The balance sheet provides a snapshot of the sole trader's financial position at a specific point in time, typically the end of the reporting period. It lists the assets owned by the business, liabilities owed, and the owner's equity in the business, representing the difference between assets and liabilities.

**5.2 The Statement of Profit and Loss or the Income Statement**

The Income Statement of a sole trader, also known as a Profit and Loss Statement, summarizes the revenues, expenses, and resulting net profit or loss of the business over a specific period, such as a month, quarter, or year. The income statement of a sole trader usually takes the following format:

ABC Sole Traders

Profit and Loss Statement

For the Year Ended December 31st 2023

|  |  |  |
| --- | --- | --- |
| **Revenue** |  |  |
| Sales Revenue | XX |  |
| Other Sources of Revenue | XX |  |
| Total Revenue |  | XX |
| Less Cost of Sales |  | (XX) |
| Gross Profit |  | XX |
| **Expenses** |  |  |
| Rent | (XX) |  |
| Electricity | (XX) |  |
| Staff Salaries | (XX) |  |
| Depreciation expenses | (XX) |  |
| Total Expenses |  | (XX) |
| **Net Profit** |  | XX |

**Notes:**

**Revenue:** This section lists all sources of income generated by the business, such as sales revenue from products or services and any other revenue streams, like interest income or rental income.

**Expenses:** This section includes all costs incurred to generate revenue and operate the business. It typically includes the cost of goods sold (COGS), operating expenses (e.g., rent, utilities, salaries), depreciation expense, interest expense on loans, income tax expense, and any other relevant expenses.

**Net Income (Profit/Loss):** This section calculates the net profit or loss by subtracting total expenses from total revenue. A positive number indicates a net profit, while a negative number indicates a net loss.

The Income Statement provides valuable insights into the financial performance of the sole trader's business during the specified period, helping them assess profitability and make informed decisions for future operations and investments.

**5.3. Statement of Financial Position(Balance Sheet)**

The Statement of Financial Position for a sole trader, also known as a Balance Sheet, presents the financial position of the business at a specific date, typically the end of the reporting period. The most common format of the balance sheet of a sole trader is shown below:

**ABC Limited**

**Statement of Financial Position**

**For the Year Ended December 31st 2023**

|  |  |  |
| --- | --- | --- |
| **Assets** |  |  |
| **Non-Current Assets** |  |  |
| Equipment and Machinery | XX |  |
| Land | XX |  |
| Delivery Vehicles | XX |  |
| **Total Non-Current Assets** |  | **XX** |
|  |  |  |
| Current Assets |  |  |
| Inventory | XX |  |
| Trade Receivables | XX |  |
| Prepaid Expenses | XX |  |
| Cash in Hand | XX |  |
| Cash at Bank | XX |  |
| **Total Current Assets** |  | **XX** |
| **Total Assets** |  | **XX** |
|  |  |  |
| **Capital and Liabilities** |  |  |
| **Liabilities** |  |  |
| Non-Current Liabilities |  |  |
| Long term loan from Equity Bank | XX |  |
| Total Non-Current Liabilities |  | XX |
|  |  |  |
| **Current Liabilities** |  |  |
| Trade Payables | XX |  |
| Accrued Expenses | XX |  |
| Total Current Liabilities |  | XX |
| Total Liabilities |  | XX |
|  |  |  |
| **Owners’ Equity** |  |  |
| Owners capital Contribution | XX |  |
| Add: Profit for the year | XX |  |
| Less: Drawings by Owners | (XX) |  |
| Capital Balance |  | XX |
| **Total Capital and Liabilities** |  | **XX** |
|  |  |  |

**Notes:**

**Assets:** This section lists all resources owned or controlled by the business, categorized into current assets (expected to be converted into cash within one year) and non-current assets (expected to be held for more than one year).

**Liabilities:** This section lists all obligations of the business, categorized into current liabilities (due within one year) and non-current liabilities (due after one year).

**Owner's Equity:** This section represents the owner's investment in the business (Owner's Capital) and the cumulative profits retained in the business (Retained Earnings).

**Total Assets:** The sum of all current and non-current assets.

**Total Liabilities:** The sum of all current and non-current liabilities.

**Total Owner's Equity:** The total value of the owner's investment and retained earnings.

The Statement of Financial Position provides a snapshot of the sole trader's financial health, showing the assets owned, liabilities owed, and the owner's equity in the business at a specific point in time.

**Chapter Six: Financial Statements of a Partnership**

**Introduction**

A partnership, in accounting terms, refers to a business structure where two or more individuals or entities join together to carry out a business for profit. In a partnership, each partner contributes capital, skills, labor, or property, and they share in the profits, losses, and management responsibilities according to a predetermined agreement.

From an accounting perspective, a partnership is treated as a separate entity, distinct from its individual partners, but it's not a separate legal entity like a corporation. Partnerships typically use the accrual basis of accounting, recording transactions when they occur regardless of when the cash is exchanged.

Partnership accounting involves maintaining records of all financial transactions, preparing financial statements such as the income statement, balance sheet, and statement of partners' equity, and allocating profits and losses among the partners based on the partnership agreement.

**6.1. The Partnership Deed**

A partnership deed, also known as a partnership agreement or articles of partnership, is a legal document that outlines the terms and conditions governing the establishment and operation of a partnership. It serves as a contract between the partners, detailing their rights, duties, responsibilities, and the rules governing the partnership's management and operations.

The key elements typically included in a partnership deed are:

**Name and Address of the Partnership**: The legal name and principal place of business of the partnership are stated.

N**ame and Address of Partners:** The full names and addresses of all partners are listed, along with their contributions to the partnership (capital, property, or services).

**Nature of Business:** A description of the business activities that the partnership will engage in.

**Duration of Partnership:** The duration of the partnership, whether it's for a specific period or until certain conditions are met, is specified.

**Capital Contributions:** The amount of capital contributed by each partner and the method of determining future contributions are outlined.

**Profit and Loss Sharing:** The manner in which profits and losses will be shared among the partners, including any specific ratios or formulas, is detailed.

**Management and Decision-Making:** The responsibilities and authority of each partner in managing the partnership affairs, as well as the decision-making process for major business decisions, are defined.

**Drawings and Salaries:** The rules regarding partner drawings (withdrawals) and any salaries or compensation to be paid to partners are established.

**Admission of New Partners:** Procedures for admitting new partners into the partnership, including criteria and approval processes, are laid out.

**Resignation or Retirement of Partners:** The process for partners to resign, retire, or be expelled from the partnership, along with the distribution of their interests, is specified.

**Dispute Resolution:** Mechanisms for resolving disputes among partners, including mediation or arbitration procedures, may be included.

**Dissolution and Winding-Up:** The circumstances under which the partnership may be dissolved and the procedures for winding up its affairs and distributing assets are outlined.

A well-drafted partnership deed helps prevent misunderstandings, conflicts, and legal disputes among partners by clearly defining the terms of their relationship and the operation of the partnership. It is typically prepared with the assistance of legal professionals and signed by all partners to formalize their agreement.

**6.2. The Statement of Profit and Loss and Appropriation for a Partnership**

The statement of profit and loss for a partnership is almost similar to that of a sole trader, with the only major difference being the appropriation section that allocates the profit made to each partners based on the profit sharing ratio. The most common format is shown below:

ABC Partnership

Profit and Loss Statement

For the Year Ended December 31st 2023

|  |  |  |
| --- | --- | --- |
| **Revenue** |  |  |
| Sales Revenue | XX |  |
| Other Sources of Revenue | XX |  |
| Total Revenue |  | XX |
| Less Cost of Sales |  | (XX) |
| Gross Profit |  | XX |
| **Expenses** |  |  |
| Rent | (XX) |  |
| Electricity | (XX) |  |
| Staff Salaries | (XX) |  |
| Depreciation expenses | (XX) |  |
| Total Expenses |  | (XX) |
| **Net Profit** |  | XX |
| **Appropriation Section** |  |  |
| **Add: Interest on Drawings** |  |  |
| Partner One Interest on Drawings | XX |  |
| Partner Two Interest on Drawings | XX |  |
| Partner Three Interest on Drawings | XX | XX |
| **Less Interest on Capital Invested** |  |  |
| Partner One Interest on Capital | (XX) |  |
| Partner Two Interest on Capital | (XX) |  |
| Partner Three Interest on Capital | (XX) | (XX) |
| **Less Salaries Paid to Partners** |  |  |
| Partner One Salary | (XX) |  |
| Partner two Salary | (XX) |  |
| Partner Three Salary | (XX) | (XX) |
| **Balance of Profit to be Shared** |  | XX |
| **Share of Remaining Profit** |  |  |
| Partner One (1/3rd of profit) | XX |  |
| Partner Two (1/3rd of profit) | XX |  |
| Partner Three (1/3rd of profit) | XX | XX |

Sometimes, students are required to create the appropriation account separately in a T format. The general format is shown below:

|  |  |  |  |
| --- | --- | --- | --- |
| **Appropriation Account Format** | | | |
|  |  | **Net Profit** | XX |
| **Interest on Capital** |  | **Interest on Drawings** |  |
| Partner One Interest on Capital | XX | Partner One Interest on Drawings | XX |
| Partner Two Interest on Capital | XX | Partner Two Interest on Drawings | XX |
| Partner Three Interest on Capital | XX | Partner Three Interest on Drawings | XX |
| **Salaries to Partners** |  |  |  |
| Partner One Salary | XX |  |  |
| Partner two Salary | XX |  |  |
| Partner Three Salary | XX |  |  |
| **Share of Remaining Profit** |  |  |  |
| Partner One (1/3rd of profit) | XX |  |  |
| Partner Two (1/3rd of profit) | XX |  |  |
| Partner Three (1/3rd of profit) | XX |  |  |
| **Total** | **XX** |  | **XX** |

**6.3. Partner’s Current and Capital Accounts**

In partnership accounting, partners maintain two main types of accounts: current accounts and capital accounts. These accounts help track each partner's contributions to and share of the partnership's profits and losses. Here's an explanation of each:

**Current Accounts:**

* Current accounts are also known as "drawing accounts" or "income accounts."
* These accounts record each partner's share of the partnership's profits or losses for a specific accounting period.
* Current accounts are temporary accounts that are reset at the end of each accounting period (typically annually).
* They are used to track withdrawals, distributions, and any additional contributions made by partners during the accounting period.
* At the end of the accounting period, the balance in the current account is transferred to the partner's capital account.
* The balance in the current account represents the partner's share of the partnership's net income or loss for the period.

|  |  |  |  |
| --- | --- | --- | --- |
| **Partner’s Current Account Format** | | | |
| Balance b/d | XX | Balance b/d | XX |
| Interest on drawings | XX | Salary received | XX |
| Share of loss |  | Sales commission earned | XX |
| Drawings | XX |  |  |
| **Total** | **XX** | **Total** | **XX** |

**Capital Accounts:**

* Capital accounts represent each partner's equity or ownership interest in the partnership.
* These accounts are permanent and are not closed at the end of each accounting period.
* Capital accounts initially reflect the amount of capital contributed by each partner to the partnership at the beginning of the partnership's formation.
* Additionally, capital accounts are adjusted to reflect the partner's share of profits or losses, withdrawals, and any additional contributions.
* The balance in the capital account represents the partner's total investment in the partnership at any given time.
* The capital account balance can be used to determine each partner's share of the partnership's assets in the event of dissolution or liquidation.

|  |  |  |  |
| --- | --- | --- | --- |
| **Partner’s Capital Account Format** | | | |
|  | XX | Balance b/d | XX |
|  | XX | Salary received | XX |
|  |  | Sales commission earned | XX |
| Drawings | XX |  |  |
| **Total** | **XX** | **Total** | **XX** |

In summary, current accounts track each partner's share of profits or losses on a temporary basis for each accounting period, while capital accounts represent each partner's equity or ownership interest in the partnership on a permanent basis. Both accounts are essential for accurately tracking the financial performance and ownership structure of the partnership.

**6.4 The Statement of Financial Position**