Accounting for Lawyers

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lawAfrica

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Dedication

To my husband Anthony & our lovely daughter Zindzi, for their support and insistent pressure to conclude it in the "shortest" time possible to enable us spend more time together. Am done!

PREFACE

The Accounting Standard Board (1991) defined accounting as the provision of information about the financial position, performance and financial adaptability of an enterprise that is useful to a wide range of potential users including the legal practitioners. Historically, accounting has been called "the language of business." More recently, accounting has been described as the "language of corporate governance." The importance of accounting in the practice of law cannot be underestimated. Financial frauds involving Enron Corp. ("Enron"), WorldCom Inc. ("WorldCom"), and the recent recession inflicted on the world through poor financial policies are key reminders of poor financial and legal control of our accounting procedures. Every successful lawyer is expected to have or develop some working knowledge on accounting. In particular, every competent business lawyer should understand basic accounting principles. Arguably as a matter of professional responsibility more so as every lawyer or law firm represents businesses, their owners, or clients with diverse legal interests, such as creditors and customers.

Accounting play a pertinent role in the representation of Non-Governmental Organizations, Government entities, and private individual matters. Almost all lawyers, therefore, will encounter financial statements in their professional careers or personal lives. Every lawyer will be expected to draft, negotiate, or sign an agreement or other legal document containing accounting terminology or concepts.

Hence all competent lawyers should be well equipped to identify and understand financial discrepancies that often lead to litigation. Issues such as misstatement of inventories or other assets, allocation of expenses to the wrong accounting periods, failure to record or disclose liabilities are common issues leading to fraud. Lawyers encounter different accounting issues in their different areas of emphasis; litigators encounter accounting issues when calculating damages in contract and tort cases; throughout securities fraud cases, and in discovery. Transactional lawyers frequently draft negotiate and determine taxable income. Environmental lawyers face significant cost contracts and other legal documents involving accounting terminologies. Tax lawyers, in particular, must understand the time value for money. They depend on accounting concepts on allocation and disclosure issues. Labour lawyers often draft, negotiate, or litigate profit-sharing agreements. Domestic relations law frequently requires lawyers to interpret financial statements in property settlement, maintenance, or child support matters. Regulatory lawyers, whether representing clients in the health care, insurance, or public utility industries, use accounting to resolve reimbursement issues, establish reserves, and petition for rate approvals. "White collar" crime, especially financial fraud, has become increasingly important to criminal lawyers.

This book recognizes the fear faced by many law students and to a great extent the practicing lawyer concerning accounting and seeks to provide a basic and simplified understanding to accounting principles for those who have no previous accounting background while at the same time introducing some advanced topics for students with previous exposure and thus a deeper scope of accounting principles. The book also sought to incorporate key accounting principles and relevant changes and developments in the Kenyan industry. A comprehensive glossary of terms has been provided to assist learners in grasping key meanings and explanations. It is my hope that the text will be of much help in providing the much needed accounting knowledge and insights for lawyers into the previously feared accounting world and that it can be used in the ongoing transformations of Kenya's legal system through provision of learned and well versed lawyers.

Mary Kimari

Acknowledgement

It would not have been possible to produce this work without support from family, friends and colleagues. It would be hard to name them all without writing a treatise in that respect. At the risk of inadvertent omission, let me thank:

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My ever doting Mum, Doris for the support through time.

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Chapter One

Introduction

1.1 Introduction

Accounting is a part of our everyday life, one that determines our level of responsibility in *personam* and in *rem*, controlling our day to day actions.

Accounting is the process of communicating the status of a business entity to the users in form of financial statements/and on reports.

The accounting process entails recording, classifying, summarizing, reporting, analyzing and interpreting the financial/economic information of a business entity.

It is concerned with recording all business transactions systematically and the arranging them in various accounts and financial statements.

A complete set of financial statements consists of:

- a statement of financial position/previously referred to as the balance sheet.
- a statement of comprehensive income previously called the profit and loss account.
- a statement of change in equity
- a statement of cash flows.
- notes to the financial statements consisting of a summary of significant policies and other explanatory notes
- a statement of financial position for the previous comparative accounting period

Effectiveness of accounting lies in the information being relevant and reliable. The principles of accountancy are applied three main ways; accounting, bookkeeping and auditing.

The basic accounting equation is:

Assets = Liabilities + Equity

1.2 Nature and Purpose of Accounting

The nature of accounting theory is twofold:

I. Positive theory.
II. Normative theory – this affirms how things; it seeks to derive

The purpose of accounting is to provide important/necessary financial information to aid users make effective (fast and precise) decisions:

i. Ascertain the results of operations during a specific period
ii. Ascertain the financial position
iii. Maintain control over the firm's financial activities

1.3 Objectives of Accounting

- **Systematic Records**

Accounting is carried out to keep a systematic record of all financial transactions.

- **Financial Position of the Firm**

The profit & Loss simply ascertains the profit earned or loss suffered during a particular period. This is definitely not enough for some users e.g. the shareholder who would want to know what he owes and what he owns. This objective is served by a statement of assets and liabilities (balance sheet) of the business as at a given date for a specified period. It serves as a barometer for ascertaining the financial health of the business.

- **Operational Profit or Loss**

By ensuring that proper records of revenues and expenses of the firm are maintained, net profit earned or loss suffered can be ascertained.

- **Protect Business**

Accounting provides to some extent protection to business properties from unjustified and unwarranted use.

It also ensures that funds in the business are not necessarily kept idle or underutilized.

- **Decision Making**

Accounting facilitates rational decision making through recording, classifying, summarizing, reporting, analyzing and interpreting financial information at a given period of time and to the relevant levels of authority.

- **Information System**

Accounting functions as an information system for collecting and communicating economic information about the business enterprise. This information helps users in decision making process. This function is rapidly gaining importance in the business environment.

The standard steps in the accounting process

1. Journalizing

To record the transactions in the journal.

2. Posting

Transfer the transactions recorded in the journal in the respective ledger accounts.

3. Balancing

Ascertain the difference between the total debit amount column and the credit amount column of a ledger account.

4. Trial Balance

Prepare a list showing the balances of each and every account to verify whether the sum of the debit balance is equal to the sum of the credit balance.

5. Income Statement

Prepare a trading and profit & loss account to ascertain the financial position as at the end of the accounting period.

6. Statement of Financial Position

Prepare a balance sheet to aid the user assess the financial soundness of the enterprise in terms of liquidity risk.

The balance sheet is structured in such a way that the total assets of a firm equal to the total liabilities and equity.

Assets from an entity may be financed from internal sources (that is, share capital and profits) or from external sources (example, bank loan and trade creditors). Since the total assets of a business must be equal to the amounts of capital invested by the owners and any borrowings, the total assets of a business must be equal to a sum of equity and liabilities.

Statement of financial position helps users of financial statements to assess the financial health of an entity.

When in conjunction with other financial statements of a firm, the balance sheet may help to identify the relationships and trends which are indicative of potential problems or areas for further improvement.

1.4 Users of accounting information

Users of accounting information can be categorized broadly as:

a) external users
b) internal users

External users are parties outside the reporting entity or company who are interested in the accounting information.

Types of external users include:

- Investors (i.e., owners), who use accounting information to make buy, sell or keep decisions related to shares, bonds, etc.
- Creditors (i.e., suppliers, banks), who utilize accounting information to make lending decisions.
- Taxing authorities (i.e., Kenya Revenue Authority, Tanzania

Revenue Authority, Uganda Revenue Authority), who need accounting information to determine a company's tax liabilities.

- Customers, who may need accounting information to decide which products to buy from which companies.

Internal users are parties inside the reporting entity or company who are interested in accounting information.

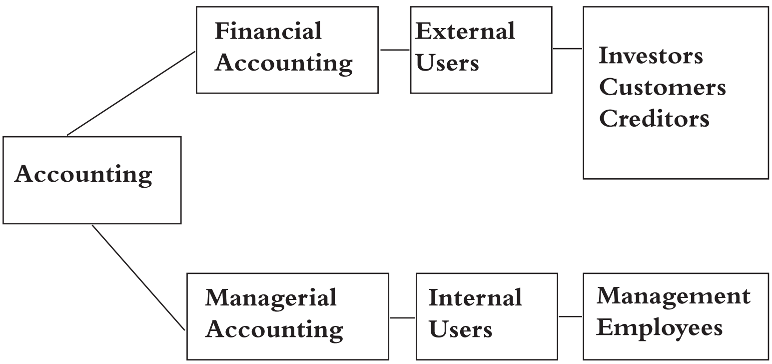
Types of internal users include:

- A company's senior and middle management, who use accounting information to run the business.
- Employees who use accounting information to determine a company's profitability and profit sharing.

Financial accounting provides information that is designed to satisfy the needs of external users. Such reporting is usually done in the form of financial statements.

Managerial accounting provides information that is useful in running a company by internal users. Such reporting is usually accomplished through custom-designed (or managerial) reports.

Illustration 1: Types and relationship of accounting and accounting information users



1.5 Regulatory Framework of Accounting

Company Law requires all companies to comply with the provisions of the Companies Act. Among other requirements and regulations, the financial statements are required to represent a true and fair view of the state of affairs of a business enterprise.

The accounting standard board has issued the Accounting Standards such as International Financial Reporting Standards (IFRS) and SSAPs (Statement of Standard Accounting Practice) with the aim of narrowing the disparity and variety in accounting practice.

Statements of Standard Accounting Practice are issued by the Accounting Standards Board. However, many have been suspended by financial Reporting Standards.

The Urgent Issues task force is an important part of the ASB in that it is required to tackle urgent matters not covered by existing standards. The review panel is concerned with the examination and questioning of departures from accounting standards by large companies.

Additionally the companies are required to follow the Accounting Policies, set out in IFRS 18 and the Companies Act and it must be noted that there is a distinction between the accounting policies and accounting estimates.

The accounting policy is concerned with;

a) the recognition
b) Selection of measurement base and
c) Presentation

Of assets, liabilities, gains and losses of an entity. E.g. Prudence or Accruals? The choice must be based on which may provide the most true and fair view.

Accounting estimate is the method used to establish the monetary value of assets, liabilities, gains and losses using the measurement base selected by the accounting policy, e.g. depreciation (straight line or reducing balance?)

The ASB also developed a Statement of Principles, which is concerned with:

a) the objective of financial statements

b) the reporting entity
c) The qualitative characteristics of financial information.

The statement of principles provides a Conceptual Framework which forms the theoretical basis for determining which events should be accounted for, how they should be measured and how they should be communicated to the user. A conceptual framework is a statement of generally accepted theoretical principles, which form the frame of reference for financial reporting. These theoretical principles provide the basis for the development of new reporting standards and the evaluation of those already in existence. In other words, they are there to provide consistency, clarity of information.

For example, companies listed on the Nairobi Stock Exchange or Johannesburg Stock Exchange are required to comply with specific rules and regulations governing these markets.

In addition to the Financial Statements, limited companies are required to provide notes and disclosures to the accounts, such as:

1. Statement of movements in reserves
2. Details of Fixed Assets.
3. Details of post balance sheet event.
4. Details of contingent liabilities and contingent assets.
5. Details of research and development expenditure.
6. Statement of total recognized gains and losses.
7. Note on historical cost profits and losses.

1.6 Nature and role of organizations that set accounting standards and guidelines

- **International Accounting Standard Board**

IAS were issued between 1973 and 2001 by the Board of the International Accounting Standards Committee (IASC). On April 1, 2001, the new IASB took over from the IASC the responsibility for setting International Accounting Standards. During its first meeting the new Board adopted existing IAS and Standing Interpretations Committee standards (SICs). The IASB has continued to develop standards calling the new standards IFRS

- **International Financial Accounting Committee**

IFRS are principles-based standards, interpretations and the framework (1989) adopted by the international accounting standards board (IASB). Many of the standards forming part of IFRS are known by the older name of International Accounting Standards (IAS).

- **Institute of Certified Public Accountants of Kenya (ICPAK)**

ICPAK is a statutory body established under the Accountants Act, 1977 for purposes of regulation of the profession of accountancy in Kenya.

Key mandate include setting and enforcing standards of professional practice including accounting, auditing and ethical standards.

Overall the Accountants Act, No 15 of 2008 prescribes that the institute promote standards of professional competence and practice amongst members of the institute among other prescriptions.

1.7 Accounting Standards

- International Accounting Standards (IAS)
- International Financial Reporting Standards (IFRS)

1.8 Accounting concepts and principles

While preparing financial statements there are several accounting principles that are followed:

a) Going concern

This principle presumes that the functioning of the company will be smooth and the business entity will continue to operate for a fairly long period. This assumes that a business will continue to trade in the future.

b) Historical cost concept

The principle requires that assets are recorded at cost price which is the basis for valuation

c) Consistency

The same principles must be used for every set of accounts prepared. For example, depreciation must always be set at the same percentage. This means that different sets of accounts can easily be compared to see trends and growth rates. This principle requires that the accountants use the same methods and functions for different periods of time. For example, the same rate or percentage should be applied for all depreciation. This principle is also known as the principle of regularity.

d) Accruals

a. Sales and costs are considered to be incurred at the point that the sale is made and good delivered, rather than when the company is actually paid. This means that sales which have been secured, perhaps in the form of orders taken but not yet delivered, will not be taken into account.

e) Prudence

The main objective of this principle is to show the real financial position of the company. The accountants should show the correct revenue accounts and provide a provision for expenses which may occur in the future. Accountants should always err on the side of caution in their estimates and valuations. For example if revenue were to be over-estimated dividends may appear to be due to shareholders that have not actually been earned

Realisation concept is a strain of the prudence concept which holds that profit can only be accounted for when realisation occurs. Realisation can only take place if:

i. The goods or services have been provided to the buyer
ii. The monetary value of the goods or services has been ascertained

iii. The buyer accepts liability to pay for the goods or services
iv. The buyer is in a position to pay for the goods or services.

Note: It is not
i. When the order is received, or
ii. When the customer pays for the goods.

f) Substance over form

This principle requires a transaction to be accounted for in a way to reflect the real effect on the economic status of the firm

Example: For a hire purchase contract, the relevant entries shall be made at the time that a payment is recorded.

g) Monetary measurement

This principle assumes that transactions are recorded in a single currency and exchange rate. This will help the company compare its accounts to the previous years, in spite of a change in the rate of inflation.

h) Materiality

This is about the relative importance of individual transactions. Most parties will only be interested in significant amounts. This means that lots of low value sales for one customer could be combined together. However if combining transactions could mislead the user of the accounts the amounts should be split out.

i) Duality

Duality dictates that every transaction has two effects. For example, if a company buys a new asset such as a new printing machine, then fixed assets must be shown to increase and either cash or liabilities must also show an increase.

This is the basis of the accounting equation:

Assets = Liabilities + Equity

Assets are owned by a business, and liabilities are the debts of a business, that the company owes to its creditors. Equity is what the company owes to its owners. So all transactions must comply with the basic accounting equation illustrated above.

j) Time interval concept

Final accounts are prepared at regular intervals of one year.

k) Separate Determination

Financial transactions from one person or group of people should be isolated from other unrelated transactions from the same person or group. In determining the aggregate amount of each asset or liability, the amount of each individual asset or liability should be determined separately from all other assets and liabilities.

Example

Shupavu is a client of ABC & Co. Advocates. ABC is defending Shupavu in court in a copyright matter which the plaintiff alleges he has infringed the plaintiff copyright in a book. Shupavu has also instructed ABC Advocates to commence the transfer of a one acre piece of land in Kiriko County

Under the separate determination principle, ABC shall treat each instruction separately; (Individual asset – debt or liability – owing)

l) Business Entity Concept

Assumption that only those transactions that affect the firm, not the owner's personal businesses will be recorded.

m) Stable Money

Transactions that happen over a period of time must reflect a single currency and exchange rate. This will allow one year's set of accounts to be compared with another regardless of the rate of inflation.

Chapter Two

Bookkeeping

2.1 Introduction

The law requires all companies and many other organizations to prepare accounts that conform with certain criteria. This can only be done if the basic, supporting financial records are in place. It involves recording financial transactions so as to permit analysis in a systematic fashion, in a way that can be applied to the law firm, and that is intelligible not only now but at any future time.

Book-keeping is the accurate and systematic recording of business transactions. It is part of accounting. However, accounting is book-keeping plus the organizing, interpreting and reporting of financial information and preparing of financial statements that enable decisions to be taken.

Two common bookkeeping systems used by businesses are single entry bookkeeping system and the double entry bookkeeping system.

Single entry bookkeeping

It arises where single entries are recorded. It uses only income and expense accounts and is recorded primarily in a revenue and expense journal. It is adequate for small businesses.

Double entry bookkeeping

Just from the term double it requires each transaction to be posted twice using debit and credit.

2.2 Source documents

In the normal course of business or when a financial transaction is carried out, a document is produced giving rise to paper trail. This paper trail is the source document. The source document is essential to the bookkeeping and accounting process since it is the evidence that a financial transaction has occurred. Thus, a source document should be recorded in the appropriate accounting journal as soon as possible after the transaction. After recording ensure that they are filed away where they can be retrieved if and when they are needed. Note, if the firm is audited, source documents back up the accounting journals and general ledger as an indisputable trail.

A source document describes all the basic facts of the transaction:

1. The amount of the transaction
2. To whom the transaction was made
3. The purpose of the transaction
4. The date of the transaction

Examples of common source documents:

- Invoice
- Quotation
- Deposit slip
- Purchase order
- Goods dispatch note
- Remittance advice
- Computer generated receipt
- Cash register receipt
- Cancelled cheque
- Credit memo for a customer refund etc

2.3 Books of original entry

Bookkeeping is the process of recording primary information that has financial effect on business transactions into books of accounts.

A book of original entry is a descriptive and chronological record of day to day financial transactions also called a daybook. The daybook's details must be recorded formally into journals to enable postings to the respective ledgers.

The daybooks include:

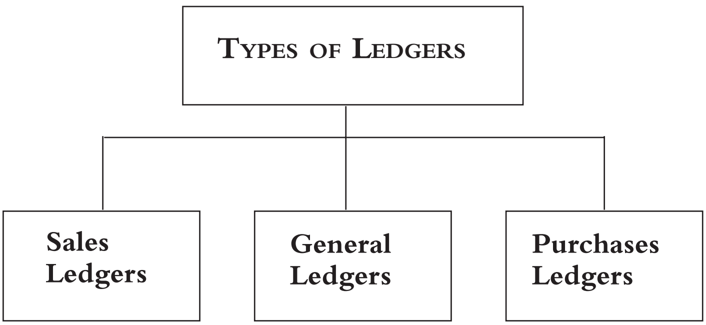
- Sales daybook – for recording all the sales invoices.
- Sales credit daybook – for recording all the sales credit notes.
- Purchases daybook – for recording all the purchase invoices.
- Purchases credit daybook – for recording all the purchase credit notes.
- Cash daybook – for recording all money received as well as paid out. It may be split into two: receipts daybook for money received and payments daybook for money paid out. A petty cash day book for recording small value purchases paid by cash and usually controlled by imprest system may also be maintained over and above a cash day book.
- General journal daybook – for recording journals

2.4 Ledgers

A ledger is a record of accounts recorded separately showing the beginning or ending balance.

It sums up the total of every account which is then transferred into the income statement and balance sheet/statement of financial position.

In bookkeeping there are three different types of ledgers



1. Sales ledger

This deals mostly with the accounts receivable account; financial transactions made by the customers to the business

2. Purchase ledger

This deals with the accounts payable; purchasing transactions that a firm undertakes.

3. General ledger

This represents the original five main accounts: Assets, Liabilities, Equity, Income and Expenses.

There are two main books in the accounting system:

- General journal
- General ledger

General journal is the original book of entry. Information recorded on this book is usually extracted from the source documents. It generally shows the account to be debited and credited and a short description of the transaction .A firm can maintain one journal for all transactions, or keep several journals based on similar activity i.e. sales, cash receipts, revenue etc. For every debit journal entry recorded there should be a corresponding credit journal entry to maintain a balanced accounting equation.

The information will then be posted to the ledger.

Illustration

On 21 February 2012, Mangwe started her firm with KShs 500,000 which she deposited into the bank

General journal

Date	Account narration	Debit	Credit
21/02/2012	Bank Capital (Money introduced into the business by the owner)	500,000	500,000

General ledger is the main book of accounts. This is the book where all the accounts are kept. Each account maintained in this book will contain specific information relating to that particular item. The information used will generally be from the journal.

Illustration

Bank Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
21/02/12	Capital	MA 1	500,000				

Capital Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
				21/02/12	Bank	MA 1	500,000

Note: A cash account is not opened in the ledger since the cash column in the cash book serves the purpose of a cash account.

2.5 Control Accounts

Trade Receivables Control Account and Trade Payables Control Account

We have seen the three types of Ledger : Sales Ledger, Purchases Ledger and General Ledger.

While the accuracy of the General Ledger is assessed by preparing the Trial Balance, the accuracy of the Sales Ledger and the Purchases Ledger are checked by preparing control accounts.

Notably, the Sales Ledger (Receivables Ledger) is the book in which accounts of credit customers are kept. Amount owed by customers are called trade receivables. To control the Sales Ledger, the Trade Receivables Control Account is prepared. It is often called Receivables Control Account.

Purchases Ledger (Payables Ledger) is the book in which accounts of credit suppliers are kept. Amount owed to suppliers are called trade payables. To control the Purchases Ledger, the Trade Payables Control Account is prepared. It is often called Payables Control Account.

Purposes of Control Accounts

a) Primary Purpose

The primary purpose of control accounts is to act as independent check on the accuracy of the Sales and the Purchases Ledgers. This is done by using totals from subsidiary books in control accounts to calculate trade receivables and trade payables. These figures are then compared with figures obtained from the list of balances from Sales and Purchases Ledgers.

b) Secondary Purposes

The other purposes of control accounts are as follows:

- They are used to calculate the total of trade receivables and trade payables quickly, especially when the trial balance has not yet been prepared.
- They are used to detect errors.
- They are used to deter fraud.
- They may also be used to check the work of inexperienced staff members like the receivables ledger and payables ledger clerk.

Sources of Information for Control Accounts

Given that control accounts act as independent check on the accuracy of the Sales Ledger and the Purchases Ledger, the source of information to prepare control accounts should be different from that used to prepare accounts in the sales ledger and purchase ledger. The latter are prepared from individual entries of subsidiary books and are also corresponding entries on the opposite side (debit or credit) of the General Ledger.

To act independently, control accounts are prepared rather from totals of subsidiary books.

1. *Sales Ledger Control Account*

This consists of the total debtors. It records the total amount owed by debtors obtained from the individual balances in the sales ledger accounts. It also features bad debts, return inwards, discounts allowed, dishonored cheques, set offs/contra – entry.

2. *Purchases Ledger Control Account*

This consists of the total creditors. It records the total amount owed to the suppliers obtained from the individual balances in the purchases ledger control account. It also features return outwards, discounts received, dishonored cheques and set off/contra- entry.

Illustration:

The following information has been extracted from the books of Ellen Co. Ltd for the month of February 2010.

Balance as at 1 February

Sales Ledger:	Debit balances	980,000
	Credit balances	215,000
Purchases Ledger	Debit balances	225,000
	Credit balances	628,000
Transactions during the month		
Credit Sales		5,200,000
Return inwards		80,000
Cheques received from trade debtors		3,000,000
Dishonored cheques		500,000
Cash received to redeem the dishonored cheques		450,000
Discount Allowed		45,000
Credit purchases		3,400,000
Return outwards		150,000
Cash paid to trade creditors		600,000
Cheques paid to trade creditors		2,500,000
Discount Received		50,000
Bad debts written off		50,000
Credit sales offset against credit purchases		400,000
Balances as at 28 February 2010		

Sales ledger credit balances	226,000
Purchases Ledger debit balances	314,000

Required:

a) Sales Ledger control Accounts for the month ended 28 February 2010

b) Purchases Ledger control Accounts for the month ended 28 February 2010

Sales Ledger Control Account

	KShs		KShs
Bal b/d	980,000	Bal b/d	215,000
Sales	5,200,000	Return inwards	80,000
Dishonored cheques	500,000	Bank	
Bal c/d – Cash	226,000	Bad debts w/o	50,000
		Discount Allowed	45,000
		Cash	450,000
		Purchases ledger (contra)	400,000
		Bal c/d shs	5,666,000
	6,906,000		**6,906,000**

Purchases Ledger Control Account

	KShs		KShs
Bal b/d	225,000	Bal b/d	628,000
Return outwards	150,000	Purchases	3,400,000
Bank			
Discount Received	50,000		
Cash	600,000		
Sales ledger (contra)	400,000	Bal c/d	314,000
Bal c/d	2,917,000		
	4,342,000		**4,342,000**

Question:

The following information has been extracted from the books of Bjorn Co. Ltd for the month of August 2009.

Balance as at 1 August		
Sales Ledger:	Debit balances	1,080,500
	Credit balances	425,000
Purchases Ledger	Debit balances	380,000
	Credit balances	926,000

Transactions during the month	
Credit Sales	8,950,000
Return inwards	160,000
Cheques received from trade debtors	4,980,000
Dishonored cheques	680,000
Cash received to redeem the dishonored cheques	690,000
Discount Allowed	60,000
Credit purchases	6,800,000
Return outwards	128,000
Cash paid to trade creditors	400,000
Cheques paid to trade creditors	4,920,000
Discount Received	86,000
Bad debts written off	64,000
Credit sales offset against credit purchase	696,000

Balances as at 30 August 2009	
Sales ledger credit balances	755,000
Purchases Ledger debit balances	522,000

Required:

a) Sales Ledger control Accounts for the month ended 30 August 2009

b) Purchases Ledger control Accounts for the month ended 30 August 2009

2.6 Cash book

In business most of the transactions relate to receipt of cash, payments of cash,sale of goods and purchase of goods. So it is convenient to have separate books for each such class of transaction, one for receipts and payments of cash, one for purchase of goods and one for sale of goods. These books are called subsidiary books.

A Cash book is a subsidiary book which records the receipts and payment of cash. With the help of cash book cash and bank balance can be checked at my point of time.

Types of Cash books

Cash book can be of four types:

1. Simple Cash Book.
2. Two column cash book.
3. Three column cash book.
4. Petty cash
5. Multi Column cash book

Simple cash book

A simple cash book is prepared like any ordinary account. The receipts are recorded in the Dr Side and the payments are recorded in the Cr side of the cash book. The specimen Performa of a simple cash book is given as follows:

Date	**Particulars**	**KShs**	**Date**	**Particulars**	**KShs**

Dr Receipts Payments Cr

Balancing the Cash Book

The Cash book is balanced like any other account. The receipts column total will be more than the payments column total. The difference will be written on the Cr. Side as "By Bal c/d".

Illustration

You are required to enter the following information in a simple cash book.

	KShs
March 1 Cash in hand	50,000
March 8 Received cash from Shawn	25,000
March 12 Paid rent	60,000
March 13 Sold goods	70,000
March 16 Paid Mark	18,000

Dr Simple cash book Cr

Date	**Particulars**	**KShs**	**Date**	**Particulars**	**KShs**
March 1	Bal b/d	50,000	March 12	Rent	60,000
March 8	Shawn	25,000	March 16	Mark	18,000
March 13	Sales	70,000	March 31	Bal c/d	67,000
		145,000			**145,000**

Two column cash book

A two – column cash back records discount allowed and discount received along with the cash payments and cash receipts.

Discount allowed is the concession given by the businessman to its customers or debtors e.g. if a debtor has to pay KShs 160,000 and he is allowed 10 percent discount, now he will pay only KShs. 144,000 to the firm. This is called discount allowed, it is a type of loss for the business so it is to be debited and recorded in Dr. Side of the cash book.

Discount received is the concession received by the business man from the creditors. e.g. if a firm has to pay KShs 160,000 to its creditors and discount received is 20 percent then the firm has to pay only KShs 128,000 to the creditor. This is called discount received, it is a gain or profit for the firm so it is to be credited and recorded in the Cr. side of the cashbook.

Date	Particulars	Discount Allowed	KShs	Date	Particulars	Discount Received	KShs

Illustration

You are required to enter the following information in a two column cash book.

		KShs
March 1	Cash in hand	50,000
March 8	Received cash from Shawn	25,000
March 8	10% Discount Allowed	2,500
March 12	Paid rent	60,000
March 13	Sold goods	70,000
March 16	Paid Mark	18,000
March 16	5% Discount Received	600

Dr Two Column Cash Book Cr

Date	Particulars	Discount Allowed	KShs	Date	Particulars	Discount Received	KShs
March 1	Bal b/d	2,500	50,000	March 12	Rent	600	60,000
March 8	Shawn	2,500	22,500	March 16	Mark	600	17,400
March 13	Sales		70,000	March 31	Bal c/d		65,100
			142,500				142,500

Three column cash book

A three column cash Book is a cash book which contains bank column along with cash and discount columns.

A firm normally keeps the bulk of its funds at a Bank; money can be deposited and withdrawn at will if it is a current account. Payments into and out of the bank will be more numerous than strict cash transactions. They're in only a little difference between cash in hand and cash at bank. Therefore it is very convenient if in the cash book on each side another column is added – to record moneys deposited at bank and payments out of the bank.

Date	Particulars	Discount Allowed	Cash KShs	Bank KShs	Date	Particulars	Discount Received	Cash KShs	Bank KShs

Balancing:

The discount columns are totaled but not balanced. The cash columns are balanced exactly in the same manner as indicated for the simple cash book. The process is similar for balancing the bank columns also. It is possible, however, that the bank may allow the firm to withdraw more than the amount deposited, i.e. to have an overdraft. In such a case the total of the bank column on the credit side will be more than the one on the debit side. The difference is written on the debit side as "To Bal c/d". Then the totals are written on the two sides opposite one another; the balance is then entered on the credit side as "By Bal b/d".

However the norm is that payments into the bank will exceed the withdrawals or payments out of the bank. Then the bank columns are balanced just like the cash columns.

The receipt of the cash is debited to the cash column on the date received while a subsequent credit entry is posted in the customer's personal account. I.e.

- Credit the asset account/cash account which is represented by the cash column in the cash book when the asset of cash is decreased.
- Debit the asset account/bank account which is represented by the bank column in the cash book when the asset of bank is increased.
- Credit the asset account/bank column in the cash book when the asset of bank is decreased.
- Debit the asset account/cash column in the cash book when the asset of cash is increased.

Illustration:

Enter the following transactions in a Three-column cash book.

Note: Cheques are first treated as cash receipts

March 1 Cash in hand 50,000

March 2 Paid into bank 30,000

March 4 Received a cheque from Kip 8,000

March 5 deposited the cheque into the bank

March 8 Paid Okello by cheque 67,000 who allowed us a discount of 3000

Date	Particulars	Discount Allowed	Cash KShs	Bank KShs	Date	Particulars	Discount Received	Cash KShs	Bank KShs
March 1	Bal b/d		50,000	30,000		By Bank		30,000	
	To cash					By Bank		18,000	
	To Kip		18,000			By Okello	3,000		67,000
	To cash			18,000					

Note

1) When cash is paid into bank the entry passed is
   Bank A/C Dr. (Bank balance increased)
   To Cash A/C (Cash balance decreased)
   (This type of transaction affects both cash and bank, these are called contra transactions)
2) When cheque is received two entries are passed
   Cash A/C: Dr. (When cheque is received)
   Debtors: Cr

   Bank A/C: Dr. (When cheque is deposited into Bank)
   Cash: Cr

Question

Balances brought down from December	27,000
Cash Balance	50,000
Bank Balance	70,000
Debtors Accounts:	
Tom	15,000
Tim	20,000
Tony	7,000
Creditors	
Ann	10,000
Alice	3,000
Agnes	6,500

Tim paid us by cheque less 5% cash discount.

We paid Ann her account less 2.5% cash discount.

Tom paid us in cash

We withdrew 5,000 from the bank for business use

We paid Alice 3000

Tony paid us by cheque 7,000

We paid Agnes 6,000 after having deducted 500 cash discount

Question

A three column cash book is to be written up from the following details:

March	1	Balances brought down: Cash 50,000; Bank 980
	3	Mark, Morris and Martin paid their accounts by cheque. Morris deducted 5% cash discount. Mark 100,000; Morris 150,000; Martin 55,000.
	6	Paid rent by cheque shs 60,000
	7	We paid Trina and tiffany by cheque deducting 5% from Trina. Trina 80,000; Tiffany 65,000.
	9	Paid Motor vehicle insurance shs 76,000
	10	Withdrew 100,000 from the bank for business use.

12 Cash drawings 10,000.

15 Purchased fittings by cheque 45,000

17 We paid Joshua 40,000 in cash

20 We received payments from Ongaro and Okisai by cheque both deducting 2.5%

24 Received commission by cheque 210

26 Paid wages in cash 200,000

30 Paid general expenses by cheque 74,000

Petty cash

A business makes a number of small payments like postage, bus fare, airtime etc. These transactions are petty in nature and value thus would just make the cash book bulky. Therefore, firms usually appoint a petty cashier who makes these small payments and keep record of these payments in a separate cash book which is called Petty Cash book.

There are mainly four advantages of maintaining a cash book:

1. Saves time
2. Effective implementation of labour.
3. Control – It provides control over small payments.
4. Convenience in preparing ledger amounts.

Petty Cash Book

Receipts	Date	V NO.	Particulars	Total	Transport	Postage	Stationery	Sundries

Imprest System of Petty Cash

The petty cash is a sum of money given in the beginning of the period.

During the period payments are made out of this money. At end of the period specified the firm reimburses the amount paid out so that the balance of cash remains the same as was at the beginning of the period as well as at the end of the period. This is called the Imprest system of petty cash Book.

Illustration

March 1 Received 25,000 as petty cash

March 3 Paid bus fare 100

March 4 Paid postage 550

March 5 Paid bus fare 1200

March 7 Bought Stationery 800

March 9 Paid bus fare 250

March 15 Paid sundry expenses 8000

Receipts	Date	V NO.	Particulars	Total	Transport	Postage	Stationery	Sundries
25,000	2012							
	March 1	1	To cash a/c					
	March 3	2	Transport	100	100			
	March 4	3	Postage	550		550		
	March 5	4	Transport	1200	1200			
	March 7	5	Stationery	800			800	
	March 9	6	Transport	250	250			
	March 15	7	Sundry expenses	8000				8000
25,000	March 31		Bal c/d	10,900 14,100	1,550	550	800	8000
14,100 10,900	April 1		Bal b/d To Cash					

2.7 Balancing of Accounts

An account is a record of a financial transaction. There are various types of accounts:

- Personal accounts
  Are accounts which represent persons and organizations.

- Real Accounts
  Are accounts which represent assets.
- Nominal Accounts
  Are accounts which represent expenses, losses, incomes, gains.

Balancing accounts, simply means adding up the entries on both sides of the account in order to determine the outstanding amount of each item.

Bank Account

Date	Details	Folio	Amount	Date	Details	Folio	Amount
21/02/12	Capital Balance	MA 1 b/f	500,000 500,000 500,000		Balance	c/f	500,000 500,000

Capital Account

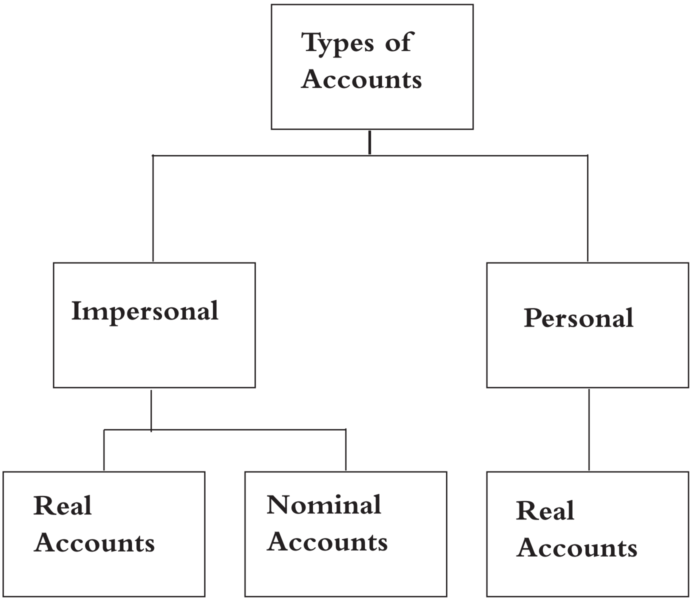
Date	Details	Folio	Amount	Date	Details	Folio	Amount
	Balance	c/f	500,000 500,000	21/02/12	Bank Balance	MA 1 b/f	500,000 500,000 500,000

Note

The balance brought forward under each account indicates the amount that would still be outstanding i.e.:

- The amount or value of a property owned (Asset)
- Total amount or value of resources contributed into the business by the owners (Capital)
- Total value of resources owed to other parties (Liabilities)
- Total monetary value of resources consumed (Expense)
- Total amount of income earned (Revenue)

Relationship between types of Ledgers and types of Accounts



2.8 Trial balance

After balancing all the accounts, one should ensure that the double entry system has been observed and no errors have been committed. This is possible by extracting the trial balance.

1. List all the balances that have been brought forward (b/f) under each account.
2. List as they were posted that is Debit or Credit
3. The total of the debits should equal the total of the credits (If the totals are not equal, this would mean that there is an error has been made either in the journals or during the posting of the transactions.)The error must be located and rectified, the totals of the debit column and credit column recalculated to check for agreement before any further processing can take place.
   The difference between the total of the debit side and the total of the credit side being placed in a temporary account called a Suspense Account. Should the total of the debit column of the trial

balance have a smaller total than the credit column, a Suspense Account is inserted in the debit column to equalize the amounts on the two columns and vice versa.

Example:

The below debit and credit columns do not agree and thus a suspension account is introduced to make the trial balance, balance:

Total of Debit Column	Total of Credit Column
KShs	KShs
560,457	560,132
	325
560,457	**560,457**

In the final accounts, the above suspense account would be shown as a current liability of KShs 325 on the draft balance sheet. Amended errors should be used to correct draft final accounts and the suspense accounts eliminated upon this correction of the final accounts. This correction is referred to as Casting. Undercast refers to a lower total balance while Overcast refers to a greater total balance

Illustration

Trial balance as at 21 February 2012

Account Name	**DR**	**CR**
Bank	500,000	
Capital		500,000
Total	**500,000**	**500,000**

Balancing the Accounts and extracting a Trial balance

To extract a trial balance, all ledger accounts should be balanced off so as to get the balances at the end of the financial period. The ledger accounts totals at the end should be equal. However keeping in mind that the two columns may not add up to equal figures, the difference between the two columns which allows the two columns totals to be equal is referred to as balance carried down (c/d) of balance carried forward (c/f). This balance is introduced at the beginning of the period at which stage it is then referred to as balance brought down (b/d) or balance brought forward (b/f).

The balance brought forward is used to tell whether the account has a debit or a credit balance. Where the ledger has a balance brought down on the debit side, it is said to have a debit balance and if it is on the credit side it is said to have a credit balance.

Illustration:

Mr. Ochola had the following transactions for the month ended 31 December 2008.

I. Started business with a cheque of 100,000 and cash of 40,000.
II. Paid rent 10,000
III. Purchased goods worth 55,000
IV. Sold goods worth 70,000

Required:

Balance off the following transactions and extract a trial balance

Cash Account

Date	Details	Amount	Date	Details	Amount
	Capital Sales	40,000 70,000 110,000	31 Dec 2008	Purchases Rent Bal c/f	55,000 10,000 45,000 110,000
1 Jan 2009	Bal b/f	45,000			

Bank Account

Date	Details	Amount	Date	Details	Amount
	Capital	100,000 100,000	1 Dec 2008	Bal c/f	100,000 100,000
1 Jan 2009	Bal b/f	100,000			

Capital Account

Date	Details	Amount	Date	Details	Amount
31 Dec 2008	Bal c/f	140,000 140,000		Bank Cash	100,000 40,000 140,000
			1 Jan 2009	Bal b/f	140,000

Rent Account

Date	Details	Amount	Date	Details	Amount
	cash	10,000 10,000	31 Dec 2008	Bal c/f	10,000 10,000
1 Jan 2009	Bal b/f	10,000			

Purchases Account

Date	Details	Amount	Date	Details	Amount
	Cash	55,000 55,000	31 Dec 2008	Bal c/f	55,000 55,000
1 Jan 2009	Bal b/f	55,000			

Sales Account

Date	Details	Amount	Date	Details	Amount
31 Dec 2008	Bal c/f	70,000 70,000		Cash	70,000 70,000
			1 Jan 2009	Bal b/f	70,000

Mr. Ochola

Trial Balance as at 31 December 2008

	Debit	**Credit**
Cash	45,000	
Bank	100,000	
Capital		140,000
Rent	10,000	
Purchases	55,000	
Sales		70,000
Total	210,000	210,000

Question

Wambura started a business on 3 January 2011 by investing KShs 500,000 which she deposited in the bank.

The following transactions took place in the course of the month.

Jan 2011	Paid rent by cheque 10,000
4	Paid Electricity 3,000
4	Purchased 2nd hand furniture worth 16,000
5	Paid 9,000 for advertisements
5	Paid 5,500 for renovation of the premise
6	Purchased goods worth 300,000
9	Paid Wages 9,000
10	Sold goods worth 180,000
12	Withdrew 12,000 for personal use
13	Purchased goods on credit worth 100,000
14	Paid insurance 5,600
15	Bought an office phone worth 3,500
15	Sold goods on credit to Francis worth 135,000
18	Paid wages 9,000
20	Received a cheque from Francis of KShs 100,000
22	Sold goods worth 68,000 to bahati and allowed him 2000 discount for prompt payment.
23	Deposited 60,000 to the bank
24	Bought a computer and ETR Machine for 15,000 and 5,000 respectively.
26	Paid general expenses 5,600
29	Paid rent 10,000
30	

Required:

Draw the relevant ledger accounts and extract a trial balance as at 31 January 2011.

Correction of Accounting Errors

Accounting errors are simply mistakes that arise in the process of accounting. They are both procedural as well as arithmetical. Regardless of how keen one is, human is to error and thus it is expected that an error may occur in the course of postings and computing throughout the year. Therefore the accountant should be in a position to identify and correct the errors

Types of accounting errors

Accounting errors have been summarized over the years as errors affecting the trial balance and those that do not affect it.

1. Errors affecting the trial balance

A trial balance is simply litmus to test both the procedural and arithmetical accuracy of the accounting process. In instances where the test fails i.e. the trial balance does not balance then there is an error either from the posting or wrong arithmetical computation.

Types of errors

1. Making an entry on one side without a corresponding entry on the other side.
2. Posting an amount on the correct side of one account and on the same side(wrong) in the other account .i.e. On double entry the transaction figure is debited twice in two accounts e.g. rent paid

   a.

Error	**Correct**
Cash a/c: Debited	Cash a/c: Debited
Rent a/c: Debited	Rent a/c: Credited

3. Errors of addition or casting errors. This either leads to overcast or an Undercast.

To correct:

i. If the trial balance does not balance, the difference is transferred to a suspense account. Once the error is identified it is corrected which ideally clears the suspense account and necessary adjustments are carried out on other accounts. The suspense balance shall be posted to the balance sheet.
ii. Undertake a systematic approach to identify the error i.e.
iii. Confirm the trial balance totals of the debit and credit columns.
iv. Compute the difference between the totals and divide it by two. Review the trial balance and journal for each of these amounts.
v. Recalculate the ledger account balances confirming that the entries were posted right.

vi. Compare the account balances in the trial balance with the ledger accounts balances.
vii. Trace the entries as recorded from the journal to the ledger accounts.

Illustration

While drawing the accounts of Wafula a sole proprietor you realize that the trial balance fails to balance by a debit figure of KShs 4,200 which you post to a suspense account and proceed to draw the trading, profit and loss account for the year ended 31 December 2011.

You obtain a profit of KShs 120, 000.

Later in an attempt to locate the errors you observe the following

Drawings	2000
Sales overcast	3000
Depreciation overcast	600
Rates Undercast	1,200
Rent Undercast	1,600

Required:

a) Draw the suspense account

b) Prepare the statement of corrected profit and loss

Suspense account

Date	Particulars	Kshs	Date	Particular	Kshs
	Bal b/d	4,200		Rent	1,600
	Sales	3,000		Creditors	2,000
	Depreciation	600		Rates	1,200

Sales

Date	Particulars	KShs	Date	Particular	KShs
	Suspense	3,000		Profit & Loss	3,000
		3,000			3,000

Depreciation

Date	Particulars	KShs	Date	Particular	KShs
	Suspense	600		Profit & Loss	600
		600			600

Rent

Date	Particulars	KShs	Date	Particular	KShs
	Suspense	1,600		Profit & Loss	1,600
		1,600			1,600

Rates

Date	Particulars	KShs	Date	Particular	KShs
	Suspense	1,200		Profit & Loss	1,200
		1,200			1,200

Bank a/c

Date	Particulars	KShs	Date	Particular	KShs
				Drawings	2,000

Drawings a/c

Date	Particulars	KShs	Date	Particular	KShs
	Bank	2000			

Statement of corrected profit

Net profit		120,000
Add:		
Depreciation overcast		600
		120,600
Less:		
Sales overcast	3000	
Rent Undercast	1600	
Rates Undercast	1200	(5800)
Adjusted Net Profit		**114,800**

2. *Errors not affecting the trial balance*

These errors do not affect the double entry system, however in instances whereby they do they are compensating in nature such that the trial balance still balances.

1. Error of commission

This occur where the correct amount is posted in the wrong account of the same class.

Example:

Mark and Anthony are credit customers. Mark purchases goods on credit worth 3,000, which is then posted to Anthony's account.

To correct:

	Debit	Credit
Anthony	3,000	
Mark		3,000

(*Correction of credit sales debited in the wrong persons account.)*

2. Error of omission

This occurs where an item is completely omitted from the books of accounts. Example:

A cash sale of KShs 550,000 is omitted from both the cashbook and the sales account

To correct:

	Debit	Credit
Cashbook	550,000	
Sales		550,000

(Correction of cash sales completely omitted from the books.)

3. Error of original entry

The original figure posted in the books is incorrect. It has been deemed to be right during the entire process.

Example: Credit sales of 2,400,000 are posted in the books as 2,200,000.

To correct:

	Debit	Credit
Debtors	200,000	
Sales		200,000

(Correction of error of original entry where sales and debtors were understated by 200,000.)

4. Error of principle

This is where a principle of accounting is violated i.e. an amount is entered in the wrong class of accounts.

Example:

Purchase of furniture and fittings worth 890,000 is debited in the general expense account instead of the furniture and fittings account

To correct:

	Debit	Credit
Furniture and fittings account	890,000	
General expense account		890,000

(Correction of furniture and fittings purchase recorded as an expense)

5. Transposition

This occurs when there is a change in sequence of characters in a figure.

Example:

A cash sale figure of 869,000 is posted as 896,000. The effect of the error is an overstatement of 27,000.

To correct:

	Debit	Credit
Sales account	27,000	
Cash account		27,000

(Correction of transposition error whereby cash sales were overstated by 27,000)

6. Compensating errors

These are errors that compensate each other. The errors cancel each other out such that the debits are equals to the credits.

Example:

Sales are Undercast by 10,000 and purchases Undercast by 10,000

To correct:

	Debit	Credit
Purchases	10,000	
Sales		10,000

(Correction of a compensating error in sales and purchases)

7. Complete reversals of entries

In this case correct amounts are used ,but they are posted on the wrong side of the account.

Example:

Payment of rent of KShs 80,000 is credited to the rent account and debited to the bank account.

To correct

	Debit	Credit
Rent account	80,000	
Cashbook		80,000

(Correction of rent payment credited in the rent a/c and debited in the cash book)

8. Slide errors

This arises when the decimal point of comma is misplaced.

Example:

Ann purchased goods on credit worth KShs 110,000 which was posted as KShs 1100.00.The effect is to understate sales and debtors by KShs 108,900

To correct:

	Debit	Credit
Debtors	108,900	
Sales		108,900

(Correcting a slide error whereby credit sales were overstated by 108,900)

2.9 Income Statement

The income statement summarizes the revenues and expenses generated by the company/entity for a specific period. Unlike a balance sheet which represents a single moment in time, an income statement represents a period of time.

The income statement is also referred to as a statement of comprehensive income, a profit and loss (P&L) statement, statement of operations etc

The basic equation on which an income statement is based is:

Revenues – Expenses = Net Profit

To remain in business, all companies need to generate revenue. Revenues are used to pay expenses. After the costs of doing business are paid, the remaining amount is the net profit/income.

Income statements are all organized the same way, regardless of industry. The basic outline is shown in the following illustration.

Income Statement for XYZ Co Ltd, for the period ending 31 December 2011.

	KShs	KShs
Total Revenue		1,200,000
Cost of Goods Sold		(280,000)
Gross profit		920,000
Less **Operating Expenses**		
Salaries	110,000	
Rent	60,000	
Utilities	45,000	
Depreciation:		
Motor vehicle	8,000	
Machinery	5,000	228,000
Earnings before interest & tax		692,000
Interest Expense		(10,0000
Earnings before tax		682,000
Taxes		(204,600)
Net Income		477,400

Illustration

A profit and loss statement of a partnership (e.g. Advocates), Muungeno and Mwakilishi Co. Advocates

	KShs	KShs
Fees receivable		2,400,000
Less Expenses		
Rent and rates	60,000	
Staff salaries	120,000	
Travelling expenses	48,000	
Professional subscriptions	16,000	
Electricity	6,000	
General expenses	8,750	
Depreciation		
Motor vehicles	3,500	
Office equipment	1,280	
Total Expenses	263,530	
Net profit shared		**2,136,470**
Muungano	1,068,235	
Mwakilishi	1,068,235	
		2,136,470

2.10 Position Statement

The financial position of an organization/firm is primarily provided in the statement of financial position. The elements include:

Asset: An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise. They are classified into two;Fixed and Current assets. Fixed Assets are those that a company expects to retain for a long time and indirectly aids the profit making process. Whereas, current assets are those held for conversion into cash.

Liability: A liability is a present obligation of the enterprise arising from the past events, the settlement of which is expected to result in an outflow from the enterprise' resources, i.e., assets. They are categorized into two i.e. Current Liabilities and long term or deferred liabilities. Current liabilities are payable before or within one year while those that are payable after one year are referred to as the long term liabilities.

Equity: Equity is the residual interest in the assets of the enterprise after deducting all the liabilities under the Historical Cost Accounting model. Equity is also known as owner's equity. Under the units of constant purchasing power model equity is the constant real value of shareholders´ equity.

Statement of Financial Position

Fixed Assets	KShs	KShs
Plant		1,600,000
Equipment and Machinery		800,000
Goodwill		250,000
		2,650,000
Current Assets		
Stock	60,000	
Prepayments	100,000	
Cash	50,000	
Bank	400,000	610,000
		3,260,000
Current Liabilities		
Creditors	60,000	
Accruals	40,000	(100,000)
		3,160,000
Authorized share capital		3,000,000
Long Term Liabilities		
12% treasury bonds		160,000
		3,160,000

2.11 Incomplete Records

Incomplete records arise in the following cases:

- Records loss due to theft, fire, flood, cyclone etc
- Full double entry records not kept - single entry recording or no records kept at all

However, whatever the situation, profit or loss need to be calculated. The means by which profits will be calculated depend on the information available.

Profit as the difference between capitals/equity

To note that profit increases equity. As such, any excess of equity at end over equity at start would mean the business has earned a profit (assume there is neither additional equity brought in nor drawings).

Illustration:

	KShs
Equity at start of the year	500 000
Equity at end of the year	550 000

Profit is calculated by preparing a Statement of profit or loss for the year.

Statement of profit and loss for the year ended 2011

Equity at end of the year	550 000
Equity at start of the year	500 000
Profit for the year	50 000

Illustration:

1. The following information is available for a business:

	KShs
Equity at 31 December 2010	4,234 000
Equity at 31 December 2011	5,234 000

Calculate profit or loss for the year ended 31 December 2011.

Solution:

Statement of profit and loss for the year ended 31 December 2011

Equity at 31 December 2011	4234 000
Equity at 31 December 2010	5234 000
Profit for the year	1,000,000

(Note: Equity at 31 December 2010 is closing equity at for year 2010 and therefore becomes opening equity for year 2011).

2. The following information is available for a business:

	KShs
Equity at 1 January 2011	5,234 000
Equity at 31 December 2011	4,234 000

Calculate profit or loss for the year ended 31 December 2011.

Solution:

Statement of profit and loss for the year ended 31 December 2011

	KShs
Equity at 31 December 2011	4,234 000
Equity at 31 December 2010	5,234 000
Loss for the year	(1,000,000)

Note: When closing equity is less than opening equity, a loss arises.

Adjustment for additional capital (equity) brought in and drawings

Additional equity brought in increases equity at end of the period. Hence, it has to be deducted from equity to arrive at the profit figure of the period.

Drawings made by trader decreases equity at end.

These can be best understood by looking at the equity part of a sole trader's balance sheet (Statement of financial position) which is as follows:

Equity at start	★★★★★
ADD	
Additional equity brought in	★★★
ADD	
Profit for the year	★★
LESS	
Drawings	(★)
Equity at the end of the period	★★★

Mathematical formula:

Equity at start + Additional equity + Profit – Drawings = Equity at end

Now, if all items except profit are given, profit can be calculated as:

Profit = Equity at end + Drawings - Equity at start - Additional equity

Adjustments in the final accounts

There are various transactions or eventualities that require adjustments to the final accounts to be carried out. This may include depreciation, provision for depreciation, net book value, bad debts, cash discount, prepayment, accruals, drawings, carriage inwards, carriage outwards, return inwards, return outwards etc.

2.12 Depreciation

Depreciation is a non-cash expense that reduces the value of an asset as a result of wear and tear, age, or obsolescence. Most assets depreciate, that is, lose their value over time and must be replaced at the end of their useful life. Since depreciation is a non cash expense. It depreciation decreases the company's reported earnings while increasing free cash flow.

Depreciation expense does not require current outlay of cash. However, the cost of acquiring depreciable assets may require such outlay. Thus, depreciation does not affect a statement of cash flows, but cost of acquiring assets does.

Depreciation is generally recognized under historical cost systems of accounting. Some proposals for fair value accounting have no provision for depreciation expense.

Depreciation refers to two very different but related concepts:

a) Fair value depreciation – the decrease in value of assets. It affects values of businesses and other entities.
b) Matching principle 'depreciation' – the allocation of the costs of assets to periods in which the assets are used it affects the net

> income. Generally the cost is allocated, as depreciation expense, among the periods in which the asset is expected to be used. Such expense is recognized by businesses for financial reporting and tax purposes.

Methods of computing depreciation may vary by asset for the same business. Methods and lives may be specified in accounting and/ or tax rules in a country. Several standard methods of computing depreciation expense may be used, including fixed percentage, straight line, and declining balance methods

Depreciation expense generally begins when the asset is placed in service.

Accounting concept

In determining the profits (net income) from an activity, the receipts from the activity must be reduced by appropriate costs.

One such cost is the cost of assets used but not currently consumed in the activity. Such costs must be allocated to the period of use. The cost of an asset so allocated is the difference between the amount paid for the asset and the amount expected to be received upon its disposition. Depreciation is any method of allocating such net cost to those periods expected to benefit from use of the asset. The asset is referred to as a depreciable asset.

Any business or income producing activity using tangible assets may incur costs related to those assets. Where the assets produce benefit in future periods, the costs must be deferred rather than treated as a current expense. The business then records depreciation expense as an allocation of such costs for financial reporting. The costs are allocated in a rational and systematic manner as depreciation expense to each period in which the asset is used, beginning when the asset is placed in service. Generally this involves four criteria:

- Cost of the asset,
- Estimated useful life of the asset
- Expected salvage value/Residual value of the asset,
- Method of apportioning the cost over such life.

Depreciable basis

Cost is the amount used to purchase an asset, including all costs related to acquisition. The life of an asset is based on business experience, or an objective method may be chosen from one of several acceptable methods.

Net basis

When a depreciable asset is sold, the business recognizes gain or loss based on net value of the asset. This net basis is cost less depreciation.

Impairment

Accounting rules also require that an impairment charge or expense be recognized if the value of assets declines unexpectedly. Such charges are usually nonrecurring, and may relate to any type of asset.

Depletion and amortization

Depletion and amortization are similar concepts for minerals (including oil) and intangible assets, respectively.

Accumulated depreciation

While depreciation expense is recorded on the income statement of a business, its impact is generally recorded in a separate account and disclosed on the balance sheet as accumulated depreciation, under fixed assets, according to most accounting principles

Depreciation expense is usually charged against the relevant asset directly, however where the same has not been carried out, then an accumulated depreciation account is maintained on the balance sheet. The values of the fixed assets stated on the balance sheet will decline, even if the business has not invested in or disposed of any assets. The amounts will roughly approximate fair value. Showing accumulated depreciation separately on the balance sheet has the effect of preserving the historical cost of assets on the balance sheet. If there have been no investments or dispositions in fixed assets for the year, then the values of the assets will be the same on the balance sheet for the current and prior year.

Methods of depreciation

There are several methods for calculating depreciation, generally based on either the passage of time or the level of activity / usage of the asset.

1. Straight-line depreciation

Straight-line depreciation is the simplest and most-often-used technique, in which the company estimates the salvage value of the asset at the end of the period during which it will be used to generate revenues (useful life) and will apportion original cost in equal increments over that period. The salvage value is an estimate of the value of the asset at the time it will be sold or disposed of; it may even be zero. Salvage value is also known as scrap value or residual value.

Straight-line method:

$$\frac{\text{Cost of depreciable fixed asset} - \text{Residual Value}}{\text{Useful life of Asset (Years)}} = \text{Annual Depreciation Expense}$$

For example, a vehicle that depreciates over 5 years, is purchased at a cost of KShs 1,200,000, and will have a salvage value of KShs 20,000, will depreciate at 236,000 per year:{ (1,200,000 − 20,000)/ 5 years = 236,000 annual straight-line depreciation expense} ;depreciable cost of the asset divided by the number of years of its useful life.

This table illustrates the straight-line method of depreciation. Book value at the beginning of the first year of depreciation is the original cost of the asset. At any time book value equals original cost less accumulated depreciation.

book value = original cost − accumulated depreciation

Book value at the end of year becomes book value at the beginning of next year. The asset is depreciated until the book value equals scrap value.

Book value at the beginning of the year (Original costs)	**Depreciation Expense**	**Accumulated Depreciation**	**Book Value at the end of the year**
1,200,000	236,000	236,000	964,000
964,000	236,000	472,000	728,000
728,000	236,000	708,000	492,000
492,000	236,000	944,000	256,000
256,000	236,000	1,180,000	20,000

If the vehicle were to be sold and the sales price exceeded the depreciated value (net book value) then the excess would be considered a gain and subject to depreciation recapture. If the sales price is ever less than the book value, the resulting capital loss is tax deductible. If the sale price were ever more than the original book value, then the gain above the original book value is recognized as a capital gain.

2. Declining-balance method (or Reducing balance method)

This method provides that a higher depreciation charge in the first year of an asset's life and gradually decreasing charges in subsequent years are called accelerated depreciation methods. This may be a more realistic reflection of an asset's actual expected benefit from the use of the asset: many assets are most useful when they are new. One popular accelerated method is the declining-balance method. Under this method the book value is multiplied by a fixed rate.

Annual Depreciation = Depreciation Rate x Book Value at Beginning of Year

3. Activity depreciation

Activity depreciation methods are not based on time, but on a level of activity. This could be miles driven for a vehicle, or a cycle count for a machine. When the asset is acquired, its life is estimated in terms of this level of activity.

Example:

A vehicle is estimated to go 150,000 kilometers in its lifetime. The per-kilometers depreciation rate is calculated as: (KShs 1,200,000 cost - 20,000 salvage) /150,000 kilometers = KShs 7.87 per kilometer. Each year, the depreciation expense is then calculated by multiplying the rate by the actual activity level.

4. Sum-of-years' digits method

Sum-of-years' digits is a depreciation method that results in a more accelerated write-off than straight line, but less than declining-balance method. Under this method annual depreciation is determined by multiplying the Depreciable Cost by a schedule of fractions.

depreciable cost = original cost − salvage value

book value = original cost − accumulated depreciation

Example: If an asset has original cost of KShs 1,200,000, a useful life of 5 years and salvage value of 20,000.

Compute its depreciation schedule.

i. Determine years' digits. Since the asset has useful life of **5 years,** the years' digits are: **5, 4, 3, 2,** and **1**.
ii. Next, calculate the sum of the digits. **5+4+3+2+1=15**
The sum of the digits can also be determined by using the formula $\mathbf{(n^2+n)/2}$ where n is equal to the useful life of the asset. The example would be shown as $\mathbf{(5^2+5)/2=15}$
iii. Allocate the depreciation rates are as follows:
5/15 for the 1st year, **4/15** for the 2nd year, **3/15** for the 3rd year, **2/15** for the 4th year, and **1/15** for the 5th year.

Book value at beginning of year	**Total depreci-able cost**	**Depreci-ation rate**	**Depreciation expense**	**Accumu-lated depreci-ation**	**Book value at end of year**
1,200,000	1,180,000	5/15	1,180,000 x 5/15 = 393,333	393,000	807,000
807,000	1,180,000	4/15	1,180,000 x 4/15 = 314,667	708,000	492,000
492,000	1,180,000	3/15	1,180,000 x 3/15 = 236,000	944,000	256,000
256,000	1,180,000	2/15	1,180,000 x 2/15 = 157,333	1,102,000	99,000
99,000	1,180,000	1/15	1,180,000 x 1/15 = 78,667	1,180,000	20,000

5. Units-of-production depreciation method

Under the units-of-production method, useful life of the asset is expressed in terms of the total number of units expected to be produced:

$$\text{Annual Depreciation Expense} = \frac{\text{Cost of Fixed Asset} - \text{Residual Value}}{\text{Estimated Total Production}} \times \text{Actual Production}$$

Suppose, an asset has original cost KShs 270,000, salvage value KShs 10, 000, and is expected to produce 90,000 units.

Depreciation per unit = (270,000−10,000) / 26,000 = 10

10 × actual (what has actually been produced).production = depreciation cost of the current year.

Illustration

A table of Units-of-production depreciation schedule of the asset.

Book value at beginning of year	Units of production	Deprec-iation cost per unit	Depreci-ation expense	Accumu-lated depreci-ation	Book value at end of year
270,000	21,000	10	210,000	210,000	60,000
60,000	1,100	10	11,000	221,000	49,000
49,000	1,200	10	12,000	233,000	37,000
37,000	1,300	10	13,000	246,000	24,000
24,000	1,400	10	14,000	260,000	10,000

Note:

Original cost = 270,000

Scrap Value = 10,000

Depreciation stops when book value is equal to the scrap value of the asset. In the end, the sum of accumulated depreciation and scrap value equals the original cost.

6. Units of time depreciation

Units of time depreciation are similar to units of production. This method of depreciation is used to depreciate mining equipment, equipment used for natural resource, or cases where the usage frequency of the asset is not linear year to year.

A simple example can be given for construction companies, where some equipment is used only for some specific purpose. Depending on the number of projects, the equipment will be used and depreciation charged accordingly.

7. Group depreciation method

Group depreciation method is used for depreciating multiple-asset accounts using straight-line-depreciation method. Assets must be similar in nature and have approximately the same useful lives.

Asset	Historical Cost	Salvage Value	Depreciable Cost	Asset Life	Depreciation per year
Delivery Vans	5,000,000	50,000	4,950,000	7	707,142.857

8. *Composite depreciation method*

The composite method is applied to a collection of assets that are not similar, and have different service lives. For example, computers and printers are not similar, but both are part of the office equipment. Depreciation on all assets is determined by using the straight-line-depreciation method.

Asset	Historical Cost	Salvage Value	Depreciable Cost	Asset Life	Depreciation per year
Computer	500,000	50,000	450,000	5	90,000
Printer	800,000	60,000	740,000	6	123,333.3
Total	1,300,000	110,000	1,190,000	5.6	213,333.3

- Composite life equals the total depreciable cost divided by the total depreciation per year. (1,190,000 / 213,333.3 = 5.6 years.)
- Composite depreciation rate equals depreciation per year divided by total historical cost. (213,333.3 / 1,300,000 = 0.16 = 16%)
- Depreciation expense equals the composite depreciation rate times the balance in the asset account (historical cost). (0.16 x 1,300,000) 213,333.3.

  Debit: depreciation expense

  Credit: accumulated depreciation.

When an asset is sold,

Debit: cash for the amount received

Debit: the difference between the two to accumulated depreciation.

Credit: asset account for its original cost.

Under the composite method no gain or loss is recognized on the sale of an asset. This is because the gains and losses from assets sold before and after the composite life will average themselves out.

To calculate composite depreciation rate, divide depreciation per year by total historical cost.

To calculate depreciation expense, multiply the result by the same total historical cost. The result shall be equal to the total depreciation Per Year.

Real property

In Kenya land is deemed to be the fastest appreciable asset and thus depreciation in terms of land is an alien concept. However, for tax purpose systems prescribe longer depreciable lives for buildings and land improvements. Such lives may vary by type of use. Some of the systems, including the United States and Canada, permit depreciation for real property using only the straight line method, or a small fixed percentage of cost. Generally, no depreciation tax deduction is allowed for bare land. In the United States, residential rental buildings are depreciable over a 27.5 year or 40 year-life, other buildings over a 39 or 40 year-life, and land improvements over a 15 or 20 year-life, all using the straight line method

Note:

Depreciation is a method of allocation, not valuation.

Bad debts

In business cash sales will always be the best in the sense that you receive the cash as and when due(at the point of sale) thus you can use it to generate even more income and you also eliminate the risk of losing the money due to nonpayment (bad debts).

When goods are sold on credit, the credit sale is recognized as sales revenue. If a customer fails to pay, the sale revenue recognized earlier shall not be realized thus an adjustment to write it off against profits as an expense shall be carried out. This may arise in instances where the customer has been declared bankrupt, is diagnosed insane, dies and has no estate to claim from etc.

Accounting entries:

Debit: Debtors account

Credit: Bad debts account

Debtor's a/c

Date	Particulars	KShs	Date	Particular	KShs
	Bal b/f	Xx		Cash	Xx
	Sales	Xxx		Bad debts	X
				Bal c/d	Xx
		xxx			xxx

Bad Debts a/c

Date	Particulars	KShs	Date	Particulars	KShs
	Debtor's a/c	Xx		Profit & Loss	Xx
		xxx			xxx

Provision for bad debts

When a firm is not able to collect sales recognized from debtors the same is referred to as bad debts. However, there instances where revenue does not qualify as non collectible but there are doubts if the firm shall manage to collect it. This may be due to perhaps the debtor taking a longer period than one agreed upon, Or certain events occurring which affect the debtor's financial standing. In such cases it is prudent to set aside such debts as doubtful. A provision for bad debts is set at the end of the period and compared with the provision of bad debts set for the previous year. An increase in the provision is charged to the profit and loss account as an expense while a decrease is a credit to the profit and loss account.

The determination of the amount of provision for bad and doubtful debts is a matter of policy and thus vary from one firm to the other. Some of the most common methods used are :

1. *Percentage of debts outstanding*

In this case the doubtful debts are analyzed in relation to the outstanding debtors. If in the course of your business you note that

2% of your outstanding debtors turn out to be bad debts, the a basis for future estimation is set.

2. *Debt ageing analysis*

An analysis of outstanding debtors account balances is carried out according to the periods of time that each of these debts are outstanding, in which case an ageing schedule is developed.

3. *Percentage of credit sales*

A trend analysis has to be carried out of bad debts in relation to the credit sales for one to be in a position to estimate the average rate of debtors than turn out to be bad debts out of the total credit sales.

Note:

While preparing the balance sheet at the end of the period, the provision for the bad debts should be deducted from the debtor's figure.

Provision for bad and doubtful debts a/c

Date	Particulars	KShs	Date	Particular	KShs
	Bal b/d	Xx		Bal b/f	Xx
				Profit & loss (Increase)	X
		xxx			xxx

Bad debts recovered

Writing off bad debts does not necessarily mean that they cannot be recovered. In some cases they are recovered and such a receipt is recognized as income for the period of recovery. It is credited to the bad debts recovered account since it is not an income generated from the normal business activities.

Debit: cash book
Credit: Bad debts recovered a/c

The balance in the bad debts recovered account is either credited to the profit and loss account or to the bad debts account. The effect on profit is the same.

Drawings

Where the owner withdraws money from the business for personal use , the same is referred to as drawings. It has the effect of reducing the amount of capital in the business.

This plays in the balance sheet i.e.

Capital b/d		xxx
Add Net Profit		x
Less Drawings	(xx)	
Capital balance b/f	xxx	

Discount received & Discount Allowed

A discount is an incentive given to a customer by a supplier. This could be due to bulk purchases (trade discount) or payment in cash promptly (cash discount) or other personal reasons.

A trade discount is not included in the books since it is negotiated before the transaction whereas a cash discount is granted after the transaction therefore entered in the specific books. There are two types of discounts:

Discount Allowed

This is granted to the debtors thus reducing the amount of debtors. It is an expense which is charged to the profit and loss account.

Debtors a/c

Date	Particulars	KShs	Date	Particular	KShs
	Bal b/f	Xx		Cash	Xx
	Sales	Xxx		Bad debts	X
				Discounts Allowed	Xx
		xxx		Bal c/d	xxx

Discount Allowed

Date	Particulars	KShs	Date	Particular	KShs
	Debtors	Xx		Profit & Loss a/c	Xx
		xxx			xxx

Discount Received

This is granted by the business creditors thus reducing the business obligation to pay. It is an income thus credited to the profit and loss account.

Creditors' a/c

Date	Particulars	KShs	Date	Particular	KShs
	Cash	Xx		Bal b/d	Xx
	Discounts	X		Purchases	Xx
	Received	Xx			
	Bal b/f	xxx			xxx

Discount Received

Date	Particulars	KShs	Date	Particular	KShs
	Profit & Loss a/c	Xx		Creditors	Xx
		xxx			xxx

Prepayments and Accruals

A prepayment is a payment made before the due date. I.e. an amount by which an expense is over paid for a given period. It is a current asset in the balance sheet.

Electricity a/c

Date	Particulars	KShs	Date	Particular	KShs
	Bal b/d Cash	Xx X xxx		Profit & Loss a/c Bal b/f (Prepayment)	Xx Xx xxx

An accrual on the other hand is an expense incurred in a given period and is yet to be paid. It is overdue. The accrual concept provides that expenses are recognized and charged to the profit and loss account where the amount is incurred. If the amount paid is less than the amount incurred, the difference is referred to as the accrued expense.

In the balance sheets accruals are noted as current liabilities.

Rent a/c

Date	Particulars	KShs	Date	Particular	KShs
	Cash Bal b/f(Accrual)	Xx X xxx		Bal b/d Profit & Loss a/c	Xx Xx xxx

Question

Munga is a sole proprietor. His trial balance for the year ended 31 October 2012 is as follows:

	Dr	Cr
Sales		907,000
Return inwards	50,000	
Discount Allowed	6,000	
Purchases	400,000	
Return outwards		25,000
Discount Received	8,000	
Carriage inwards	4,500	
Carriage outwards	5,500	
Stock 1-11-2011	287,000	
Debtors	523,000	
Bad debts	98,000	
Provision for bad debts		24,150
Creditors		288,000
Motor vehicle	680,000	
Motor vehicle expenses	12,000	
Rent	15,000	
Electricity	3,000	
Salaries and wages	86,000	
Telephone	2,000	
Drawings	20,000	
Furniture and Fixture	500,000	
Capital		1,455,850
	2,700,000	2,700,000

Additional Information

1. Stock as at October 2012 amount to KShs 492,000.
2. The cash at hand as at 31 October 2012 is KShs 2,000.
2. Provision for bad and doubtful debts is 5% of the debtor
3. Depreciation is provided on motor vehicles and fixtures at a rate of 10% and 5% respectively on costs.

Required:

a) Munga trading, profit and loss account for year ended 31 October 2012

b) Balance Sheet as at 31 October 2012

Question- confirm ans

The following trial balance was extracted from the books of Kuria kale, a sole trader as at 31 October 2011

	Dr	Cr
Sales		860,000
Return inwards	50,000	
Discount Allowed	8,000	
Purchases	560,000	
Return outwards		45,000
Discount Received		12,000
Carriage inwards	6,000	
Carriage outwards	9,800	
Stock 1 November 2011	6,400	
Debtors	4,200	
Bad debts	240,000	
Provision for doubtful debts	345,000	
Creditors		49,500
Premises	40,000	
Motor vehicle	140,000	
Proceeds from sale of motor vehicle	1,200,000	
Motor vehicle expenses	220,000	
Rent & Rates	32,000	
Electricity	58,000	
Salaries and wages	3,100	
Telephone	46,000	
Insurance	7,500	
General expenses	12,500	
Drawings	18,000	
Capital		2,000,000
	3,006,500	3,006,500

Additional information:

1. Stock as at 31 October 2011 was valued at shs
2. Insurance of KShs 3,000 was prepaid
3. Electricity of KShs 20,000 was due
4. The provision for doubtful debts be adjusted to 5% of the trade debtors, while KShs 2,400 of the debtors was regarded as bad debts.
5. Depreciation on motor vehicle at 5% and furniture 2.5% p.a.
6. On September 2011 a motor vehicle purchased at 240,000 was sold for 90,000.The transaction was recorded in the sale proceeds from sale of motor vehicle account.

Required:

a) Trading, profit and Loss account for the year ended 31 October 2011.
b) Balance sheet as at 31 October 2011.

Bank Reconciliation Statement

Any difference between the cash book and the closing balance of the bank account shown by the bank statement for the same period is explained by a bank reconciliation statement.

The bank reconciliation statement lists the items in the cash book which are not on the bank statement, and those on the bank statement which are not on the cash book.

Purpose of a bank reconciliation statement.

Causes of differences between cash and bank balances

1. Timing difference

These are differences caused by delays or lags in the receipt of information or recording of a transaction between the business and the bank.

Examples:

a) Bank Charges
b) Direct credits
c) Unpresented Cheques
d) Unpaid Cheques

e) Uncredited cheques
f) Payment of a standing Order.

2. Differences caused by errors

The errors are made either by the business or bank while recording transactions.

The bank reconciliation process

Upon receipt of a bank statement, one reviews it to identify any errors that may be present. Such errors are corrected and then a reconciliation of the difference between the cashbook balance and the bank balance is carried out.

Cash book adjustments

Balance as per cash book	xxx	
Bank charges	(x)	
Direct credits	xx	
Standing order		(x)
Adjusted cash book balance	xxx	

Bank Reconciliation Statement as at 30 Sept 2012

Adjusted cash book balance	xxx
Add Unpresented cheque	xx
Less uncredited cheque	(x)
Balance as per bank statement	xxx

Bank overdraft

Some banks allow their clients to enjoy the service of acquiring money to a certain limit in the event that the client does not have sufficient funds in the account. In essence thereof, the negative balance posted in the bank account/statement is referred to as an overdraft. This is a sum owed to the bank by the client who is under an obligation to reimburse it within an agreed stipulated time plus an interest agreed upon. Thus, a negative sum in the bank statement (sum) DR simply symbolizes an overdraft.

Dishonored cheques

A cheque generally, is a negotiable instrument, an instruction to the bank (drawee) by the drawer to pay the person whose name is on the face of the cheque (payee) the sum of money specified.

In various circumstances the bank may fail to honor the instructions, notably;

a) If there is insufficient funds in the account
b) In case of a countermand
c) If the cheque is stale
d) If the cheque is defaced
e) If the instructions are defective
f) If the signature of the drawer do not match the banks specimen signature or is forged
g) If the drawer's account has been closed
h) If the drawer is deceased
i) If the bank is insolvent

In Kenya, issuing a cheque to be drawn against a drawer with insufficient funds is a criminal offence 316A of the Penal Code Cap 63 of the Laws of Kenya.

The dishonored cheques should be corrected and the reconciliation process is carried out. The cash book balance is adjusted to remove the effect of the dishonored cheque.

Illustration

From the company's cash book and bank statement for the month of December 2010, prepare a bank reconciliation statement for the period.

Key steps

I. Check the transactions in the cash book
II. Check the entries on receipt of the bank statement
III. Update the cash book, and make any amendments where necessary

Question

From the following draw up a bank reconciliation statement from details as on 31 December 2012

- Cash at bank as per bank column of the cash book – KShs 200,000
- Unpresented cheques – KShs 120,000
- Cheques received and paid into the bank but not yet entered into the bank statement – KShs 560,000
- Credit transfers entered as banked on the bank statement but not yet entered in the cash book – KShs 744,000
- Cash at bank as per bank statement – KShs 504,000

Solution

Cash at bank as per cash book		200,000
Add unpresented cheques	120,000	
Credit Transfers	744,000	
Less uncredited cheques	560,000	
Cash at bank as per bank statement		504,000

Question:

Cash book

Date	Particulars	Bank	Date	Particulars	Bank
	Bal b/d J.	2,000		Tiles and Tinkles	512,000
	Kungu	420,000		Verve Energy	385,000
	T. Nyachae	340,000		B.Insurance	94,000
	Riungu & Co.	680,000		Kirima foundation – 62106	68,000
	Kiekie	320,000		Z.Kihara	50,000
	Kiragu & Partners	314,000		Miklos	115,000
				Tecla & Sons – 62115	75,000
	Fly 260	185,000			
	Kilmer	56,000		Rent & Rates	95,500
	M. Celeste	254,000		Salaries	540,000
	Kioko & Co	800,000		Seta Holdings – 62117	1,200,000
				Bal c/d	236,500
		3,371,000			3,371,000

Bank statement

Date	Particulars	Debit	Credit	Balance (000)
	Bal b/f		307,000	
	T. Nyachae		340,000	647
	Tiles and Tinkles	512,000		135
	Riungu & Co.		680,000	815
	Kiragu & Partners		314,000	1,129
	Verve Energy	385,000		744
	B. Insurance	94,000		650
	Z. Kihara	50,000		600
	Rent & Rates	95,500		504.5
	Fly 260		185,000	689.5
	Yuan kabala	5,000		684.5
	Kioko & Co		800,000	1,484.5
	Bank Charges	3,500		1,481
	Salaries	540,000		941
	Mbogori		8,500	949.5

Required:

A bank reconciliation Statement

Adjusted cash book		
Balance as per Cash book	236,500	
Less Bank Charges	(3,500)	
Less Standing Order		(5,000)
Add Direct Credit	8,500	
Balance as per adjusted cash book	**236,500**	

Bank Reconciliation		
Adjusted cash book	236,500	
Add Unpresented cheques	1,343,000	
Less uncredited cheques	630,000	
Balance as per bank statement		**949,500**

Workings

Unpresented cheques

Seta	1,200,000
Tecla	75,000
Kirima	68,000
	1,343,000

Uncredited cheques

Celeste	254,000
Kiekie	320,000
Kilmer	56,000
	630,000

Question

Monika, a sole proprietor received her bank statement for the month ended 30 November 2011. As at that date the balance was KShs 958,200 while the cash book balance was KShs 3,770,000. Upon investigation the following discrepancies were discovered:

a) Cheques drawn by Monika totaling KShs 200,000 had not been presented
b) Bank charges of KShs 7,800 had not been captured in the cash book
c) Standing order payments amounting to KShs 230,000 had not been entered in the cash book
d) A cheque of 970,000 had been dishonored and the same had not been corrected on the cash book.
e) The bank had not credited Monika with of KShs 64,000 deposited on 25 November 2011.
f) In the cash book Monika has entered a payment of KShs 469,000 as KShs 496, 000.
g) The bank had credited some deposits amounting to KShs 1,770,000 to another customer's account, which Monika had already debited in the cash book based on the notification text messages from the customers upon depositing.
h) A direct credit of KShs 57,000 was made to Monika's account

Required:

1. A statement showing Monika's adjusted cash – book balance as at 30 November 2010.
2. A bank Reconciliation statement as at 30 November 2010

Bank Reconciliation Statement

Balance Sheet as per cash book	3,770,000
Bank Charges	(7,800)
Standing Order	(230,000)
Direct Credit	
Dishonoured cheque	(970,000)
Adjustment (error-transportation)	(27,000)
Balance as per adjusted cash book	2,592,000
Adjusted cash book balance	2,592,000
Add unpresented cheques	200,000
Less uncredited cheques	(1,834,000)
Balance as per bank statements	958,200

Workings:

1. unpresented cheques	uncredited cheques
200,000	64,000
	1,770,000
	1,834,000

Chapter Three

Advocates Accounts

3.1 Introduction

Lawyers occupy important decision making positions in the organizations which require them to observe the principles of corporate governance.

The Act also provides that practicing advocates should maintain separate client's accounts. Good accounting is a fundamental pillar of corporate governance. Corporate governance cannot exist where poor or no accounting system exists. Governance requires clarity and integrity of action implementation which requires accounting in one way or another.

Therefore, the lawyer should strive to understand the advocate accounts to aid them uphold the fundamental pillar of corporate governance.

Lawyers maintain the clients account for recording all the transactions relating to the clients.

Transactions relating to the balance sheet are recorded in the office account. The client account is open in the clients name in a recognized bank recording:

a) Deposits and withdrawals on behalf of the client
b) Payments of expenditure on behalf of the client
c) Withdrawal of professional fees as authorized by the client.

An advocate may withdraw from the client account, money;

a) Required towards payment of advocates' costs where a bill of costs has been delivered to the client.
b) Required for payment to the client over payment authorized by the client.
c) Deposited to the clients account by error.
d) To be transferred to a separate account opened in the clients name.

The accounts maintained by professionals have special features, either stipulated in law or developed out of practice.

The Advocates Act section 83(i) empowers the Council of the Law Society of Kenya to make rules regarding:-

a) The keeping of accounts by advocates; section 83(i)(b).
b) The annual submission to the Council by every advocate of a certificate by an accountant, that he has examined the books, accounts and documents of the advocate; section 83(i)(c)
c) The retention by advocates of interest earned on monies deposited, received or held for or on account of clients section 83(i)(d).

The rule of thumb; every advocate shall at all times keep proper written books which show:

a) The amount in a client account held on behalf of specific clients.
b) Every receipt of money for each client.
c) Every payment by the advocate from the client's account specifying the client.

Other forms

- **Disbursements**

These are payments made on behalf of the client with insufficient funds. Such reimbursements are to be reimbursed by the client.

- **Work in Progress**

This is the value of uncompleted work on behalf of the client not yet charged. A service provided thus is not yet charge

E.G. A case pending in court as at the year end. Such is recorded as income earned but not yet received and therefore not adjusted in the fixed income account

Dr. Work in Progress (Asset)
Cr. Fixed Income
To ascertain the correct fees income;

Fees Income	⋆⋆
Add closing WIP	⋆⋆
Less Opening WIP	(⋆⋆)
	⋆⋆⋆

3.2 Clients account

This is an account that records all transactions relating to the client. Where all the clients' accounts are maintained in one account, the client account is maintained in two columns in order to separate clients with sufficient funds in the account and those with insufficient funds.

Accounting Entries

1. To record funds received on behalf of the client.
   Dr. Cash book – Client column
   Cr. Client – Client Column

2. To record payments on behalf of the clients (With sufficient funds)
   Dr. Client account – Client column
   Cr. Cashbook – Client column

3. To record payments on behalf of the clients (With insufficient funds)
   Dr. Client account – Office column
   Cr. Cashbook – Office column

4. T o record fees charged to the client
   Dr. Client account – Office column
   Cr. Fees Income

5. To record cash received from the client (fees charged and disbursements)
   Dr. Cashbook – office column
   Cr. Client account – office column

6. To record transfer of funds from clients account to office account (Authority Granted)
   a. **Transfer from client to office account**
      Dr. Cashbook – Office Column
      Cr. Cash – Client Column

   b. **Contra entry – set off**
      Dr. Client account – Client column
      Cr. Client account – Office column

7. To record office expenses
   Dr. Expenses
   Cr. Cash book – Office column

Illustration (Format of the various ledger accounts and statements)

Maena & co Advocates

Trial balance as at 30 April 2007

Capital account			4,010,00
Disbursements on behalf of clients		560,000	
Salaries		280,000	
Stationery		250,000	
Work in progress on March 2007		280,000	
Clients: for the moneys held on their behalf			440,000
Creditors			160,000
Sundry offices expenses		70,000	
Furniture,		500,000	
Equipment		1,500,000	
Library books		300,000	
Drawings		200,000	
Cash at bank:			
Clients' account	440,000		
Office account	230,000		
	4,610,000		4,610,000

Additional information:

1. The work in progress as at 30 April 2007 was valued at KShs 480,000.
2. Valuation of the firm's goodwill was quoted at KShs 195,000.
3. A loan of KShs 1,500,000 was advanced to the company repayable as a lump sum in two years which attracted a 13% interest p.a.
4. Depreciation should be provided at 10% per annum on the book value of the furniture, 12.5% on library books 20% on equipment.
5. At the end of the year clients were charged a sum of KShs 1,420,000.
6. Various payments and receipts had not been posted i.e.

   Payments

   i. Paid rent on behalf of a client of KShs 270,000
   ii. Paid KShs 820,000 on behalf of a client with sufficient funds as a deposit for the purchase of land.

iii. Purchased shares for the firm and on behalf of a client with insufficient funds valued at KShs 320,000 & 180,000 respectively.

<u>Receipts</u>

i. Received funds from clients KShs 1,680,000.

ii. A client authorized a transfer of KShs 600,000 to the advocate as fees.

Required:

a) Profit and loss account for the year ended 30 April 2007.

b) Balance sheet as at 30 April 2007.

Cash Book

	Office	**Client**		**Office**	**Client**
Balance b/d	440	230	Rent–Client		270
Clients fees	1,420		Land–Client		820
Clients – cash		1680			
Transfer from client	600		Shares–Client	320	180
			Transfer to Office		600
Client – cash for land	180				
			Salaries & wages	280	
				70	
			Office expenses	430	
			Creditors	200	
			Drawings	1,340	40
			Balance c/d		
	2640	**1910**		**2640**	**1910**

Client Account

	Office	Client		Office	Client
Fees Income	1420		Balance b/d	440	230
Rent - Client		270	Cash book	1420	
Land - Client		820	Cash - Client		1680
Shares	320	180	Contra - set off	600	
Contra – setoff		600	Cash – land deposit	180	
Balance c/d	900	40			
	2640	**1910**		**2640**	**1910**

Fees Income

Balance c/d	KShs **1420**	Client	KShs **1420**

Stationary Account

Balance	KShs		KShs
b/d Creditors	80	P& l	250
	280	Bal c/d	110
	360		**360**

Creditors

Cash	KShs		KShs
Bal c/d	430	Bal b/d	310
	160	Stationary	280
	590		**590**

Depreciation

Equipment = 10/100 *1500 = 150

Furniture = 12.5/100 * 500 = 62.5

Library books = 20/100 * 300 = 60

MAENA & CO. ADVOCATES

Income Statement

For The Year Ended 30 April 2007

	KShs (000)	KShs (000)
Fees		1420
Closing WIP	480	
Less Opening WIP	(280)	200
		1620
Operating expenses		
Stationary	250	
Depreciation:		
Equipment	150	
Furniture and Fitting	62.5	
Library books	60	
Salaries and Wages	280	
Interest	195	
Office expenses	70	**(1067.5)**
		552.5
Reserve for fees in arrears		(1420)
Deficit after reserve for fees in arrears		**(867.5)**

Maena & Co. Advocates

Balance Sheet

As at 30 April 2007

	KShs	KShs
Fixed assets		
Equipment		1,350,000
Furniture		437,500
Library books		240,000
Goodwill		195,000
		2, 222,500
Current assets		
Debtors for fees	1,420,000	
Less reserve	(1,420,000)	
Work in progress	480,000	
Disbursements & fees	560,000	
Cash – Office	1,340,000	
- Client	40,000	2,420,000
		4,642,500
Current Liabilities		
Creditors	160,000	
Clients	40,000	(200,000)
		4,442,500
Financed by:		
Capital		4,010,000
Less Deficit		(867,500)
Less drawings		(200,000)
Long term Liability		
13% Loan		1,500,000
		4,442,500

Office account – an account that records transactions relating to the client. They include; Disbursements, fees paid to client, amount paid & reimbursed by client.

Client account – An account that records transactions relating to clients. They include cash received on behalf of clients, payments made on behalf of clients and any transactions made as authorized by client.

Costs charged to client – Are fees charged to clients for services rendered.

Work in Progress – Value of uncompleted work not yet charged to the client.

JUNE 2009

Office Account

	Office	**Client**		**Office**	**Client**
Balance b/d	250	310	Rent		70
Clients deposit		1450	Land		180
Transfer - client	1265		Insurance		140
Disbursement fee	930		Motor vehicle	280	
			Transfer - office		1265
			Creditors – Stationery	420	
			Rent	240	
			Creditors-equip	280	
			Salaries	480	
			Bank loan	200	
			Interest	54	
			Library books	100	
			Drawings	150	
			Balance c/d	241	205
	2415	**1760**		**2415**	**1760**

Client account

	Office	Client		Office	Client
Bal b/d	380	70	Balance b/d	1265	310
Rent		180	Cash deposit		1450
Land		40	Transfer – client	930	180
Insurance		1450	Disbursement & fee	285	140
Motor vehicle	280	1265	Balance c/d		
Transfer – office		205			
Balance c/d					
	2480	**1761**		**2480**	**1761**

Equipment Account

	KShs		KShs
Balance b/d	2000		
Creditors	300	Bal c/d	2300
	2300		**2300**

Creditors (Equipment) account

	KShs		KShs
Bank	280	Bal b/d	–
Bal c/d	20	Equipment	300
	300		**300**

Stationary Account

	KShs		KShs
Balance b/d	100	P& l	390
Creditors	360	Bal c/d	70
	460		**460**

Creditors (Stationary) account

	KShs		KShs
Bank	420	Bal b/d	150
Bal c/d	90	Stationary	360
	510		**510**

Bank loan account

	KShs		KShs
Danil	200	Bal b/d	800
Bal c/d	600		
	800		**800**

Library books account

	KShs		KShs
Bal b/d	500	Bal c/d	600
Bank	100		
	600		**600**

Salaries account

	KShs		KShs
Bank	480	Bal b/d	90
Accruals	40	P& L	430
	520		**520**

Rent account

	KShs		KShs
Bal b/d	80	P & L	260
Bank	240	Prepayment	60
	320		**320**

Depreciation

Equipment – 10% * 2300 =230

Furniture – 12.5/100 *800 = 100

Library books – 20/100 *600 = 120

Statement of Comprehensive Income

For the Year Ended 30 April 2003

	KShs (000)	Shs (000)
Fees		1820
Closing WIP		210
Opening WIP		(180)
		1850
Operating expenses		
Stationary	390	
Salaries	430	
Rent	260	
Depreciation		
-Equipment	230	
-Furniture	100	
-Library books	120	
Loan interest	54	**(1584)**
NET PROFIT		**266**

XYZ & CO. ADVOCATES
STATEMENT OF FINANCIAL POSITION
AS AT 30 APRIL 2007

Fixed assets	**KShs** **Cost**	**KShs** **Depreciation**	**KShs** **NBV**
Equipment	2300	(2000-1200+230)=1030	1270
Furniture	800	(800-400+100)= 500	300
library books	600	(500-300+120)= 320	280
			1850
<u>Current assets</u>			
Work in progress	210		
Disbursements & fees	285		
Stationary	70		
Cash at bank – Office	241		
- Client	205		
	1071		
<u>Current Liabilities</u>			
Creditors – equipment	20		
-Stationary	90		
Accrued salaries	40		
Clients	205		
	355		**716**
			<u>2566</u>
Financed by:			
Capital			1850
Add Net profit			266
			2116
Drawings			(150)
			1966
Bank loan			600
			<u>2566</u>

Question

A & B advocates have been in practice for two years. They share profits and losses equally. The following financial information is availed.

A& B

Balance sheet as at December 2009

Fixed Assets		**Capital** : A	2,000,000
Motor vehicle	1,200,000	B	1,800,000
Equipment	1,100,000		
Furniture & Fixtures	600,000		
Current Assets		**Current Liabilities**	
Outstanding fees	980,000	Client a/c	410,000
Cash at bank: Office	120,000	Accrued rent	30,000
Client	320,000	Accrued salaries	80,000
	4,320,000		**4,320,000**

A& B,

Receipts and Payments for the year 2009

Receipts		
Fees for service rendered		2,500,000
Received from clients: Disbursements		
Stationery	26,000	
Transport	50,000	
Miscellaneous		**40,000**
Payments		
Transport	150,000	
Office rent	80,000	
Telephone	92,000	
Printing & Stationery		104,000

Motor vehicle expenses	87,000	
Electricity	18,000	
Salaries & Wages	780,000	
Drawings: A	125,000	
B	160,000	
Equipment Purchased		**370,000**

Additional information:

1. An investment account had not been opened to post PQF shares worth KShs 280,000.
2. A fee in arrears at the end of the year is KShs 1,000,000.
3. Depreciation is provided at 5%, 10% & 10% for furniture, Equipment and Motor vehicle respectively.
4. Disbursements for Transport at KShs 18,000, Stationery KShs 40,000 and miscellaneous expenses at KShs 6,000
5. Accrued expenses were Telephone 12,000 and rent 80,000.

Required:

a) The Cash book, clients account(s) and other necessary ledger accounts for the period.
b) The advocates Income and expenditure account for the year ended 31 December 2010.
c) Balance sheet as at 31 December 2010

Cash book

Date	**Particulars**	**Office** (000)	**Client** (000)	**Date**	**Particular**	**Office** (000)	**Client** (000)
	Bal b/d	120	320		Transport	150	
	Debtors fees	2,500			Office rent	80	
	Disburse-ments:				Telephone	92	
	Stationery		26				
	Transport		50				
	Misc expenses		40				
	Stationery	40			Printing & Stat	104	
	Transport	18			M. vehicle expenses	87	
	Misc expenses	6			Electricity	18	
					Salaries & Wages	780	
					Drawings	125	
					A	160	
					B	180	
					Misc expenses		40
					Stationery		18
					Transport		6
					Misc expenses	370	
					Equipment	538	372
		2,684	436		Bal b/d	2,684	436

Client Account

Date	Particular	KShs	Date	Particular	KShs
	Stationery	40,000		Bal b/d	20,000
	Transport	18,000		Disbursements: cashbook	
	Misc expenses	6,000			26,000
				Stationery	50,000
				Transport	40,000
		372,000		Misc expenses	
	Bal c/d				
		436,000			436,000

Transport A/C

Date	Particular	KShs	Date	Particular	KShs
	Cash book	150,000 150,000		Client a/c Inc & exp	18,000 132,000 150,000

Stationery A/C

Date	Particular	KShs	Date	Particular	KShs
	Cash book	104,000 104,000		Client a/c Inc & exp	40,000 64,000 104,000

Rent A/C

Date	Particular	KShs	Date	Particular	KShs
	Cash book Bal c/d	80,000 80,000 160,000		Bal b/d Inc & exp	30,000 130,000 160,000

Salaries & Wages A/C

Date	Particular	KShs	Date	Particular	KShs
	Cash book	780,000 780,000		Bal b/d Inc & Exp	80,000 700,000 780,000

Miscellaneous Expenses

Date	Particular	KShs	Date	Particular	KShs
	Cash book	180,000 180,000		Client a/c Inc & Exp	6,174,000 180,000

Debtors A/C

Date	Particular	KShs	Date	Particular	KShs
	Bal b/d Fees(Inc & exp)	980,000 2,520,000 3,500,000		Cash book Inc & Exp	2,500,000 1,000,000 3,500,000

Workings for depreciation:

- Motor vehicle 10% x 1,200,000 = 120,000
- Equipment 10% x (1,100,000 +370,000) = 147,000
- Furniture 5% x 600,000 = 30,000

A and B

Income statement for the year ended 2010.

Income			
Fees Income			2,520,000
Expenditure			
Transport		132,000	
Rent		130,000	
Telephone		104,000	
Printing & Stationery			64,000
Motor vehicle expenses		87,000	
Electricity		18,000	
Salaries & Wages		700,000	
Depreciation			
Motor vehicle	120,000		
Equipment	147,000		
Furniture	30,000		
Miscellaneous expenses	174,000		(1,706,000)
Net profit			**814,000**

Capital A/C

	A	B		A	B
Drawings	125,000	160,000	Bal b/d	2,000,000	1,800,000
Bal c/d	2,282,000	2,047,000	Share of surplus	407,000	407,000
	2,207,000	**2,207,000**		**2,207,000**	**2,207,000**

A& B,

Statement of financial position as at 31 Dec 2010

Fixed Assets		
Motor vehicle 1,200,000 - 120,000		1,080,000
Equipment (1,100,000 +370,000) - 147,000		953,000
Furniture 600,000 - 30,000		570,000
PQF Shares Investments		280,000
		2,883,000
Current Assets		
Debtor's Fees	1,000,000	
Bank: Office	538,000	
Client	372,000	1,910,000
		4,793,000
Current Liabilities		
Accrued Telephone	12,000	
Accrued Rent	80,000	
Client a/c	372,000	(464,000)
		4,329,000
Financed by:		
A		2,282,000
B		2,047,000
		4,329,000

Question

Munene & Okisai Advocates have been in practice for several years. They share profits and losses equally. The following financial information is available:

Balance Sheet as at 31 December 2010

	KShs	KShs
	(000)	(000)
Fixed Assets		
Furniture and Fittings	132	
Equipment	320	
Motor Vehicles	1040	1492
Investment in NSE Shares		4,824
Current Assets		
Work in Progress	1,092	
Cash: Office	612	
Client	98	1,802
		8118
Capital Account:		
Munene		4180
Okisai		3500
Current Liabilities		
Client Account	98	
Accrued rent	172	
Accrued salaries	168	438
		8118

Receipts and payments Account for the year ended 31 December 2010

	KShs (000)		KShs (000)
Receipts		**Payments:**	
Proceeds from the sale of equipment	280	Drawings: Munene	200
		Okisai	400
Fees for services rendered	5,762	Deposit on land purchase	1200
Client's deposit for land buying	1,096	Transport	232
Received from clients for:		Office rent	100
		Telephone and postage	170
Disbursements		Printing and stationery	102
– stationery	56	Motor vehicle expenses	252
- transport	68		
- miscellaneous	100	Water and electricity	35
		Office repairs	88
		Salaries and wages	1067
		Miscellaneous expenses	220

Additional information:

1) Depreciation is to be provided for on reducing balances at 10% for furniture, 5% for equipment, and 15% for motor vehicles.
2) Disbursements for stationery, KShs 28, 000, transport, KShs 20, 000 and miscellaneous expenses, KShs 2, 000 have been charged to the client's account.
3) Fees in arrears at the yearend was KShs 1, 120,000. The advocates have agreed to create a reserve against the fees in arrears.
5) Accrued expenses were KShs 8, 000, KShs 122, 000 and KShs 56, 000 for telephone, rent and salaries respectively.

Required:

a) The advocates Income and expenditure account for the year ended 31 December 2010
b) The clients account(s) for the same period
c) Balance sheet as at 31 December 2010

(Total: 20 marks)

Worked example

Cashbook

	Office KShs (000)	Client KShs (000)		Office KShs (000)	Client KShs (000)
Balance b/d	2,400	112	Equipment	1765	
Debtors: fees	5,762		Drawings:		
Client A/C:			Munene	200	
Land deposit		1,096	Okisai	400	
Client A/C:			Client A/C:		1,200
disbursements			Land purchase		
stationery		56	Transport	232	
transport	28	68	Rent	920	
miscellaneous	20	100	Telephone and postage	170	
	12		Printing and stationery	102	
			Motor expenses	252	
			Water and electricity	35	
			Office repairs	88	
			Salaries and wages	1067	
			Miscellaneous expenses	220	
			stationery		28
			transport		20
			miscellaneous		12
			Balance c/d	2,771	172
Balance b/d	8,222	**1,432**		**8,222**	**1,432**
	2,771	172			

Client Account (*All Clients)*

	KShs (000)		KShs (000)
Land Purchase cb	1200	Bal b/d	136
Disbursements:		Land purchase cb	1816
Transport a/c	28	Disbursements: cb	
Stationary a/c	20	Transport	56
Miscellaneous a/c	12	Stationery	68
Balance c/d	172	Miscellaneous	100
	1,432		**1,432**

Stationery

	KShs (000)		KShs (000)
Cash book	160	Client a/c	28
		Income/Expense	142
	160		**160**

Transport

	KShs (000)		KShs (000)
Cash book	232	Client a/c	20
		Income /Expense	212
	232		**232**

Rent

	KShs (000)		KShs (000)
Cash book	920	Balance b/d	150
Balance c/d	122	Income expenses	892
	1042		**1042**

Miscellaneous expenses

	KShs (000)		KShs (000)
Cash book	220	Client a/c	12
		Income Expense	208
	220		**220**

Salaries

	KShs (000)		KShs (000)
Cash book	1,067	Bal b/d	183
Bal c/d	56	Income/Expense	940
	1,123		**1,123**

Debtors

	KShs (000)		KShs (000)
Bal b/d	560	Cashbook	5,760
Fees	6320	Client a/c	
		Income/Expense	1,120
	6,880		**6,880**

Munene and Okisai

Income and Expenditure a/c for the year ended 31 December 2010

	KShs (000)	KShs (000)
Income		6,320
Fees income		
Expenditure		
Depreciation: Furniture	13.2	
: Equipment	16	
: Vehicles	156	
Transport	212	
Rent	892	
Telephone and postage	178	
Printing and stationery	74	
Motor vehicle expenses	252	
Water and Electricity	35	
Office repairs	88	
Miscellaneous expenses	208	
Salaries and wages	940	
		(3,064.2)
Surplus before reserve for fees in arrears		3,255.8
Reserve for fees in arrears		(1,120)
Surplus after reserve for fees in arrears		**2,135.8**

Capital A/C

	Munene KShs (000)	Okisai KShs (000)		Munene KShs (000)	Okisai KShs (000)
Drawings	200	400	Balance b/d	4,180	3,500
Balance c/d	5,047.9	4,167.9	Share of Surplus	1067.9	1067.9
	5,247.9	**4,567.9**		**5,247.9**	**4,567.9**

Munene & Okisai Advocates Balance Sheet as at 31 December 2010

	KShs (000	KShs (000
Fixed Assets		
Furniture and Fittings(132-13.2)		118.8
Equipment(320 – 16)		304
Motor Vehicles(1540- 156)		1,384
Investment in NSE Shares		4,824
		6,630.8
Current Assets	1,120	
Debtors	(1,120)	
Less reserve		
Bank :Office a/c	2,771	
:Client a/c	172	
Current Liabilities		
Client Account	172	
Accrued rent	122	
Accrued salaries	56	
Accrued Telephone	8	
		9,215.8
Capital		
Munene		5,047.9
Okisai		4,167.9
		9,215.8

Advocates Act Excerpts

"Advocate" means any person whose name is duly entered upon the Roll of Advocates or upon the Roll of Advocates having the rank of Senior Counsel and, for the purposes of Part IX, includes any person mentioned in the section 10:

"client" includes any person who, as a principal or on behalf of another, or as a trustee or personal representative, or in any other capacity, has power, express or implied, to retain or employ, and retains or employs, or is about to retain or employ an advocate and any person who is or may be liable to pay to an advocate any costs;

3.3 The Advocates (Deposit Interest) Rules

1. These Rules may be cited as the Advocates (Deposit Interest) Rules.

2. Except as provided by these Rules an advocate is not liable by virtue of the relation between advocate and client to account to any client for interest received by the advocate on moneys deposited in a client account being moneys received or held for or on account of his clients generally.

3. When an advocate holds or receives for or on account of a client money on which, having regard to all the circumstances (including the amount and the length of time for which the money is likely to be held), interest ought in fairness to the client to be earned for him, the advocate shall take instructions from the client concerning the investment of that money.

4. An advocate is liable to account to a client for interest received on moneys deposited in a client account where the moneys are deposited in a separate designated account.

5. In these Rules "separate designated account" means a deposit account in the name of the advocate or his firm in the title of which the word "client" appears and which is designated by reference to the identity of the client or matter concerned.

3.4 The Advocates (Accountants Certificates) Rules

1. These Rules may be cited as the Advocates (Accountant's Certificate) Rules.

2. (1) In these Rules –

"accountant's certificate" means the certificate provided for by rule 3.

"advocate" means any person whose name is duly entered upon the roll of advocates but does not mean any person whose name is duly entered upon the roll of advocates having the rank of Queen's Counsel;

"the Council" means the Council of the Law Society of Kenya;

"the secretary" means the Secretary of the Law Society of Kenya and includes any person appointed temporarily to perform the duties of the office;

(2) The expressions "client", "client account", and "client money", have the meanings assigned to them in the Advocate (Accounts) Rules.

3. Subject to these Rules, every advocate shall once in every practice year deliver to the Council a certificate signed by an accountant and complying with these Rules.

4. (1) An accountant is qualified to give an accountant's certificate if –

(a) he has neither been at any time during the accounting period, nor subsequently, before giving the certificate, become a partner, clerk or servant of such advocate or any partner of his; and

(b) He is not subject to notice of disqualification under paragraph (2).

(2) In either of the following cases, that is to say, where –

(a) the accountant has been found guilty by the Disciplinary Tribunal of his professional body of professional misconduct or discreditable conduct; or

(b) the Council is satisfied that an advocate has not complied with the provisions of the Advocates (Accounts) Rules in respect of matters not specified in an accountant's certificate and that the accountant was negligent in giving such certificate, the Council may at its discretion at any time notify the accountant concerned, that he is not qualified to give an accountant's certificate and it may give notice of that fact to any advocate on whose behalf he has given an accountant's certificate, and after the accountant has been so notified, unless and until the notice is withdrawn by the Council, he is not qualified to give an accountant's certificate, is coming to its decision the Council shall take into consideration any observations or explanations made by the accountant or by any professional body of which he is a member.

5. (1) With a view to the signing of an accountant's certificate an accountant is not required to do more than –

(a) make a general test examination of the books of account of the advocate;

(b) ascertain whether a client account is kept;

(c) make a general test examination of the bank pass books and statements kept in relation to the advocate's practice;

(d) make a comparison, as at not fewer than two dates selected by the accountant, between –

(i) the liability of the advocate to his client as shown by his books of account;

(ii) the balance attending to the credit of the client account; and

(e) Ask for such information and explanations as he may require arising out of (a) to (d) above.

(2) If after making the investigation prescribed by paragraph (1), it appears to the accountant that there is evidence that the Advocates (Accounts) Rules have not been complied with, he shall make such further investigations as may be necessary to enable him to sign the accountant's certificate.

6. An accountant's certificate delivered by an advocate shall be in the form set out in the Schedule or in a form to the like effect approved by the Council.

7. The Council will in each practice year be satisfied that the delivery of an accountant's certificate is unnecessary, and shall not require evidence of that fact, in the case of an advocate who –

(a) holds his first current practising certificate; or

(b) after having for twelve months or more ceased to hold a current practising certificate, holds his next current practising certificate; or

(c) delivers to the Council a statutory declaration stating that the Advocates (Accounts) Rules did not apply to him because he had not, during the period to which the declaration refers, practiced on his own account either alone or in partnership or held or received client's money; or

(d) has ceased to hold a current practising certificate and, if he has at any time after the 31 December 1967, held or received client's money, has delivered an accountant's certificate covering an accounting period ending on the date upon which he ceased to hold or receive client's money; or

(e) has at no time since the 31 December 1967 held a current practising certificate or held or received client's money.

7A. A statutory declaration delivered under rule 7 by an Advocate in the employment of an unqualified person or body shall state whether such advocate has complied with rule 5 of the Advocates (Practice) Rules.

8. Subject to rules 9, 10 and 11, the accounting period specified in an accountant's certificate shall –

(a) begin at the expiry of the last preceding accounting period for which an accountant's certificate has been delivered;

(b) cover not less than twelve months;

(c) terminate not more than nine months before the date of the delivery of the certificate to the Council; and

(d) Where possible, consistently with paragraphs (a), (b) and (c) correspond to a period or consecutive periods for which the accounts of the advocate or his firm are ordinarily made up.

9. The accounting period specified in an accountant's certificate delivered during the practice year beginning on the 1 January, 1968, shall begin on –

(a) the date to which the advocate's books were last made up before the 1 January, 1968; or

(b) if the books were not made up during the practice year beginning on the 1 January 1967, either on the 1 January 1967, or on the day upon which the advocate first began or began again to hold or receive client's money, whichever be the later; or

(c) in the case of an advocate retiring from practice who has ceased to hold or receive client's money after the 1 January 1967, the period up to the date upon which he so ceased.

10. In any practice year beginning on or after the 1 January, 1969 –

(a) in the case of an advocate who –

(i) becomes under an obligation to deliver his first accountant's certificate; or

(ii) having been exempt under rule 7 from delivering an accountant's certificate in the previous practice year, becomes under an obligation to deliver an accountant's certificate,

the accounting period shall begin on the date upon which he first held or received client's money or after such exemption, began again to hold or receive client's money, and may cover less than twelve months, and shall in all other respects comply with rule 8; and

(b) in the case of an advocate retiring from practice who, having ceased to hold or receive client's money, is under an obligation to deliver his final accountant's certificate, the accounting period shall end on the date upon which he ceased to hold or receive client's money, and may cover less than twelve months, and shall in all other respects comply with rule 8.

11. (1) In any practice year beginning on or after the 1 January, 1969, in the case of an advocate who –

(a) was not exempt under rule 7 from delivering an accountant's certificate in the preceding practice year; and

(b) Since the expiry of the accounting period covered by such accountant's certificate has become, or ceased to be, a member of a firm of advocates; the accounting period may cover less than twelve months and shall in all other respects comply with rule 8.

(2) In the case of an advocate who has two or more places of business –

(a) separate accounting periods, covered by separate accountant's certificates, may be adopted in respect of each such place of business provided that the accounting periods comply with rule 8; and

(b) The accountant's certificate or accountant's certificates delivered by him to the Council in each practice year shall cover all client's money held or received by him.

12. If any advocate fails to comply with these Rules a complaint in respect of such failure may be made by or on behalf of the Council to the Disciplinary Committee.

13. On receipt either of an accountant's certificate or of a declaration under rule 7(3) the Secretary will forward to the advocate a certificate under his hand stating that an accountant's certificate for a specified period has been received or that no accountant's certificate is required for a specified period, as the case may be.

14. A certificate under the hand of the Secretary is, until the contrary is proved, evidence that; in advocate has or has not, as the case may be, delivered to the Council an accountant's certificate or supplied any evidence required under these Rules.

15. Every notice to be given by die Council under these Rules to an advocate shall be in writing under the hand of the Secretary and sent by registered post to the last address of the advocate appearing in the roll of advocates kept by the Registrar under section 20 of the Act and when so given and sent, is taken to have been received by the Advocate within seven days after die date of posting.

16. Every notice given by the Council under these Rules to an accountant shall be in writing under the hand of the Secretary and sent by registered post to the address of the accountant shown on an accountant's certificate or appearing in the records of the accountancy body of which the accountant is a member, and where so given and seat, is taken to have been received by the accountant within seven days after the date of posting.

FORM OF ACCOUNTANT'S CERTIFICATE

Note: In the case of a firm with a number of partners, carbon copies of the certificate may be delivered provided section t below is completed on each certificate with the name of the Individual advocate.

1. Advocate's full name

2. Firm(s) name(s) and address (es)

Note: All addresses at which the advocates) practise(s) must be covered by an accountant's certificate or certificates.

3. State whether practising alone or in partnership

4. Accounting period(s)

Note: The period(s) must comply with the Advocates (Accountant's Certificate) Rules.

Draft - ACCOUNTANT'S CERTIFICATE

TO: The Secretary,

The Law Society of Kenya

P.O Box *****

Nairobi

ACCOUNTANT'S CERTIFICATE

In compliance with the Advocates (Accountant's Certificate) Rules,

I Mhasibu Shupavu have examined the books, accounts and necessary documents of the above named advocate relating to the above practice submitted to me and i hereby certify that the same conforms to the Advocates (Accountant's Certificate) Rules rule 5.

From the information gathered, I am satisfied that:

*(1) during the above-mentioned period(s) he has complied with the provisions of the Advocates (Accounts) Rules except so far as concerns: -

(a) certain trivial breaches due to clerical errors or mistakes in book keeping, all of which were rectified on discovery: I am satisfied that none of such breaches resulted in any loss to any client;

(b) The matters set out on the back hereof;

*(2) Having retired from active practice as an advocate he ceased to hold client's money on the ....

Particulars of the Accountant

Full Name:

Professional Registration Number:

Firm Name:

Address:

Signature:

Date:

The accounts prepared by professional firms e.g. Advocates, Doctors etc follow the same accounting principles used in other forms of business. However, they have special features:

(a) Since no trading is carried out, no trading account is prepared but instead either
   (i) An income and expenditure account is prepared; or
   (ii) A profit and loss account is prepared; the income is ascertained by preparing a cost account or a fees income account, which is essentially a sales account. The income recognised is transferred from the cost account to the Profit and Loss Account.

(b) Income may be recognised on a cash basis or on an accruals basis. Under the cash basis, the reported income is usually the cash received; under the accruals basis income is recognised when earned and not as cash received.

Question Two

Kariuki & Co. Advocates recorded the following transactions for the month of May 2012

1. Received funds from various clients namely:

   a. Simpson 20,000

   b. Stephanie 15,000

   c. Simone 37,000

   d. Sharon 24,000

2. On 17 May Stephanie authorized the firm to make a payment of KShs 5,000 to the plaintiff in her matter before the High Court as adjournment costs.
3. A new client Mkangula who required a legal opinion on a Limited Liability Partnership was charged KShs 50,000.
4. On 18 May for witnessing and certifying documents, Omollo was charged KShs 7,500 and the firm received KShs 20,000 from Mkangula.
5. On 20 May the firm made a payment on behalf of Omollo of KShs 1000.
6. On 22 May the firm filed a memorandum of appearance and a defence on behalf of Simone. She was charged an interim deposit of KShs 15,000 which the client authorized a transfer.
7. The firm has incurred expenses to the sum of KShs 50,000 as at 25 May.

Required

Formulate the necessary accounts and post the transactions appropriately.

(20 Marks)

Cash Book

Date		**Office**	**Client**	**Date**		**Office**	**Client**
	Simpson		20,000		Stephanie		5,000
	Stephanie		15,000				
	Simone		37,000				
	Sharon		24,000				
	Mkangula	20,000			Omollo	1,000	
	Simone	15,000			Simone		15,000
					Expense	75,000	
	Bal c/d	61,000			Bal c/d		86,000
		76,000	**96,000**			**76,000**	**96,000**

Client a/c

Date		Office	Client	Date		Office	Client
	Stephanie		5,000		Simpson		20,000
	Mkangula	50,000			Stephanie		15,000
	Omollo	7,500			Simone		37,000
	Omollo	1,000			Sharon		24,000
					Mkangula	20,000	
	Bal c/d		91,000		Bal c/d	38,500	
		58,500	**96,000**			**58,500**	**96,000**

Fixed Fee Income

Balance c/d	57,500	Mkangula Omollo	50,000 7,500
	57,500		**57,500**

Expenses Account

Cash Book	75,000	Balance c/d	75,000
	75,000		**75,000**

Question Three

The following balances were extracted from the books of Mona Lisa, a sole trader as at 1 January 2011.

Fixed Assets	300,00
Stock in Trade	42,000
Trade debtors	10,000
Balance at bank	96,000
Trade creditors	55,000
Cash Balance	22,000
Bank Loan	180,000
Accrued Sundry Expenses	10,000

The following transactions took place in the month of January 2011

January 3	The business made credit sales of KShs 850,000 and cash sales of KShs 120.000.
January 5	The business purchased goods on credit worth KShs 630,000. Further purchases of goods worth KShs 80, 000 were made and paid for by cheque.
January 9	Debtors paid KShs 800, 000 less a discount of 2%.
January 12	Fixed Assets were purchased for KShs 150, 000 and paid for by cheque.
January 22	The proprietor withdrew KShs 40, 000 from the bank and KShs 20, 000 from the cash at hand to pay outstanding car insurance for his wife's vehicle.
January 24	Trade creditors were paid KShs 600, 000 by cheque less 3% discount.
January 25	Bank loan repayment of KShs 20,000 was made by cheque while salaries and wages amounting 48,000 were also paid by cheque.
January 26	A cash deposit of KShs 100, 000 was made in the bank from the cash account.
January 30	Sundry expenses for the month of January amounted to KShs 23,000. A sum of KShs 28,000 were paid for sundry expense by cheque.

Required:

1) Relevant Ledger accounts to record the above transactions.
2) Trial Balance as at 31 January 2003

(20 Marks)

Question Four

(a) Briefly explain the following terms as used in the accounts of professional practitioners:

I. Office account

II. Client account

III. Costs charged to clients

IV. Work-in-progress

(b) Given below is a trial balance extracted from the books of Ngugi and Nnajala, a firm of practicing advocates as at 31 December 2010:

Ngugi and Nnajala Advocates

Trial Balance

	KShs		KShs
Capital account			1,400,000
Disbursements on behalf of clients	26,000		
Drawings	60,000		
Salaries	90,000		
Rent and rates	50,000		
Printing and stationery		20,000	
Postage and telephone		26,400	
Costs charged to clients			470,000
Work in progress on 1 Nov 2010	87,000		
Clients: for the moneys held on their behalf			80,220
Creditors			42,390
Debtors	124,000		
Sundry offices expenses	15,000		
Furniture, fittings and library books		1,160,000	
Cash at bank:			
Clients' account	152,000		
Office account	182,210		
	1,992,610		1,992,610

Additional information:

1. The uncompleted work on 31 December 2010 was valued at KShs 58,200.
2. It is estimated that debts amounting to KShs 10,000 are uncollectible and should be written off.
3. Depreciation should be provided at 20% per annum on the book value of the furniture, fittings and library books.

Required:

c) Profit and loss account for the year ended 31 December 2010.

d) Balance sheet as at 31 December 2010.

Question

A, B and C Advocates are in partnership. They share profits and losses in the ratio 3:2:1. The following balances were extracted from their books for the year ended 31 March 2010.

Trial Balance as at 31 March 2010

	KShs	KShs
Capital account A,		4,000
B		3,000
C		2,000
Current Account Drawings A,		890
B		1,210
C		420
Disbursements on behalf of clients		526
(Balance not yet charged to clients)		
Salaries	1,852	
Rent and Rates	600	
Printing and stationery	288	
Postages, telephone etc.	168	
Costs charged to client		8,000
Work in progress, 1 April 2010		983
Work in progress provision, 1 April 2010		983
Monies held on clients behalf		1,800
Creditors		600
Debtors Provision, 1 April 2010		2800
Debtors (includes 800 for disbursements)		4200
Sundry office expenses		700
Furniture, fittings and library		3200
Cash at Bank: Client	1800	
Office	7333	9133
Petty Cash	65	
	23,709	**23,709**

Additional information

i) Work in Progress as at 31 March 2010 was KShs 1,200.

ii) Bad Debts amounting to KShs 76 are to be written off.

iii) Profits are to be divided amongst partners on a cash basis after allowing for interest on capital at 5% p.a.

Required:

i) Income and expenditure account for the year ended 31 March 2010,

ii) Balance Sheet as at 31 March 2010.

Chapter Four

Trust Accounts

4.1 Introduction to trusts accounts

The fiduciary nature of the relationship and the need for public confidence in the legal profession require lawyers to have a sound understanding of trust accounts. Note, the purpose of a trust account is to safeguard client and third party funds from loss in which case the lawyer must maintain trust accounts.

The responsibility for compliance with trust accounting rules lies solely with the lawyer. This duty cannot be delegated away, since all administrative work on trust accounts must be closely reviewed and supervised by the lawyer.

A trust is a legal agreement in which a specialist manages the assets of a trust beneficiary, or trustee. Trust accounting is a simple form of bookkeeping used exclusively for trust transactions. It is the recording by a trustee of the receipt and payment of other people's money into individual trust ledger accounts maintained for the person from or on whose behalf the money was received.

A trust accountant records trust transactions and prepares financial statements that comply with trust agreements, regulatory guidelines, industry practices and accounting principles.

Trusts accounts are kept by executors, administrators and trustees

Purpose of keeping trust accounts is twofold:

(i) To keep a detailed record of the affairs which have been vested on executors, administrators and trustees

(ii) To give information to the beneficiaries of the trust.

Executors, administrators and trustees are under an obligation to administer the property in a particular way. They are entitled to hold and utilize the trust property to generate funds for a particular purpose.

NB: Distinguish trusteeship from agency/power of attorney

Trusteeship is imperative whereas the others are discretionary.

An Executor is one who administers the estate of a deceased person in accordance with a will. He acquires his rights and authority from the letter of the will i.e. deceased death. The powers and duties of executors begin upon the death of the deceased.

Administrator deals with people of a deceased person where the deceased did not make a will, that is, intestate death. The duties and obligations of an administrator only crystallize once. There is a grant of letters of administrator by a court.

REF; *Trouistik Union/International & Awor v Jane Mbeyu & Awor* (Ca 145/90)

An administrator is vested to act for and on behalf of an estate once the court has issued letters of administration.

Trustee: one who administers people held in trust for another or others.

The need to keep trust accounts arises out of the obligation by law due to that relationship of trustee-beneficiary.

Section 3 Law of Succession Act: any trustee or executor must keep accounts.

A trust accountant records trust transactions and prepares financial statements that comply with trust agreements, regulatory guidelines, industry practices and accounting principles.

Section 83 also gives the court an inherent power to act duo matters and require an account from the administrator.

4.2 Nature of trust accounts

Duties of the trustees with regard to accounts

1) The accounts must be proper, faithful and accurate. The trustee has the discretion to delegate this duty in circumstances where he is not in a position to do so.

a. The accounts of each trust must be kept separate from all other matters.
b. The accounts must contain particulars of all receipts and all payments.
c. Receipts and payments must be supported by vouchers (authority).

2) The trustees should always ensure the accounts are up to date thus ready to render them when called upon.
3) A statement of what a beneficiary is entitled should be rendered periodically without request. A deed of release shall not discharge the trustee where the trustee has not fully disclosed the rights of the beneficiaries.
4) The trustee should give proper information as to the investment of the trust property/estate.
5) Under an express trust, a trustee has a duty to inform a legatee who becomes entitled to capital or income that he has an interest in the trust funds.
6) A retiring trustee must produce all documents and entries relating to the estate to his successor.
7) The trustee is under a duty to furnish auditors appointed by the beneficiaries with all the information in their possession pertinent to the audit process.
8) The trustee must allow the beneficiaries:
    a. To inspect the accounts and other documentations
    b. To investigate the accounts
    c. T o take copies of the accounts and vouchers.

4.3 Rights of beneficiaries

In addition to those cited above,

a) To examine any investments, secondary securities and anything else held by the trustee.

'Beneficiary' may inspect the books either personally or by agent properly authorized so to do.

Has a right to investigate the accounts make any inquiries thereon and ask any questions regarding the accounts to which he is entitled to answers – demands to be reasonable.

To take copies of any documents or accounts that he may need – has to pay for copying.

If the trustee retires or otherwise ceases to be so he must hand over all books and accounts to his successor and the beneficiary have a right to expect such handing over. *Tiger v BBK.*

*Befry entitled to full, accurate and regular information with regard to running of the account amount and state of any funds and property of the estate. If any investments made, belfry has a lot to know the nature thereof and the returns thereon.

see page 39 infra

To examine any 3rd party basis of the trustees' administration of the estate e.g. Legal opinion, stockbroker, valuer, Befry has a right to see the information from the 3rd party.

NB: Befry has no if to expect advice or any form of counseling from the trustee and trustee has no obligation to deliver it.

To receive accounts prepared in good faith that are complete and reflect the trustee's obligations vis-à-vis the trust.

An executor operated under a will is entitled to reflect that appointment. Once he accepts it he is governed by the provisions of the will and any codicil and the provisions of the Trustees Act.

b) When property is left in trust for minors, the income earned from capital investment should be shared between the beneficiaries as per the ratio prescribed by the trust deed or equally for lack of a prescription clause. Income received from accumulated investment should be shared amongst the beneficiaries in accordance with their accumulated account balances at the beginning of the period.

Any amount paid for the maintenance of the minors should be debited in the respective account in the accumulation account. When a minor comes of age, his /her entitlement to the trust capital and accumulation fund must be calculated and appropriate asset transferred to the beneficiary

Procedure in the distribution process

1) Update the accumulation account up to the date of distribution (enter any income and any maintenance payment to this account).
2) Revalue all the assets of the trust and introduce profit and loss of revaluation into the accounts:
a) Profit or loss on revaluation of capital investment is recorded in the trust capital account and shared between the beneficiaries equally;
b) Any profit or loss on revaluation of accumulated investment should be entered in the accumulation account and shared between the beneficiaries according to the accumulation account balances at the beginning of the period.
c) Calculate the amount due to beneficiaries coming of age and transfer that amount from a trust capital account and accumulation account to the distribution account.
d) The amount due to the beneficiaries is paid using the assets of the trust i.e. amount due on trust capital is settled using the capital investment while the amount due on accumulation account is settled using accumulation investment.

4.4 Estate Books

All the accounts of the trustee are contained in the Estate Book (Analogous to the general ledger, it is the book that contains all the accounts of the trust. Once the trustee has completed his role it is the estate Book that remains as the evidence of the dealings of the trust must be retained for at least six years.

Estate Book should have:

i. Documents
ii. Memorandum
iii. Schedule of assets
iv. Schedule of Liabilities
v. Cash Accounts
vi. Income Accounts
vii. Special Income Accounts
viii. Investment Accounts
ix. Apportionment Accounts
x. Distribution Accounts

Documents

The purpose of keeping a separate record of documents is to ensure that any documents relating to the trust shall be properly kept and available to the beneficiaries and any other interested party the record of documents will justify the action taken by the trustee on the basis of any action taken and enables the trustee to fulfill the mandate and obligation imposed on him by the will or grant of letters documents which include the will, any *codials any revoked wills any expert opinion/advice sought pursuant to the running of the estate (e.g. with regard to investment),the grant of probate, grant of letters of administration, gazette notices, adverts , court orders of any nature, proceedings in any relevant matters, any applications for revocation of will, certificate of death etc.

The information must be *complete* and *accurate*

Memorandum

This consists of notes containing various items of information which may prove valuable to the trustees. e.g. details of the testator's family, domicile, administrative issues, interests of the beneficiaries which may include gift *intervivos*, bankruptcy etc. It provides a convenient record of all the miscellaneous pieces of information which may be needed during the course of the trust.

It is comparable to the general journal in commercial accounts. In many ways the memo is also the book of prime entry.The memo contains a narrative of everything done by trustee.

It must contain:

a) Details of the deceased, date, place of death, domicile
b) Beneficiaries of the estate giving details of their status e.g. wife/wives, age, children(date of birth, age, current marital status other beneficiaries (parents, grandparents, grandchildren), details of any other beneficiaries not relates to the deceased e.g. charity
c) Anything that may have happened to the estate prior to trustee's assumption of his duties especially where the decease died intestate.
d) Any other information relevant to the running of the estate.

Thereafter the memo must record anything else that the trustee does in the administration of the trust e.g. when the schedule of assets is drawn up, that fact must first be reflected in the memo when grant applied for, adverts, date of grant etc.

MEMORANDUM

NO.	DATE	PARTICULARS	FOLIO
1	1/1/96	On 30 November 1995, Mr. X the testator died in Nairobi domiciled in Kenya leaving a will having died intestate	P.1 documents
2	1/1/96	Deceased left survivors (1) Mrs. X aged 54 (2) Children of the marriage viz; (a) B. 11 February 1964 unmarried (b) B. 13 December 1967 at Nairobi married (c) B. 1 August 1982 at Nairobi unmarried (3) His parents – D and E aged living at Kakamega	Doc 7 birth certificate Doc 9-b.c. Doc11-b.c
3	1/1/96	On 20 December 1995 probate of testator's will dated 10 February 1996 was granted by the H.C sitting at Kakamega HCSUCC. No. -/95 granted to Executor.	Docs – 13
10	14/4/96	On 12 April 1996 paid off the balance of the loan at KCB Moi Avenue branch Nairobi in settlement of the liability recorded in the schedule of liabilities.	See , schedule of liabilities, cash account
30	17/6/96	On 14 June 96 closed off the investment accounts, apportionment accounts and distribution accounts having finally distributed the estate to the beneficiaries and having acquires from each of the beneficiaries appropriate receipts and executed letters accounts	Folio reference for receipt of letters of discharge (Documents)

31		Having finally closed off all the accounts the responsibilities of the executor terminates and the records are duly closed.	

NB: The objectives are of maintaining trust accounts are two folds

i. Competencies – the trustees should be in a position to formulate, populate and maintain the accounts

ii. The trust accounts should be accurate to portray the true and fair state of affairs.

NB: In finally settling the Estate by way of distribution, the receipts and letters of discharge serve the role of discharging the trustee from any claims.

Schedule of Assets

An itemized list of all the assets of the estate and the value applied is the nominal.

Records all assets belonging to the testator at the time of his death e.g. land or other real property, any personal chattels, moveable assets(motor vehicles, shares, bonds, bills, negotiable instruments any cash assets(bank accounts or other form)

The primary objective of Schedule of assets is to ensure that all assets of the deceased are recorded and not heat the trustee imagines are the valuable assets of the Estate.

Investments should be given their full title, including any redemption dates, to prevent mistakes arising in case of similarities.

Also to record all the assets in a manner that will enable the trustee to get their true and release value e.g. debtors

SCHEDULE OF ASSETS IN THE ESTATE OF

NO	**DATE**	**PARTICULARS**	**CASH ACCOUNT**	**MEMO**	**OTHER**
1.	1/1/96	Freehold parcel of land No. LR________ situated in Nairobi 2 acres		Item No.	
2.	1/1/96	1000 ordinary shares in ABC Ltd of par value KShs 20		Item No.	
3.	1/1/96	Motor vehicle make P/U reg No. --------------			Log book document account
4.	1/1/96	Freehold land in Taita Taveta LR No-------------- with 200 bushes of coffee			
7.	1/1/96	Account no ----------at KCB Moi Avenue branch with KShs 750,000	Opening balance		
8.	1/1/96	Cash in hand KShs 100.000	*	*	

At the end of the trustee's accounting year prepare a summary of the assets of the Estate

16.	11/3/96	Collected KShs 40,000 from Mr. W a debtor of the deceased deposited at KCB	*	*	
20.	15/4/96	Paid off the tenant for the first installment of KShs 35,000	*	*	Income account
70.		In accordance with the will freehold in Taita divided between A,B & C in equal proportion registered thus		*	Documents accounts

NB: *Balance in the books should be nil because all assets have been distributed.*

Example 1

Using the correct form show the entries to be made in the memorandum schedule of assets and cash account in respect of the lawful payment of KShs 150,000 made by the trustees to Mr. Otieno, one of the remainder men in order for Otieno to set up a legal firm in Kisumu.

Schedule of Liabilities

Also prepared by the trustees upon the death of the testator. It lists all liabilities that may be identified by the trustee as owing by deceased.

During the administration of the trust new liabilities may rise and old ones settled, these changes must be reflected in the schedule of liabilities.

At the end of every trustee's year the schedules of assets and liabilities must be brought up to date by taking into account any *motors in them and the balances carried forward to the subsequent year.

NB; *the lists of assets and liabilities do not in themselves indicate that the trustee has wither acquired possession of the assets or has accepted the validity of the listed liabilities. The lists are merely recognition of the existence.*

The legal responsibilities accrue to the trustee, ex, or administrator upon the happening of a specific event to be recorded in the memo.

SCHEDULE OF LIABILITIES

This shall include such information as amount borrowed, rate of interest, mortgage, (debts due by the deceased at the time of death and any other liabilities arising later by the trustee and charges arising by operation of law etc.

No	Date	Particulars	Amount	Cash A/C	Ref
1	14/4/95	Liabilities as at date of death loan from EABS mortgaged on LR No. 209/805/1/ Nrb dated 1 February 1989 interest payable at 16% ½ yearly	300,000		Memo folio No. 1
2	24/4/95	Medical expenses owing to Dr.Shah	115,000		memo
3.	24/6/95	Loan account at KCB secured on motor vehicle P/VKAC 814A chattel mortgage dated 01 June 1993. Interest payable at 12% monthly amount outstanding.	87,500		
4.	24/6/95	On 28 April 1996 borrowed KShs 10, 000 from K.C. Finance Ltd to pay doctor's medical fees listed as items 2 above.	10,000	Folio No.*	Description xxxxxxxx
10.	12/8/95	Paid off Dr.Shah's entire medical Bill KShs.-----------		Folio No.	Explanation
14.	30/9/95	Paid off part of the loan owing to EABS	150,000	Folio No.	Explanation

At the end of the trusteeship the liabilities will be nil.

The Cash Account

This is a crucial part of the Estate Book kept by trustee.

It is comparable to the cash book kept by the accountant in commercial enterprise.

All cash transactions i.e. receipts and payments are recorded in the cash account. The cash received (receipts) is debited acknowledging the trustee responsibility to account its possession while payments are credited. The rationale of debiting receipts is due to the fact that the trustee is *pro tanto* a debtor of the beneficiaries. Similarly, a payment made on behalf of the estate reduces this indebtedness therefore credited.

Unlike the lists of assets and liabilities the cash account automatically gives rise to legal assets and liabilities for the trustee. A debit entry in the cash account is an acknowledgement by the trustee that he has received and is liable for the cash received as recorded. Any credit entry is a statement that the trustee has applied the funds of the trust in accordance with his legal obligations

The cash account also operates as the capital account in contradiction to the income account. But: the cash account will also record income relating to the tenant for life and other beneficiaries that may be named in the will

In the case of capital and income accounts, the total of the debit will normally be greater than the credits. A credit balance may mean that the account is overdrawn.

It is possible that the cash account may have a nil balance before the termination of the trusteeship.

Since the trustees are the accounting parties, accounts sent to the beneficiaries should be headed "The Executors in Account with the Beneficiaries".

The cash account must indicate the nature of the transaction that is taking place. The cash book will indicate the source of money as an asset, liability or income.

CASH ACCOUNT

NO	DATE	PARTICULARS OF RECEIPT	FOLIO	AMT	NO	DATE	PARTICULARS OF INT	FOLIO	AMT
1	1/2/95	Assets Cash in hand	SCA Memo		1	1/2/95	Liability Payment of outstanding doctor's fees	SC.L Memo	115,000
2		Proceeds from life insurance B.A Life Policy No---		1.2m	2	30/4/95	Income Payment to the tenant for life for monthly rent	Income A/C Memo SCL	15,000
3		Income Quarterly rent in relation to hse No--------- on LR--		60,000	3		Advancement to A Befry	Memo SCL. A D/bank	
4		Liability Borrowing from ABC to pay medical expenses		10,000					
5		Cash at Delphis Bank current Account No------		3,720					
6		Capital Proceeds from sale of commercial plot No.		125,000					

Income Account

The income account is so called in contradistinction to the cash account operating as a capital account in relation to the matters of the estate the tenant for life is entitled to income whereas the remainder men are entitled to the capital of the estate.

Income takes the form of a cash account to which income received is debited and expenditure of a revenue nature credited. Where the residue is left to one or more persons absolutely, there is no need to separate income from capital items.

The income account with record the payments made to the tenant for life.

The residue in the cash account is distributed to the remainder man and the tenant for life is not entitled to the distribution of the *capital residue in the cash account*

Besides the income account there may be a special income account(s). The S.I.A is different from the income account in that whereas the tenant for life is in law entitled to income, the testator may make a specific provision for income to be paid to someone in addition to the tenant for life.

That the other person will have all payments made to him recorded in a special income account.

Where there is income from a source which is not to be paid out to the tenant for life and which is specifically devised by the testator to a particular benfry other than the tenant for life.

In either event all payments must first be recorded in the cash account and then cross-referenced and recorded in the income account or special income account as the case may be.

In preparing the income account and the SIA account it may be necessary for the trustee to record the entries in the apportionment account will record the apportionment of income/expenditure between successive beneficiaries if any income is distributed between the tenant for life and a remainder man, it will be necessary to record that apportionment of the payments between the respective beneficiaries in apportionment account.

The apportionment account will also record and distinguish between receipts and payments of an income nature and capital expenditure nature. This is because of an income nature are an entitlement to the tenant for life whereas receipts of a capital nature are due to the remainder man.

E.g. rental income from a house forming part of the Estate due to tenant for life proceeds from sale of that house are of a capital nature and are the entitlement of the remainder men.

INCOME ACCOUNT

NO.	DATE	PARTICULARS	FOLIO	AMT	NO	DATE	PARTICULARS	FOLIO	AMT
1.	30/4/95	payments of first installments of quarterly payments on house rented on LR----------	Cash book memo	60,000	1		Rates		
2		Payment of portion of dividends received from United Farmers Limited for the year ending31/12/94	SCA Memo Cash A/C App A/C	8,500	2 3		Production to tenants for life Repairs		

The income account records the entitlement of the tenant for life in the estate of the deceased.

A record in the income account records a dual purpose for the trustee:

Admission that he recognizes the liability to the tenant for life

A record of payment made to the tenant for life. It is *ev of the discharge of the responsibility of the trustee to the tenant for life.

4.5 Investment By Trustee

What nature of investment may the trustee engage in with the resources of the estate of the deceased?

What roles, if any, govern the conduct of the trustee vis-à-vis his role as an investor?

The position at common law was that the trustee was under a duty only to account for of the trust fund as he had received it. The role at common law was primarily that of a trustee as steward of the trust fund. The nature of that duty was defined in a will where it was intestate death the duty was as defined by the common law.

The principal focus of the common law then was that the trustee was primarily involved.

In administering land. The standard of care was that the trustee must administer the land as he would his own.

Towards the end of the 18th and early 19th as a result of the land revenue the role of the trustee widened. The focus now became not just land but capital for which the trustee was a steward.

By 1948 when the Trustee Act was passed it had become acceptable that the duty of the trustee went beyond the tenant for life and the remainder men.

The responsibility of the trustee remained one of the fiduciary nature even with the power to invest. The trustee was bound to act in good faith exercising such prudence and care in the role of investor as would result in the maximum benefit to the persons entitled under the trust. But the trustee had an additional duly over and above prudence and care i.e. to ensure that all persons entitled under the trusteeship would get a reasonable and comparable benefit from the investment by the trustee.

In relation to the investment the trustee was duly-bounded to seek advice on the best investment but to exercise a decision upon that advice and not merely to follow it blindly.

The trustee could only invest in authorized investment but the fact that the investment chosen by the trustee was authorized by statute did not absolve him from the responsibility of ensuring that it was the best choice for investment in the circumstances i.e. it would not afford the trustee a sufficient defense for wrongful investment for him to say that it was authorized investment.

On the other hand, the chances of proving whether or not an investment was the best in the circumstances vests in the beneficiary alleging that the trustee did not make the best choice in the circumstances.

Kinds of Investment

The trustee can only invest in authorized investment i.e. in the will or by statute.

The Trustee Act (Cap. 167) at S.$ provides for authorized investments included funds in the hands of the trustee whether at the time they come to him they are in the form of Investment or not Authorized investments may further be categorized into fixed interest investments and wider range investments.

Section 2 of the Trustee Act defines fixed interest investment (security) as:

A security which under its terms of issue bears a fixed rate of interest of;

A mortgage of immovable property or;

A deposit whether fixed item of otherwise with a bank or financial installment, building society of Kenya Posts Savings Bank.

A wider range security (investment) is designed in the schedule to the Trustee Act as a security other than a fixed interest security.

Authorised Fixed Interest Investments

Any securities in which trustees in England are for the time being authorized by the law of England to invest trust funds.

Any securities the interest on which is for the time being guaranteed by the UK Parliament or by the Government of Kenya or in any public debentures issued under the authority of and guaranteed by any Act of parliament.

Any security given by a city or municipal council established under the provisions of the Local government which the Minister has by notice in the Kenya Gazette has declared to be a trustee security for the purposes of this Act.

Any security issued by Kenya Railways

Any security issued by or any loan to the Industrial Development Bank Limited.

The purchase of immovable property in Kenya held for an estate in fee simple or for a term of a year of which not less than 40 years is unexpired and which is not subject to a rent exceeding 4 percent of the unimproved value or to conditions of reality except for non-payment of rent.

Wider Range Securities

Section 4(d) any security being a security the price of which is quoted on a recognized stock exchange in Kenya.

Qualifications

A company registered under the Companies Act

Its total issued and paid up capital must be less than KShs 10 million

The company must have paid divided for all its shares which rank for dividend in each of the 5 years immediately preceding the year in which the investors made provided. The Registrar of

Companies by notice in the Gazette certifies any company to be the successor of any former company for the purposes of this section.

Any dividends paid by the former company will then be deemed to be dividends paid by the successor company.

Section 4(e) any units or other shares of the investment subject to the trust of a unit trust and the meaning of the Unit Trust Act and registered under section 7 of that Act (Cap. 521)

Unit Trust defined in Cap 521 as any scheme or arrangements in the nature of a trust in pursuance where of members of the public are invited or are permitted as beneficiaries under the trust to acquire an interest or undivided share in one or more groups or blocks of specified securities and participate proportionately in the income or profit benefits derived there from.

Section 4(f) any shares of a building society this is considered a wider range security because it is up to the trustee to decide the nature of the share to be purchased even though it has to be in a building society.

E.g. ordinary shares which are not a fixed interest investment (any entitlement to dividends when the board declares the same).

Non-cumulative preference shares not a fixed interest investment

Further the safeguards afforded by section 4(1)(d) vis-à-vis the quoted companies are not available under paragraph (f)

Operation of Investments

When a trustee decided to invest he must divide the trust funds into two rule 3 of the schedule to the Trustee Act provided on how the trustee is to divide the trust fund

A trustee may not make or retain any wider range security unless the trust fund had been divided into parts referred to as the fixed interest part and the wider range part, the parts being equal in value at the time of the division.

(Division will become necessary only when the trustee intends to retain or make wider range investments.Also there must exist fixed interest securities before you can make wider range investments)

The main level of fixed interest investments will always be 50 per cent of total investment

Rule 3(ii) (And) where such a division has been made no subsequent division of the trust fund shall be made for the purposes this schedule and no property shall be transferred from one part of the trust fund to the other unless whether (a) the transfer is authorized or is required by the provisions of the schedule or (b) a compensating transfer is made at the same time

Rule 3 is intended to ensure that the investment made by the trustee are safe and that they afford reasonable and fair benefit to the tenant for life and the remainder man.

Fixed interest securities are attractive to the remainder man because of the guarantee (to) given their value and there also attractive to the tenant for life because of the interest which though conservative is guaranteed.

Wider range securities will primarily be attractive to the tenant for life because of the high interest returns but there also acceptable to the remainder man because of the controls afforded by section 4.

Rule 3 also forces the trustee to divide the trust and to keep it separate.

A compensating transfer means that its funds have been invested in fixed interest securities.There must be a corresponding investment in the wider range securities.

Application Rules

Rule 1

No transfer may be made from either of the account save as is expressly provided by the rules or a compensating transfer is made a transfer in the opposite direction of property of equal value.

NB; if the trustee transfers any interest accruing on a fixed interest investment to wider range securities then he must transfer an equal amount from the wider range securities be it income (interest) or the wider range investment itself.

Rule 2:

No more than ⅛ part in value of the trust fund or the sum of KShs 10, 000 whichever is the greater shall be invested in the securities of any one company or unit trust.

The purpose hereof is 3 folds

Because it relates to wider range securities the trustee has a much wider discretion as to what security he may interest in

Though section 4 of the Act already has safeguards on the appropriate wider range securities, the section does not provide for the level of investment in any one security.

Rule 2 depends on the risk (to be) incurred by the Estate though the trustees exercise of discretion investment.

Rule 2 read together with rule 7 affords the Estate maximum returns on Investment in wider range securities.

Valuation of the investment so as to maintain a 50/50 equilibrium as required by Rule 3.

Rule 6 provides that the trustee will not be held responsible for any difference between the actual value of an investment and the valuation price so long as the trustee obtains a valuation in writing firma person he considers reasonably qualified to make such a valuation.

Rule 7 makes detailed provision on the advice to be sought by the trustee on investment matters. He must have regarded to:

i. The need for diversification of investment of the trust in so far as is appropriate to the circumstances of the trust.
ii. The suitability to the trust of the investments of the kind pro–posed and the investments proposed as in investment of that kind.

The role imposes a 3 folds obligation:

i. The trustee must consider the issue of investment globally so that the sum total of investment is as diversified as possible.

ii. But at the very minimum meeting the *codous of rule 2 of the schedule

iii. Suitability to the trust of the investment of the kind proposed. Different trusts will have different characteristics which must be borne in mind e.g. if only one beneficiary, the distinction between income and capital is immaterial because everything goes to one person.

Rule 7(1)(b) suitability of the investment proposed as an investment of that kind.

Investment Account

Fixed Investment Securities

Date	Investment	Folio	Amount
1/1/96	House on Plot No LR--------	Memo – P.1 Schedule of Assets	4.5m
1/1/96	Deposits held at KCB Account No fixed deposit	Memo Cash Account S.A	2m

Wider Range Securities Investment Account

Date	Investment	Folio	Amount
1/1/96	Shares held in Brooke Bold Ltd	Memo	100,000

4.6 Apportionment Account

Apportionment refers to the need to apportion any income that may be accruing to the estate between the various beneficiaries of the estate who have different entitlements under the law.

At common law the law did not recognize any income accruing to an estate as accruing on a day-to-day basis save for any interest earned on money lent out of the estate.

Under common law the tenant for life was only entitled to interest earned on monies lent out of the estate. Any other income is presumed to be appreciation on capital and was the property of the remainder man only. This situation was obviously unfair on the tenant for life because there were other forms of income which with time were comparable to interest on money lent out.

Throughout the 19th century statutory attempts were made to remedy the common law position culminating in the Apportionment Act 1870 which now makes provision as to how apportionment is to ne made statute of general application now applied in Kenya.

The Act provides at section 2 that all rents dividends and other periodical payments in the nature of income we like interest on money lent out to be considered s accruing from day to day to apportioned accordingly in respect of time. By there is provision, apportionment was extended form merely interest on money lent to cover matter such as rent, ammenities dividends and any other periodic income.

Appointment may now be analyzed under the heads of statutory Apportionment (pursuant to the Act) and Equitable.

Statutory Apportionment

Is there apportionment on income accruing to the estate pursuant to the provisions of the 1870 Apportionment Act.

Because the focus of section 2 of the Act besides extending the preview of periodical income, is accrual on a day to day basis, statutory apportionment is also called apportionment in times basis

May: be defined as the allocation of income accruing to the estate to two or more beneficiaries on the basis of time on the entitlement under the will. The tenant for life is entitled to income that accrues firm the estate whereas capital is an entitlement of remainder men.

If the trustee is only overseeing a trust with only one beneficiary, then the question of apportionment does not arise. Similarly if there is no dispute issue as to whether income relates to the period prior to or after the death of the testator, then the question of apportionment does not arise.

The issue of apportionment will only arise when income relates to a period prior to the testator's death. The 2 question that the trustee must answer upon receipt of any monies are

To what period of time does the income relate?

When was the income received by the estate? (When did the income accrue to the estate?)

The following rules will apply to distribution upon answering those questions

All income received prior to the testator's death will be treated as capital income irrespective of the period to which it relates i.e. there is no concept of prepayments of income to the estate so long as at the time of the testator's death the income had been received and formed part of the assets of the estate.

E.g. if the testator had entered into a lease agreement in relation to property of the estate for the period 30 September 1995 – 30 September 1997 at a monthly rent of KShs 10, 000 payable to fill in advance and the money was received on 1 October 1995 and the testator died on 1 January 1996.

Monies accruing to the estate prior to the testator's death are treated as capital irrespective of when the actual cash is received. Furthermore, if the income accrues prior to the testator's death it will be regarded as capital irrespective of the period to which it relates.

E.g. in above example if Jesse pays on 30 September 1996 the money still forms part of capital and is entitlement of the remainder man.

Example 1

Onyango enters into a lease agreement covering the period 1 October 1995 to 31 March 1996. Onyango the lesser, agrees with Rashid, the Lessee, that the monthly rent payable shall be KShs 60,000 Onyango dies in R.T.A

On 1 January 1996 and appoints you executors of his will. How would you apportion income if:

i. Rashid had paid 6 months rent in advance on 1 October 1995
ii. The lease only provided for payment of one month's rent in advance but Rashid had opted to pay the entire 6 month's rent in advance but had not yet made payment at the time of the testator's death;
iii. The agreement provided for payment of one month's rent in advance nor payment had been made at the time of testator's death and you receive full payment on 31 March 1996
iv. The lease was silent as to the time of payment of monthly rent also payment has been made to date?

Rules of Equitable Apportionment

Courts of equity have stated that where statutory apportionment is not fair between tenants for life and remainder man the rules of equitable apportionment will apply.

Where statutory apportionment or apportionment on time basis does not achieve a fair distribution of the benefits to be enjoyed form the estate of the deceased, equity had intervened with rules of equitable apportionment.

The property orientation of these rules is that statutory apportionment presupposes a fairly wide discretion on the part of the executor/trustee in exercise of his duties under trust. However the rules of equitable framework with which the executor exercises that discretion,

The rules of equity attempt to interpret the best wishes of the testator not expressly provided in the instrument appointing the executor

Rule 1 Howe v Earl of Dartmouth (1802) 7 Vs 137

Provides that where on the death (of the testator) there is residuary personally that may be of wasting, future or of a reversionary interest in character or which constitute unauthorized securities. After payment of general and testamentary expenses relating to the estate of the decease to invest the balance in authorized securities. The testator may however expressly empower the executor to postpone the need to convert as contemplated by *Howe v Earl of Dartmouth*.

Rule 2

Where there is a duty to convert in accordance with the rule in *Howe v. Earl of Dartmouth* and there is no specific power to postpone conferred on the period between the death of the testator and the actual conversion of the assets, the issue of apportionment of income will be governed by the rule in *Re Fawcett* (1940) ch. 44F which sates: Between the death of the testator and the actual conversion of assets in accordance with the Rule in *Howe's* case, the executor will provide a notional valuation of the assets and apply a base rate of interest as income accruing to the tenants for life at the end of the period.

In *Re Bech* (1920) I cl the recommended interest rate to be applied was set at 4 percent of the residuary notional value. This rate has been applied all along even though it has been recommended to raise it to 8½ per cent no statutory provision to this effect has been made. Rate remains at the discretion of the court of equity.

Rule 3*. *Rule in Re Parry's Case (1947) Cap. 41 where the will gives the executor the power to postpone conversion and the executor exercises the power, for the purposes of determining income to be paid to the tenant, the value of the estate will be presumed to be that of the estate at the time of death of the testator.

NB: Rate of interest 4 percent due to tenant for life as income.

Rule 4

Where actual income received by the executor is in excess of the tenant for life's entitlement upon application of *Re Fawcett* or *Re Pary,* then the tenant for life only receives his entitlement as computed and any surplus is capitalized.

If on the other hand the tenant for life is entitled to more than what is actually received the tenant for life is paid actual proceeds of income and any deficiency is paid from future surplus income.

Rule 5 Rule in Earl of Chesterfields Trust (1883) 24 Ch.643

Provides that where an asset is subject to conversion in accordance with the Rule in *Howe's* case but if earns no income and the executor has either exercised the right of conversion or has postponed conversion at the time of conversion income is to be computed as follows:

The proceeds of the conversion we assumed to have both portions of capital and income. In order to determine the income portion, it is assumed that the capital element was invested at the time of death at its value then, and that has accrued interest in the interim.

That interest is earned on a compounding basis between death and conversion.

Hotchpot

The device used for distributing property amongst persons in predetermined proportions after taking into account property received by them previously whether from the same or another source.

E.g. children who have received advances two situations

i. where sons never formed part of estate grants advanced in deceased's lifetime
ii. Sons apportioned/advanced out of settled funds.

NB; Hotchpot clause in will allows testator to make gifts without altering the will.

Re Morley (1895) 2 ch. (Application of Chesterfield's Trust)

The court held that the proceeds of a life insurance policy were also subject to the role is they are paid after the death of the insured (testator)

The rule has also been applied to director's emoluments which were due to the deceased.

Re Paine (1943) 2 AII E.R.675

Lump sum paid after director's deaths were subject for the Rule in Re Chesterfield's Trust.

Rule also applicable to sale of testator's business received after his death.

The Distribution Account

The purpose of the distribution account is to show the final realisation and distribution of the funds subject to the trust. In a single column record, each remaining asset and liability at the value which is attached for the purpose of distribution.

The net columns are then divided in the proportions to which each legatee is entitled to, adjusting for any assets or liabilities taken over by individual beneficiaries. The net cash sum payable to or by each can then be determined.

The purpose of the trustee in administering the Estate of a deceased person is three fold:

- To establish and secure all assets and liabilities of the estate of the deceased at the time when the trustee assumes his duties as executor or administrator.
- To administer the estate of the decease fairly and evenhandedly so as to benefit all beneficiaries of the estate as equally as possible.
- To distribute the deceased's estate to the legitimate and genuine beneficiaries

During administration of the estate under 1 and 2, the entire Estate book is open and operational but at the third stage of distribution. The objective of the trustee is to pay off all the estate's liabilities and distribute the remainder to the rightful persons.

At the stage when the trustee wants to close the trusteeship and distribute the net estate, the following will be borne in mind

Under section 34 of the Trustee Act the trustee is at liberty to exercise the power of advancement of any part of the capital of the estate to any of the remainder men so long as this will be taken into account at the time of distributing the net estate.

The power of advancement enables the trustee to advance money to the remainder men before the time comes for distribution of the account.

A trustee enjoys the power of distributing the estate right from the time he accepts the trusteeship. I.e. statutory power the testator cannot fetter the trustee's power of advancement even by express provision in the will or codicil.

At the time of actual distribution the first thing will be to ascertain that all advancement have been taken care of in the Estate Book.

All the accounts in the Estate Book should be closed and bring down all the balances to the distribution account. He will close the cash, income, special income accounts schedule of assets and liabilities, apportionment accounts and bring down all balances to the distribution account.

Most likely the income and special income accounts will have no balances at all. The effect of this closing down is to enable the trustee establish the net worth of the estate;

Total Assets + Cash less Total Liabilities + Expenses

It is the net worth of the estate that is distributable to the beneficiaries.

Once the net worth has been established the next priority is to settle all liabilities of the estate to third parties.

Establish what authenticity of the claims of the claims of each beneficiary and then compose their entitlements either in accordance with the will or the law.

The trustee will then seek to have the beneficiaries reach an agreement as to how their entitlements to the estate will be paid to each of them. The beneficiaries may agree to share out the estate in specie and any shortfall or surpluses of any benfry to be offset in cash.

Alternatively, if they cannot agree on the sharing of the assets in specie the trustee will be obliged to convert all the assets into cash and distribute the same.

Example 1

Mr. Makathimo a widower dies intestate leaving 3 sons Mark, Martin and Marcus who are all aged over 18 years. Under the Law of Succession Act (Cap 160) the late Makathimo's estate falls to be distributed between the three sons in equal shares absolutely. The net estate comprises the following:

- A House on L.R 209/129 Nairobi which the valuer has assessed at KShs 300,000
- A motor vehicle valued at KShs 200,000
- Cash on the bank of KShs 10,000
- Ordinary shares in Bata Limited worth Ksh.10,000
- Personal effects worth Ksh.41,000
- The estate owes KShs 50,000 to EABS for the mortgage on the house.
- Estate owes KShs 1,000 to advocate in fees.

It is decided and agreed between all the beneficiaries that Mark will take the house in Specie and Martin will take the ordinary shares in Bata Limited in *specie.*

Draw up the distribution account.

(Next Page)

DISTRIBUTION ACCOUNT

THE ESTATE OF MAKATHIMO (DECEASED)

NO	PARTICULARS OF ASSETS AND RECEIPTS	FOLIO	KSH	NO	PARTICULARS OF LIABILITIES AND PAYMENTS	FOLIO	KSH
1	From the Schedule of Assets l..R 209/129 Nairobi	SA 11 M20	300,000	1	Mortgage	SLM	50,000
2	Motor vehicle	SA 11 M20	200,000	2	Legal Fees		1,000
3	Cash Account Cash in Bank	CA 6	10,000		Mark's Share		170,000
4	Investment account Shares in Bata Ltd	SA.9	10,000		Martin's Share		170,000
5	School of Assets Personal Effects	SA 11 M20	41,000		Marcus's Share		170,000
			561,000				561,000

After the trustee has opened the distribution account and closes of the accounts in the Estate Book the memorandum is not closed.The trustee will keep the books open for a further 6 years.

If any event takes place after the distribution the same must be recorded in the memo.

If any monies are received the cash account must be re-opened and if any assets are acquired after the distribution the schedule of assets should be reopened etc.

If any advancement s had been made to any remainder man before preparation of the distribution account the same will be treated as assets i.e. a debt owed to the estate by the remainder man

The primary event available to the trustee in the event of any claim by a benfry either of non-payment of dues on distribution or any fraud/negligence will be the Estate Book.

Even distribution will be a receipt plus a discharge letter discharging the trustee from any further liability after the payment. These documents will be filed in the documents section of the Estate Book.

Example 2

Michael dies leaving a will under which 3 of his children April, May and June are given equal shares of the residuary estate before the estate is wound up, June requires funds to open a dentist's practice and she is loaned KShs 20,000 from the estate.

Estate

		KShs.
a)	House on plot No. 321 Nyeri	200,000
b)	Michael's personal effects	10,000
c)	Cash at Bank	10,000
d)	300 shares in KCB	30,000
e)	Debt of KShs 50,000 to savings and loan limited mortgage on Nyeri House KShs 50,000	
f)	Debt of KShs 2,500to Harassed & Company	
g)	Advocates in Legal fees	

The beneficiaries have agreed that the mortgage debt will be taken over by April, May will take the personal effects and that the KCB shares will be transferred to June.

Draw up the distribution account

In the Estate of Michael

Distribution Account

NO	PARTICULARS	FOLIO	AMOUNT	NO	PARTICULARS	FOLIO	AMOUNT
1	From The Schedule of Assets House on Plot 321 Nyeri	SA 10 M.4	200,000	1	Mortgage		50,000
2	Personal Effects	SA 10 M 4	10,000	2	Legal fees		2,500
3	From Investment Account 300 shares in KCB	IA 9 M 6	30,000	3	April's shares House 200,000 Less*Mor 50,000 150,000 Less amount paid to Estate 77,000 72,500		72,500
4	From Cash Account Cash in Bank	CA	10,000	4	May's share Personal 10,000 Add *frm 62,500 72,500		72,500
5	Advancement to June	M	20,000		June's share *Adv 20,000 Shares 30,000 *FrmEst 22,000 72,500		72,500
6			270,000				270,000

- **Memorandum**

This consists of notes containing various items of information which may prove valuable to the trustees, for example, details of the testator's family, domicile, administrative issues, interests of the beneficiaries which may include gift *inter vivos*, bankruptcy etc. It provides a convenient record of all the miscellaneous pieces of information which may be needed during the course of the trust.

- **Schedule of assets**

An itemized list of all the assets of the estate. The value applied is the nominal rather than the

Investments should be given their full title, including any redemption dates, to prevent mistakes arising in case of similarities.

Rent and interest

No.	Particulars	Remarks	Cash a/c	Memo

- **Schedule of liabilities**

This shall include such information as amount borrowed, rate of interest, mortgage, (debts due by the deceased at the time of death and any other liabilities arising later rose by the trustee and charges arising by operation of law etc.

- **Cash account**

All cash transactions i.e. receipts and payments are recorded in the cash account. The cash received (receipts) is debited acknowledging the trustee responsibility to account its possession while payments are credited. The rationale of crediting receipts is due to the fact that the trustee is *pro tanto* a debtor of the beneficiaries. Similarly, a payment made on behalf of the estate reduces this indebtedness therefore credited.

In the case of capital and income accounts, the total of the debit will normally be greater than the credits. A credit balance may mean that the account is overdrawn.

Since the trustees are the accounting parties, accounts sent to the beneficiaries should be headed "The Executors in Account with the Beneficiaries".

Diagram

No.	Date	Particulars of receipt	KShs	No.	Date	Particulars of payment	KShs

Illustrations

Question One

Elijah Muthee died as a result of a motor accident on 15 November 2011. His estate at death after payment of debts, funeral and other expense consisted of the following assets:

	KShs	KShs
Freehold house	900,000	
Furniture and other personal effects	120,000	
Ornamental collection		12,000
12,000 ordinary shares in Walls Company Ltd		210,000
KShs 100,000 normal 10% Treasury stock 2008		92,000
Amount due from motor insurance company		114,000
Debt due from sally		50,000
Cash in hand and balance at bank		262,000

Through his will executed several years earlier, Elijah Muthee forgave his brother-in-law, Paul, all debts due at the date of his death and made the following bequests:

1. To my wife Grace, my freehold house, furniture and other personal effects no otherwise bequeathed.
2. To my brother William, the sum of KShs 100,000
3. To my good friend Jane Njeri, the sum of KShs 20,000
4. To each of my son Maina and Okello, the sum of KShs 200,000
5. To my daughter Leah, my holding of KShs 100,000 normal 101/4% Treasury stock 2010 and KShs 40,000 to my nephew

Nelson payable out of my holding of 9% Treasury stock 2009

6. To my niece Mary, my holding of 3,000 shares (ordinary) in Walls Company Ltd.
7. To my cousin Rupert, my motor car.
8. To my grandson David, my ornamental collection.
9. To my neighbour Jane Njeri, the sum of KShs 10,000
10. The residue of my estate to trustees, to provide an income for my wife for life and thereafter to my grandchildren in equal shares.

In addition, you are privy to the following:

a) William and Okello both predeceased Elijah Muthee, but their respective children Nelson and David survived him.
b) Jane Njeri, a lifelong friend of Elijah Muthee, had purchased the house neighbouring that of Elijah Muthee and Grace shortly before the execution of the will.
c) There are no such investments as 10% Treasury stock 2010. The date referred to in Elijah Muthee's will is believed to be a typing error not previously noticed.
d) Elijah Muthee had sold his entire holdings of 9% Treasury stock 2009 in November 2008
e) Elijah Muthee's car was totally wrecked in the accident of 5 September 2009, the sum of KShs 114,000 paid by the insurance company represents the agreed value of the motor vehicle at that date.
f) In addition, to Okello's son David, there were five other grandchildren living at the date of Elijah Muthee's death.
g) The Walls Company Ltd changed the par value of the shares from KShs 10 to KShs 5 prior to the death of Elijah Muthee. However, this had no significant effect on the market price of the shares.

Required:

a) A statement showing the distributions of Elijah Muthee's estate. (ignore all income and interest

on legacies)

b) Explain retreatment of the bequests to the following beneficiaries:
   I. Jane Njeri
   II. Leah
   III. Nelson
   IV. Mary
   V. Rupert

Question Two

a) State the fundamental requirements of a valid oral will.

b) Briefly explain the various types of legacies that may be bequeathed by way of a will.

c) Daudi Mvute, a widower, died intestate on 1 January 2006. He is survived by his two sons Mwamba and Mambo and a daughter Asha. His other daughter Furaha predeceased him. Asha is survived by a son, willi and a daughter Amina. During his lifetime Daudi Mvute had advanced his two sons KShs 500,000 each to enable them commence and run a hardware business. Daudi Mvute has also advanced KSh 400,000 to Amina to purchase equipment for use in her hair salon business. The net estate of Daudi Mvute after payment of all the expenses and liabilities on 31 May 2006 was KShs 9,000,000.

Required:

A distribution statements showing how the estate of Daudi Mvute would be shared out.

Question Three

Kiura and Maina are life tenants of a trust set up by their uncle. The trustees have investment powers restricted to those contained in the Trustee Act (Cap. 167 of the Laws of Kenya) except they could hold at their absolute discretion 2,000,000 shares of KShs 10 each in Aspen Co. Limited, a Mineral exporting company run by the uncle.

On 31 March 2010, the balance sheet of the trust was as follows:

	KShs	KShs
	000	**000**
Fixed interest investment:		
KShs 4 million 10% Zheng stock 2011 (cost)	4,000	
KShs 4 million 8% Zheng stock 2010 (cost)	3,200	
Cash at bank	800	
		8,000
Wider range investments:		
60,000 shares of sh. 50 in E.A. Breweries Ltd (cost)		3,000
Special range investments:		
2,000,000 shares in Aspen Co. Ltd. (cost)		3,000
		4,000
Trust capital		5,000
Fixed interest fund		8,000
Wider range fund		1,000
Special Range Fund		14,000

In the year 31 March 2011, the following occurred:

2009

June 23 – Interest received on 10% Zheng stock. School fees for Kiura and Maina were paid immediately using the whole amount received.

August 30 – A final dividend of 75% was received from E.A. Breweries Ltd. (payout rate 10%).

September 28 – The E.A. Breweries Ltd. Shares were sold at Sh. 110 each. At the same time, a satisfactory buyer was found for the 1000,000 shares in Kilimanjaro Aspen Limited – these shares were sold for. KShs 20 each. Some high yielding 12% Zheng stock 2012 was available at par on this date. It was decided to use all the wide range cash available to purchase this stock and designate it a wider range investment.

December 31 – Interest was received for the year on the 8% Zheng stock and sh. 16,000 interest was received on the fixed interest cash at bank.

2010

March 16 – 87,750 KShs 10 ordinary shares in Fontein Limited were purchased for KShs 40 per share using the fixed interest cash and a suitable switch was made to ensure adherence to the requirement of the Trustee Act. The market value of the 10% Zheng stock on this date was still par.

March 31 – All remaining income cash was paid across to the life tenants, after trust administration expenses of KShs 260,000 were paid for the year.

Required:

a) Write up the trust cash account, the income account (showing payments to beneficiaries in this account and the trust capital account) for the year ended 31 March 2010.

b) Prepare the trust balance sheet as at 31 March 2010.

Chapter Five

Costing

5.1 Introduction

Practicing lawyers strive to run successful law firms. One of the determinants of success is the ability to minimize costs so as to maximize profits. In order for the lawyer to run a successful business he/she must understand the various cost drivers and understand how to manipulate them for maximum advantage to be achieved.

In life everything has a cost. Many are the times we presume that since we got the material or product for free then we have naught to cost. We assume time spent and effort put, not realizing they also count. For one to declare a net profit one must understand the costs incurred and subtract them from the income realized.

Costing is a system of computing cost or of running a business, by allocating expenditure to various stages of production or to different operations of a firm. Cost accounting information is designed for managers. The accountants who handle the cost accounting information generate statements which are only discernable by the managers.

Cost accounting adds value by providing good information to managers who are taking decisions. Cost accounting information is also commonly used in financial accounting.

The control of the costs of the past, present and future is part of the job of all the managers in a company. In the companies whose objective is to maximize profits, the control of costs affects directly to them. Knowing the costs of the products is essential for decision making regarding the price and mix assignation of products and services.

Elements of cost

1) Direct material
2) Direct labor
3) Overheads (Variable/Fixed)
    - Indirect material
    - Indirect labor
    - Maintenance & Repair
    - Supplies
    - Utilities
    - Other Variable Expenses
    - Salaries
    - Occupancy (Rent)
    - Depreciation
    - Other Fixed Expenses

Classification of costs

Classification of cost means, the grouping of costs according to their common characteristics. The important ways of classification of costs are:

- **By nature or element:** materials, labor, expenses
- **By functions:** production, selling, distribution, administration, R&D, development,
- **By traceability**: direct and indirect
- **By variability:** fixed, variable, semi-variable
- **By controllability:** controllable, uncontrollable
- **By normality:** normal, abnormal

There are two ways of costing:

1) Standard costing

Standard costing allows a company's management to set operating targets and evaluate actual performance. By setting standard costs and performing standard cost variance analysis, companies can determine concrete ways to improve future operations and can prepare more realistic operating budgets.

To monitor performance and plan operations, management sets standards for resources used in production. Typical resources used in production are: direct materials, direct labor, variable factory overhead, and fixed factory overhead costs. Standard costs for the aforementioned resources are determined as follows:

Illustration 1: Typical standard cost calculation

1. Direct Materials	Standard Price (SP) per Unit of Input X Standard Quantity (SQ) per Unit of Output
2. Direct Labour	Standard Price (SP) per Labor Hour of Input X Standard Labor Hours (SR) per Unit of Output
3. Variable Factory Overhead	Standard Variable Overhead Allocation Rate (SR) X Standard Quantity of Allocation Base per Unit of Output
4. Fixed Factory Overhead	Standard Fixed Overhead Allocation Rate (SR) X Standard Quantity of Allocation Base per Unit of Output

Bibatex Ltd. produces 100% cotton khangas. The company uses one kilograms of cotton to produce two Khangas. The company expects that in January 2011 the price of cotton will be KShs 220 per kg. In December 2010 the company's management determines the following standard cost of cotton (direct materials) used in :

1. Standard price per unit of input = KShs 220 per kg of cotton
2. Standard quantity of input per unit of output = 0.5 kg of 100% cotton per khanga
3. Standard cost of aluminum per unit of output = KShs 220 per kg x 0.5 kg = KShs per kg of 100% cotton khanga.

2) *Activity Based costing*

(ABC) is a system for assigning costs to products based on the activities (the regular actions or tasks performed in the company) they require. The cost of each activity is assigned to all products and services according to the actual consumption by each.

Applicability

Activity based costing helps;

a) To allocate more resources on profitable products, departments and activities.
b) Find unnecessary costs that may be eliminated.
c) To identify inefficient products, departments and activities.
d) Control the costs at any per-product-level and on a departmental level.
e) Fixing the price of a product or service with any desired analytical resolution.
f) And it's a modeling process applicable for full scope as well as for partial views.

Limitations

Applicability of ABC is bound to cost of required data capture. That drives the prevalence to slow processes in services and administrations, where staff time consumed per task defines a dominant portion of cost. Hence the reported application for production tasks does not appear as a favorized scenario.

5.2 BUDGETING

A budget is a document that translates plans into money; money that will need to be spent to get the planned activities done (expenditure) and money that will need to be generated to cover the costs of getting the work done (income). It is an estimate, or informed assumption, about what is needed in monetary terms for work to be carried out.

Purpose

- To control activities.
- To communicate plans to various responsibility center managers.
- To motivate managers to strive to achieve budget goals.
- To evaluate the performance of managers

The process of calculating the costs of starting a small business begins with a list of all necessary purchases including tangible assets (for example, equipment, inventory) and services (for example, registration, remodeling, insurance), working capital, sources and collateral. The budget should contain a narrative explaining how you decided on the amount of this reserve and a description of the expected financial results of business activities. The assets should be valued with each and every cost. All other expenses are like labour, factory overhead etc are also included into business budgeting.

The Operational Plans

This is the plans for the actual work. They are also called action plans or business plans. In a normal planning cycle, the organization or project will begin with a strategic planning process. Identification of the problem that needs to be addressed and the specific role of your organization or project in addressing it. This then is related to what actual activities need to be undertaken to achieve the planned impact. This is the operational plan and it is the operational plan that needs to be "costed." You cannot prepare a budget until you know what it is you are planning to do. Operational costs will only be incurred when the actual work is done. They are also known as direct costs.

Estimating Costs - Categories

The cost estimate is what helps determine realistically what it will cost to implement the Operational plan.

When you carry out your plans you will probably need to make use of a wide range of inputs.

Inputs include people, information, equipment, skills. Most of these inputs will have a cost attached to them. These are the costs you need to estimate in order to develop a budget.

Careful cost estimation helps:

1) Develop an accurate budget; and
2) One to monitor and control the actual costs of carrying out activities.

The costs you need to estimate fall into the following categories:

1) **Operational costs** – the direct costs of doing the work e.g. the cost of hiring a venue, or of printing a publication, or of travelling to the sites where fieldwork needs to take place. Here you would include materials, equipment, transport and services.
2) **Organizational costs** (also called core costs) – the costs of your organizational base, including management, administration, governance. Once you have decided on the best organizational set-up to support your operational plans, you will incur the organizational expenses on a regular basis – even if you do not carry out your plans or have activity levels as high as you had hoped. So, for example, if you hire premises for four projects but only manage to carry out two, you will still have to pay rent for the extra space. If you have hired a full-time receptionist on the same belief, you will still have to pay her salary, even if she is under-utilized.
3) **Staffing costs** – these are the costs for your core staff – the people involved in management, the people doing work that cuts across projects. (These costs can be included as a category under "organizational costs".) These costs include their salaries and any benefits such as medical aid or pension fund payments for which the organization is responsible. You can "charge staff costs out" to the various projects on which the staff members work. So, for example, if your Publications Officer is going to spend half her time working on publications for a particular project, then you can include half her salary and benefits in your costing for the project.

   If your Director is going to spend 15% of her time providing management support to the head of the same project, then 15% of her time and benefits can also be charged to the project.
4) **Capital costs** – these are costs for large "investments" which, while they may be necessary because of a project or projects, will remain organizational assets even after the projects are over. Vehicles and equipment such as computers and photocopiers fit here. They may be used by all projects, or they might only be required for a specific project. Depending on how you intend to use the equipment, you might budget for it under operational costs or under organizational costs.

Types of budget

1) Working budget
2) A survival budget. This is the minimum required in order for the organization or project to survive and do useful work.
3) A guaranteed budget. This is based on the income guaranteed at the time the budget is planned. Usually the "guarantees" are in the form of promises from donors. However, unexpected situations, such as a donor grant coming through very late, may make it necessary to switch to your survival budget.
4) An optimal budget. This covers what you would like to do if you can raise additional money. Once extra money comes in or is promised, it becomes part of your working budget.

Different Budgeting Techniques

The two main techniques for budgeting are incremental budgeting and zero based budgeting.

1) Incremental budgets are budgets in which the figures are based on those of the actual expenditure for the previous year, with a percentage added for an inflationary increase for the new year. This budgeting technique is only suitable for organizations where each year is very similar to the previous one in terms of activities. Very few dynamic organizations or projects are so stable that this budgeting technique really works for them.
2) In zero based budgets, past figures are not used as the starting point. The budgeting process starts from "scratch" with the proposed activities for the year. The result is a more detailed and accurate budget, but it takes more time and energy to prepare a budget in this way unlike the laid back process carried out under the incremental budgeting. This technique is essential for new organizations and projects, but it is also probably the best route to go in a dynamic organization that is proactive in taking on new challenges.

Chapter Six

Tax

6.1 Introduction

The main duty of an advocate is to advise clients, both individuals and businesses, on various subjects which may include tax-related issues, e.g. income tax, estate, property and other taxes owed. The lawyer may be required to represent clients in tax court or help to reduce taxes and penalties owed. A lawyer will advise a client in regard to tax consequences of particular actions, such as buying or selling assets, wills and estates, without actually crunching the numbers.

Give to Caesar what belongs to Caesar and God what belongs to Him. At any one particular point an individual be it natural or artificial should ensure they make the statutory contribution to the country where they are domiciled and working for gain.

In Kenya the **Kenya Revenue Authority** (KRA) was established by an Act of Parliament, Cap. 469 of the Laws of Kenya, which became effective on 1 July 1995. The Authority is charged with the responsibility of collecting revenue on behalf of the Government of Kenya.

The main purpose of KRA is to undertake assessment, collection, administration and enforcement of laws relating to revenue collection. In which case here revenue is basically taxes.

Tax is a compulsory contribution imposed by the government from the people residing or carrying out lawful business in a country. Once collected it is utilized for the benefit of all the citizens. A tax is not levied in return of any specific service rendered by the government and thus a citizen is ideally not in a position to demand for a particular service

The essence of taxation is the absence of a direct quid pro quo equation, thus the taxpayer cannot claim for something equivalent to the tax he/she pays. Taxes are means to cover the expenses of the government and as such they are not levied for a particular purpose.

6.2 Nature and purpose of taxation

Purpose of taxation

1) To raise public revenue
2) Economic stability
3) Fair distribution of resources
4) Protection policy
5) Social welfare
6) Create employment

Canons of taxation

1) Canon of equity

Equity means fairness or justice. It is the most important principle or canon of taxation since it helps achieve justice in taxation.

Adam Smith wrote: "the subjects of every state are to contribute towards the support of the Government, as nearly as possible in proportion to their respective ability; that is in proportion to the revenue which they respectively enjoy under the protection of the state".

Every subject of a state ought to contribute a specified amount based on their ability/in proportion to their revenue. Thus the rationale of the much received in taxes from the rich and less from the poor. This canon also implies equality of sacrifice i.e. the higher the income the greater the sacrifice one is required to submit.

The proper distribution of the burden of taxation is one of the fundamental problems in public finance of modern democratic states.

An attempt to achieve equity in taxation may be through use of the following theories:

a) Purchase Theory

This theory seeks to treat tax as a payment for Public services and payment equal to the cost of the services rendered.

Limitation

1. The method of specific payment for public services does not result in justice in the distribution of the burdens of economic activities of the state.
2. It is not possible to distribute advantages among individuals and to charge them in proportion to the advantage they reap.
3. This theory implies that a citizen is at liberty to refuse the services of the state and by refusing is able to escape the necessity of paying taxes. These implications are unsound.

b) The Benefit Theory

This theory seeks to secure justice in taxation by taxing each citizen in proportion to the benefits he derives from the activity of the state. It is also known as the insurance theory or the Quid Pro quo theory of taxation.

Criticisms:

1. The weak and poor receive greater benefits from the government in the form of free education, health etc yet they are the least able to bear the burden of taxation.
2. It would be unjust to tax the poor in proportion to the benefits of government expenditure that accrues to individuals
3. It cannot apply to taxes but probably to public charges such as fees, special assessments which are levied according to benefits received by individuals.

c) Theory of Equal Sacrifice

This principle seeks to ensure that tax subjects the taxpayers to an equal sacrifice. This is through introduction of principle of progression in the tax system. Tax should impose the least aggregate sacrifice.

Disadvantages

1. It means imposing heavy taxes on a few rich people
2. Such heavy tax on the rich will discourage saving and enterprise

d) Ability Theory

This theory seeks to charge tax to each according to his "ability to Pay".

The Problems which are prone to arise are determination on the basis of the ability to pay, that is, is it property held, income or expenditure?:

If based on property then it is not number but valuation of such property

If based on ones' expenditure, then those with money and a greater number of dependants suffer high taxes in addition to catering for the large number of dependants.

In conclusion thereof, It is noteworthy to appreciate that a single test on ability to pay whether income or expenditure does not amount to Equity in taxation. Various taxes should be imposed on incomes; property ownership and expenditure so as to spread tax burden thus achieve equity.

2) Canon of certainty

Uncertainty is a good breeding ground for corruption thus the need for certainty where taxation is concerned .Every tax payer ought to be certain of how much is required, type of payment, the manner of payment, the procedure involved etc. Certainity also means the government should be certain as to the amount of the tax revenue and the manner in which it is received by the exchequer.

3) Canon of convenience

Convenience in the sense that both the type and mode of tax payment should not inconvenience the tax payer. Currently, VAT is paid only when a person has the means to spend since it is included in the price of commodities, PAYE is only paid once the employee has earned income at the end of the month etc, thus embracing the canon of convenience.

4) Canon of economy

A good tax system should thrive to optimally balance the economy. This can be maintained in two ways i.e.:

The tax system must ensure that when a taxpayer contributes tax he/she is still left with sufficient cash for consumption, savings and investment. Heavy taxes will simply discourage saving and investment and end up undermining the productive capacity of a individual.

Collection cost should not outweigh the tax collected otherwise there will be no point of levying it.

5) Canon of productivity

Taxation should amass a large revenue pool for the government however, care should be employed to ensure that the tax payer is not over burdened otherwise it shall be counterproductive.

6) Canon of simplicity

A tax system should be simple to understand. How to compute it, pay it, when to pay and where to pay should be as simple as paying other bills.

7) Canon of diversity

An economy should have a variety of taxes so that all its citizens contribute towards state revenue according to their ability to pay. However, a large multiplicity of taxes becomes difficult to administer and hence uneconomical.

8) Canon of elasticity

It requires that the government should be able to raise the tax rates when it needs more revenue keeping an eye on the counter effect (inflationary pressure in the economy).

Classification of taxes

The classification may be carried out in three ways:

1) Administrative collection arrangements; Direct & Indirect taxes
2) Tax rates
3) Tax basis

Administrative collection arrangements;

1. Direct taxes

The tax payer remits tax directly to the tax authority. The impact and incidence falls on the same person, that is, it cannot be shifted backward or forward.

Impact refers to the person who has the responsibility of collecting and remitting; while incidence refers to the person who bears the tax burden.

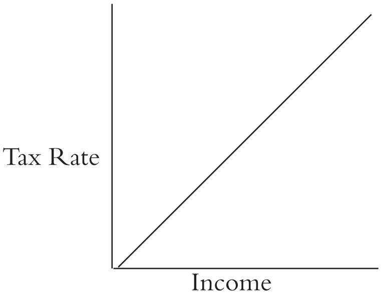
2. Indirect taxes

This tax is included in the product price or price that is unknown to the buyer. The impact could be on one person and the incidence on another through tax shifting.

Tax rates

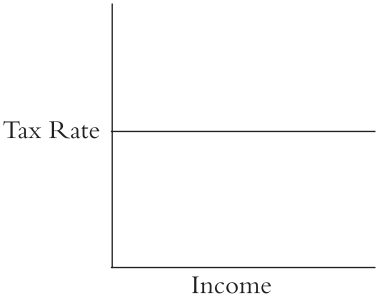
The term tax rate is used to denote the amount of tax per unit of the tax base. The base is the legal description of the object to which the tax applies such as net income, output, expenditure etc.

1) Progressive taxes – A tax that takes a larger proportion of people's income when the incomes are increased. Where income is increased the tax liability not only increases in absolute terms but also as a proportion of the increased income



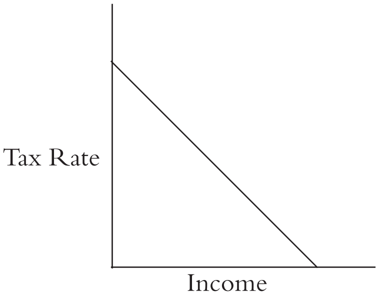
2) Proportional taxes

This is a tax that takes the same percentage of peoples' income irrespective of their levels of income. The tax increases in the same proportion as the increase in income. There's a direct linear relationship between the tax payable and the income earned.



3) Regressive tax

This is a tax that takes a smaller percentage of people's income as the income increases. People who earn lower incomes are taxed heavily than those who earn higher incomes. It implies that the tax rates increases at a decreasing rate with increase in income.



4) Digressive tax

Tax base

A tax base is a legal description of the object on which tax is applied. The object is legally defined in law for the determination of tax liability. E.g. Income tax.

6.3 Income tax

The base of the tax is the income.

Section 3(a) of the Income Tax Act provides that subject to and in accordance with the Act, tax to be known as income tax shall be charged for each year of income upon all the incomes of a person whether a resident or non resident which is accrued in or was derived from Kenya.

Section 3(1) is technically referred to as the charging section. It is the core of any tax legislation. It defines:

a) The law governing the tax;
b) The name of the tax;
c) The tax base (object of taxation);
d) The scope of the tax;
e) The person liable to the tax;
f) The jurisdiction.

The Income Tax Act does not define the term "income" but has provided in section 3 that income be classified by reference to the source from which it is derived. Income upon which tax is chargeable under this Act shall be income in respect of;

1) Employment or services rendered – employment income and professional income
2) Dividends and interests – Investment income
3) Pension scheme & Annuity – Income of retired employees
4) Rents – Income derived from granting others (tenants) rights over immovable property.
5) Income of a married woman – Deemed to be income of the husband
6) Sums recovered from previous years' provisions and reserves.

Tax is charged upon a person's total income i.e. from all sources. Income is not necessarily a receipt of money but rather a profit of an income nature thus certain benefits in kind from employment may be taxed the same as cash emoluments received by way of employment to be taxable which can either be moneys' worth but if money worth is not capable of being turned in money by the person receiving it, such benefits shall not be regarded as income for tax purposes.

Case: *Tennant v Smith*

Facts: A banking company assigned to its agent as a residence a portion of the bank premises occupied by them. The agent was required to reside in the building as the servant of the bank, and for the purpose of performing the duty which he owes to his employees.

Held: The value of the residence is not an emolument of office in respect of which the agent is chargeable with Income Tax.

Lord Morris stated:

> "...The appellant occupies the bank house as a part of his duty, and I do not see how the case can be distinguished from that so aptly put by Lord Young, as of the Master of a Ship who is spared the cost of house rent while afloat. His cabin does not on that account become a part of his income."

Income must come from a designated source that is given and supported by section 15(7)(a). It is on this basis of designated sources that most casual profits or increments are not taxed e.g. dowry, donations, gifts from friends etc. To be taxable the income must arise from one or more sources as discussed earlier.

Income must be distinguished from capital profits

The source must be distinguished from the income). A particular receipt or expenditure must be tested to see if it has the quality of capital or income by ascertaining whether it has been received or paid on account of fixed or circulating capital. The exception to this general principle is on capital allowances.

Distinction between Capital and Revenue

Capital: The money introduced by owners or investors into a venture to aid implementation of its business objectives. This money is spent on significant assets that have a long life e.g. Land, Buildings etc.

Revenue: This is the total exchange value received for goods and services provided to customers/clients.

The money is spent on the day to day items required to run services e.g. Staffing, purchases etc.

Tests for distinguishing Capital from Revenue

i) The Structure of the business

This criteria involves the enquiry whether payments received or paid are made in the course of carrying on the taxpayer trade or whether they are such as to affect the whole structure of the profit making apparatus of the taxpayer.

ii) Recurrence

Case: *Vallambrosa Rubber Co. Ltd v Farmer*

Facts: A Rubber Company had an estate of which in the year under review 1/7th only produces rubber, the other 6/7 ths being in process of cultivation for the production of rubber. (Rubber trees do not yield rubber until they're six years old).

Expenditure for superintendence, weeding and cultivation is incurred by the company in respect of the whole estate.

Held: In arriving at their taxable profits the company is entitled to deduct expenditure for superintendence etc. on the whole estate and not 1/7 of such expenditure only.

iii) Fixed Assets

A payment made on the creation or acquisition of a fixed asset, or a sum received on it's realization, is usually a capital sum.

iv) The Atherton Principle

Case: *British Insulated and Helsby Cable Ltd. v Atherton*

Facts: BIHC established a pension fund by trust deed for the benefit of its clerical and technical salaried staff.

A lumpsum payment KShs 31,784 was made irrevocably as the nucleus of the pension fund.

BIHC claimed as a deduction in computing its chargeable income, the lumpsum payment.

Held: Sum not admissible deduction.

v) The Van Den Bergh Principle

Case: *Van Den Bergh Limited v Clark (HM J.J)*

Facts: Two competing trading companies entered into an agreement by which the two companies bound themselves for the future to work in friendly alliance and to share profits in a specified proportion. With the outbreak of World War I it became impossible to effect the agreement and one of the companies a Dutch company made a compensation to the other British company. The question was whether the amount was capital or revenue in nature and therefore taxable or not.

Held: The sum was capital in nature and not taxable.

Lord Maxmillan:

> "Circulating capital is capital which is turned over and in the process of being turned over yields profit or loss.
> Fixed Capital is not involved directly in that process and remains unaffected by it .... The agreements formed the fixed framework within which their circulating capital operated. They were not part of the mechanism itself. They provided the means of making profits but they themselves did not yield profits. The profits of the appellants arose from manufacturing and dealing in margarine".

Income is taxed at the prescribed tax rates as follows:

A. Body Corporate

That is, companies, trusts, estates, clubs, co-operative societies etc.

Resident rate	Non-resident rate
Years 2000 to date, 30%	Years 2000 to date, 37.5%

B. Special Rates

(i) Resident companies mining specified minerals – for the first 4 years of mining operations income is taxed 27.5% per year, while normal rates shall apply from the fifth year of operations.

(ii) Export processing Zones enterprises (EPZ) – for the first 10 years income tax exempt. Thereafter tax rate will be 25% for a further 10 years.

(iii) Tax is charged at source for the following reasons:-
   a) To make tax collection easier, convenient to both tax payer and the taxing authority
   b) To ensure that some income will not escape taxation

(iv) Special corporate tax rate for newly listed companies (NLC) in the stock exchange.
   27% for newly listed company after 1 January 2002 for 3 years following year oflisting;
   25% for those listed after 1st January 2003 for 5 years following the year of listing; and
   20% for those listed after 1 January 2006 for 5 years following the year of listing.

(v) Special corporate tax rates for newly listed companies in the Stock Exchange. 27% for newly listed company after 1 January 2002 for 3 years following year of listings. 25% for those listed after 1 January 2003 for five years following year of listing and 20% for those listed after 1 January 2006 for five years following the year of listing

For this, the Income Tax Act requires that persons making certain payments should deduct tax from the gross amount payable at appropriate rate before making payments to recipients and to remit such tax deducted at source to the income tax department together with a return of the amount of tax deducted, name of the person to whom payment was made. Payments of tax at source has been harmonized to 20th day of the following month.

The payee is to be furnished with a certificate of tax paid at source stating amount of the payment and tax deducted. The payee receives payment net of tax.

Note

- PAYE tax is remitted by the 9th of the month following the one in which deduction takes place.
- The payee is assessed on the gross amount of income subject to withholding tax and credit is given for tax deducted at source where such income is subject to further taxation.

Income Subject to Withholding Tax

i) **Residents**

ii) **Non-residents**

Withholding Tax Rates	**Resident**	**Nonresident**
Management fees	5%	20%
Royalties	5%	20%
Leasing Equipment	15%	15%
Dividends		
Less than 12.5% voting power	5%	10%
Greater than 12.5% voting power	Exempt	10%
Interest from financial institutions:		
And Gov't 2 year bearer bonds (1)	15%	15%
Interest from bearer certificates (1)	25%	25%
Housing Bond Interest (HBI) (1)	10%	15%
Rents – Immovable Property	N/A	30%
Pension and Taxable Withdrawals:		
From pension/provident funds	10 – 30%	5%
Insurance commissions	10%	20%
Consultancy and		
Agency fees	5%	20%
Contractual fees	3%	20%
Consultancy Fee to EA Communtiy		
Countries	N/A	15%
Surplus Pension Fund Withdrawals	30%	30%
Shipping Business	N/A	2.5%
Gross amount of consideration for disposal of property	3%	3%

(1) Agency fees on export of flowers and from July 2006 on fruits and vegetables are exempted. From January 2006 audit fee for analysis of maximum residue limit paid to a non-resident laboratory or auditor are exempted.

(2) Air craft leasing exempted.
(3) This applies only to individuals. The non-resident rate is 15%. The resident rate is as shown but is not a final tax for corporations.
(4) Limited to income of Kshs. 300,000 per annum
(5) These rates apply only on the graduated PAYE tax rates for early withdrawal or in bonds of Kshs. 400,000 (for withdrawal after a 15 year period or 50 years of age)
(6) 5% if paid to a resident broker
(7) If fees in excess of Kshs. 24,000 per month when paid to a resident person.
(8) For taxable shipping business
(9) For capital gains items.

Note

- The above income is taxed according to non-residents is taxed on gross amount without allowing any expenses.
- The withholding tax deducted is the final tax.
- Lower rate may apply when there is a tax treaty in force.
- Insurance commissions received by resident insurance agents are subject to taxation at graduated scale rate, the withholding tax earlier paid being set off against the gross tax.
- Payments made by farmers to non-resident persons for farm audit fees for analysis of Maximum Residue Limit (MRL) are now exempted from withholding tax with effect from 1 July 2005. This provision is meant to encourage competitiveness of horticultural farmers.

iii) **Employment income** (Tax at source under the PAYE system)

Salaries, directors' fees, wages, overtime, non-cash benefits, etc is subjected to graduated scale rates through the PAYE system as follows:

Year 2002, 2003 and 2004	
Rate in KShs	**Income in KShs p.a**
(10%)	1st Ksh 116,160
(15%)	next Ksh 109,440
(20%)	next Ksh 109,440
(25%)	next Ksh 109,440
(30%)	over Ksh 444,480

Personal Rates of Tax

Year 2005 – 2012	
Rate in KShs	**Income in KShs p.a**
(10%)	0 – 121,968
(15%)	121,268 – 236,880
(20%)	236,880 – 351,792
(25%)	351,792 – 466,704
(30%)	over 466,704

Taxable value of employment benefits

Saloon, hatchback

Engine capacity	KShs p.a
Upto 1200 cc	43,200
1201 – 1500 cc	50,400
1501 – 1750 cc	69,600
1751 – 2000 cc	86,400
2001 – 3000 cc	103,200
Over 3000 cc	172,800

Pick-ups or panel vans

Engine capacity	KShs p.a
Upto 1750 cc	43,200
Over 1750 cc	50,400

Land rovers/land cruisers – KShs 86,400

Note: A company car provided for an employees private use is taxed at a higher of the prescribed values shown above or 2% per month of the initial capital cost of the car incurred by the employer. Where the car is hired or leased from a third party, the taxable value is the cost of hiring or leasing.

The commissioner may determine a lower rate of benefit where an employee has restricted use of a motor vehicle provided by the employer with the effect from 1 January 2008.

Other benefits

Furniture (1% of cost per month)	12%
Telephone (1% of bills)	30%

Note: Electricity, water, servants, security etc. are taxable at the higher of the cost to the employer of providing the benefit at the fair market value.

Note: Personal relief represents the amount which can be deducted by an eligible persons from tax payable by him.

The personal relief for 2005-2012 is KShs 13,944 p.a.

Where an employee has multiple employers, the employee is entitled to a relief from only one employer (PAYE Rules 2011).

iv) Pension payments beyond exempt limits (the first Kshs. 180,000 p.a. exempt for residents)

v) Presumptive income tax on specified farm produce e.g. maize, wheat, rice, coffee. The rate is 2% of gross sales. In the case of individual farmers the presumptive tax is final tax. For companies engaged in farming, PIT is not final tax, i.e. PIT is a set-off tax against tax liability of the company.

Specific Items of Expenditure Not Allowable

1. Capital expenditure, any loss, diminution or exhaustion of capital e.g. depreciation, amortization, writing off of assets or loss on sale of fixed assets.
2. Expenditure incurred by any person is maintenance of himself, his family or for personal and domestic purposes, e.g. school fees, food, clothes, recreation, etc.

3. Expenditure or loss recoverable under insurance contract
4. Income tax paid and tax of a similar nature including compensation tax paid on income but not as relief for foreign tax.
5. Payment of pension, annuity premiums and contributions to pension and provident funds which are not registered
6. Expenditure incurred in the production of some income by non-resident person e.g. rent, management fees, royalties, interest, dividends, etc. These are taxed gross at non-resident rates.
7. Hobby business expenses i.e. business carried on with a view to making profits where more than quarter of cost of production relates to self-consumption.
8. Any reserves and provisions for the reason that they are not incurred expenditure.
9. Cost of hire of non-commercial vehicles
10. Interest payments by a non-resident controlled company to the extent that loans made to that company exceed the greater of three times the sum paid up capital and revenue reserves or the sum of all loans acquired prior to 16th June 1988 and still outstanding.
11. Lease hire rentals for all vehicles.

Foreign Exchange Gains or Losses

With effect from years of income 1989, realised foreign exchange gains or losses resulting from a Kenyan business will be treated as trading receipts or deductible expenses respectively. Such gains or losses will be calculated by reference to the exchange rate ruling at 30 December 1988, or date on which the foreign asset or liability is established, whichever is the later. A foreign exchange loss will be deferred for tax purposes if realised in respect of a loan from a person who, alone or with up to four other persons controls the indebted company and where the aggregate of all loans made to that company exceeds three times the sum of paid up capital and revenue reserves – section 4(a)

Section 16 of the Income Tax Act expressly provides that in calculating the gains or profits of a person no deduction can be made for expenditure of a capital nature. The same principle is applied in disallowing capital losses, exhaustion of capital e.g. depreciation of fixed assets.

The substance of this principle is that on the other hand a disposal of a fixed asset is not a revenue receipt and therefore excluded from the computation of taxable profits.

6.4 Capital Allowances

The distinction between capital expenditure and revenue expenditure is quite essential in the study of capital allowances.

Businesses usually incur expenditure. Some of the expenditure brings economic benefits to the businesses for a short period of time (within the financial year) while others benefit the business over a long period of time. As such, expenditures are classified under different categories and are accounted for differently.

Capital Expenditure:

These are expenditure incurred in acquiring non-current assets or in making extension to existing non-current assets. Capital expenditure increases the earning capacity of a business.

Businesses benefit from such type of expenditure over a long period of time. For example, a delivery vehicle can be used for over 5 years to deliver goods to customers. Computers may easily be used for 3 or 4 years. A building may be used for over 20 years.

For the above reasons, capital expenditure are entered as non-current assets in the balance sheet. The cost of non-current assets is charged against profit over the years the assets can used and benefits derived. Such process is called "provision for depreciation".

Revenue Expenditure:

These are expenditure incurred for the day to day running of the business. Though they do not increase the earning capacity of the business but they are essential in maintaining it.

Revenue expenditure benefits the business only in the period to which they relate. For example, rent is paid monthly, so the rent paid in January only gives the possibility to the business to use a rented property in January only. Similarly, rates and license fees for a given year gives right to the business to be operational only during that year. Other examples of revenue expenditure include repairs to non-current assets, electricity and water charges, telephone expenses, vehicle expenses, fuel etc. Purchase of goods for resale is also classified as revenue expenditure.

Revenue expenditure are treated as expenses in the income statement for the period to which they relate.

The purpose of the scheme of capital allowances is threefold

1. to encourage new industrial enterprises;
2. to allow such deduction as may be deemed just and reasonable as representing the diminution in the value of fixed assets by reason of wear and tear during a particular year, of any plant or machinery used for the purpose of a business; and
3. To encourage exportation.

The capital allowances available in Kenya are:-

a. Industrial Building Allowance
b. Wear and Tear Allowance
c. Investment Deduction Allowance
d. Farmworks Deduction Allowance
e. Mining Deduction

2 Wear and Tear Allowance (W.T.A)

Qualifying Expenditure

Wear and Tear Allowance is granted in respect of depreciation of Plant and Machinery used in a business.

The second schedule of Cap 470, paragraph 7 provides "where during the year of income machine owned by a person is used by that person for the purpose of generating business income, there shall be a deduction referred to as Wear and Tear allowance in computing the gains or profits of that person."

WTA is granted in respect of machinery which must be

1. Owned by the person.
2. Used by the person to generate business income any time during the year. This implies that WTA is granted for the whole year

irrespective of when the asset was brought into life during the year

3. WTA is granted on reducing balance basis.

For the purpose of granting WTA the word machinery is given a very wide meaning and all machineries are classified into four classes for the purpose of granting WTA (pooling method). Each class has its own rate of WTA.

WTA is expressed as` a percentage of the aggregate value of assets of each class of machinery. It is not granted on the basis of a single asset.

The four classes of machinery and their corresponding WTA rates are as follows:

Class	
Class I @ 37.5%	Heavy earth moving self-propelling equipment such as: Carterpillars, tippers, lorries of 3 tonnes and above, tractors (heed, Train, Engine head, buses and coaches, loaders, rollers and graders, transport trucks, combine harvesters, mobile cranes and forklifts etc.
Class II @ 30%	Office electronic machinery and equipments e.g. computers and its peripherals, computer printers, scanners and processors, calculators, mobile phones, photocopiers, stamping and franking/fax machines, duplicating machines, photo printers, cash registers, tax registers.
Class III @ 25%	Other self-propelling machines such as motor bikes, saloon cars and hatchbacks, tutuk, pick-ups and delivery vans, aircrafts, minibuses (nissans included), lorries < 3 tonnes.
Class IV @ 12.5%	Other non-self propelling machine such as; Ship, Bicycles, Wheelbarrow, lifts & conveyor belts, carpets and curtains, partitions in a building, shelves, safes, sign boards and advertising stands, furniture and fittings, plant and machinery, security and alarm systems fixed in a car, tractor trailer, train coaches, milking machinery, beds in a hotel, a plough and lawn mowers, refrigerator, T.V, non-self propelling forklifts and cranes, boats.

The WTA schedule is prepared as follows:

Class	I @ 37.5%	II @ 30%	III @ 25%	IV @ 12.5%
W.D.V V/Bal b/f 1/1/x1	xx	xx	xx	xx
Add: qualifying costs of assets acquired	xx	xx	xx	xx
Less: qualifying disposal value of assets sold	(xx)	(xx)	(xx)	(xx)
Value for W.T.A	xx	xx	xx	xx
WTA @ WTA rate given	(xx)	(xx)	(xx)	(xx)
W.D.V 31/12/x1 = Bal c/f	xx	xx	xx	xx

Two tests have been applied by courts to determine what constitutes plant in the context of capital allowance.

The setting test

This text distinguishes plant as part of the apparatus with which the trade is carried on from assets forming part of the setting in which a trade is carried on.

This test was established in *J Lyons & Co. Ltd v A.G.*

In his judgement, Uthwatt J stated the question at issue was .... "Are the (assets) properly to be regarded as part of the setting in which the business is carried on or as part of the apparatus used for carrying on the business?"

In the case: *J. Arrold v John Good & Sons Ltd*

Facts: The company carried on business as shipping agents, acting for several lines. The business was departmentalised with fourteen departments. However, the number of departments would vary from time to time owing to fluctuation in the volume of work.

The fluctuation in the volume of work would cause fluctuation in the number of people employed in each department and in the division of the total floor area of the offices as between various departments.

The company had a building constructed and the architects were instructed that the office portion of the building be capable of the greatest possible degree of elasticity as regards its subdivision.

The architects planned a large open floor space in which partitioning could be erected so as to subdivide the floor space as desired. The partitions were moveable and in fact two alterations had been made.

The architects were of the opinion that the partitioning did not form part of the structure of the building.

The company contended that the partition was plant for the purposes of its business and that it was entitled to capital allowances.

The inspector of taxes contended that the partitioning was neither "plant" nor "machinery" and that the expenditure did not qualify for capital allowances. The basis of the contention was that the partitioning constituted part of the setting in which the business was carried out. The court observed that the two categories, that is, property regarded as part of the setting in which the business is carried on and apparatus used for carrying on the business, were not mutually exclusive. This means a particular asset may be regarded as part of the setting in which business is carried on as well as apparatus used for carrying on the business.

Held: Some fixed but movable partitions though in a sense "setting", were also capable of being "apparatus" (and so within the plant or machinery category).

The functional test

A structure will be regarded as plant if it fulfils the function of plant in the trader's operations.

This principle was established in the case of

Barclay, Curle & Co. Ltd v Commssioners of Inland Revenue

Facts: The Company carried on business as ship repairers and incurred capital expenditure of KShs 500,380 on the concrete work used in the construction of a new dry dock, and KShs 186,928 on excavating the land for the dry dock.

The company claimed a capital allowance on the whole of the expenditure on the grounds that it was spent on the provision of machinery or plant for the purposes of its business.

The Revenue department contended that the expenditure was not on the provision of machinery or plant but on an industrial building or structure.

On appeal the Special Commissioners took the view that the dock "was not a mere shelter or home but itself played an essential part in the operations which took place in getting the ship into the dock, holding it securely and then returning it to the river. They decided that the expenditure on concrete work was on plant and machinery. However, they took the view that the expenditure on excavating was not expenditure on the provision of plant and machinery on the grounds that it was expenditure on the preparation of land to receive plant or machinery.

Held: The concrete work was plant on the basis of the function of the dock. Once it was decided that the dock was plant, the cost of excavation was expenditure on the provision of machinery or plant.

In the case of *Dixon v Fitch's Garage Ltd*

Held: That a canopy over the service area of a petrol station did not constitute plant as it merely provided shelter and therefore part of the setting.

Lord Reid stated:"The only reason why a structure should also be plant, which has occurred to me, is that it fulfils the function of the plant in the trader's operations. And, if that is so, no test has been suggested to distinguish one structure which fulfils such a function from another. I do not say that every structure which fulfils the function of plant must be regarded as plant, but I think one would have to find some good reasons for excluding such a structure. And I do not think mere size is sufficient.

In the case of *Munby v Furlong*

Held: That plant included a lawyer's books it constituted plant on the basis that they were his intellectual storehouse used by the lawyer in the course of carrying on his profession.

In the case of *Bension v Yard Arm Club*

Held: That a ship which used as a floating restaurant was not plant. It was not apparatus used for the purposes of the business but the setting in which the business was carried on.

3. Investment Deduction

This is a once-for-all claim granted in the year the asset is first used based on cost of building and machinery installed therein as an incentive to encourage investments mainly in the manufacturing sector.

Investment deduction is granted to encourage:

1. Development of industries in normal manufacture, tourism and shipping
2. Exportation to earn more foreign exchange (e.g. EPZ - export processing zone enterprises)
3. Foreign investors to invest in Kenya
4. Up to 1994 to encourage development of industries outside the main urban centre's of Nairobi and Mombasa.

Types of investment deduction

1. Normal investment deduction for ordinary manufacture
2. Investment deduction bonded manufacture
3. Shipping investment deduction
4. Investment deduction on hotel buildings

Investment deduction from normal manufacture is granted to any person who incurs capital expenditure on:

a) Construction of an industrial building which is used by him or his lessee, an on installation therein of new machinery for manufacture
b) On Purchase of new machinery which is installed in a building not previously used for manufacture and such machinery is not installed as a replacement of machinery previously in use in the business.
c) On construction of building used by the owner or lessee for manufacture purposes
d) With effect from 1 January 1992 on purchase of and installation of machinery into or setting up the machinery for use as may be appropriate to be used for manufacture.

e) Construction of a Hotel building certified as an industrial building by the commissioner. Claims made by hotels relate to building cost only and not items generally considered machinery.

f) With effect from 1 January 1995 specified civil works are eligible for the allowance:
   1. roads and parking areas
   2. railway lines and related structures
   3. water, industrial effluent and sewerage works
   4. communications and electrical posts and pylons and other electrical supply works
   5. security walls and fencing

a) With effect from 1 July 1999, workshop machinery for the maintenance of machinery used for manufacturing.

Note:

b) In case a building is converted into a factory and new machinery installed for manufacture then both machinery and building quality for the allowance. Note that in the case of the building only conversion cost qualifies:

c) It is possible to construct an industrial building and do part installation of machinery. Machinery would qualify for ID in respective years of the part installation.

d) Power generation equipment also qualifies for investment deduction with effect from 1 July 2000

In a bid to encourage investment in industrial buildings, machinery and equipment, the I.D rate has changed as follows:

Year ending 31 December	I.D. rate
2001	100%
2002	85%
2003	70%
2004 - 2008	100%

Investment deduction bonded manufacture

This is granted in relation to manufacture for export only and in addition to investment deduction ordinary manufacture with effect from 1 January 1989

If IDBM is granted and the manufacturing under bond ceases before 3 years are over the IDBM is withdrawn and the difference between the IDBM claimed and the capital deductions which would have been claimed (IDB & W.T.A) is added back in the total taxable income computation and treated as a trading receipt i.e.

	KShs.	KShs.
IDBM claimed in first year of use		XX
Less:- capital deductions that would have		
been claimed if not and IDBM case:- IB.D	X	
W.T.A	X	(XX)
Trading receipt (taxable) added back		XX

Note that for the EPZ enterprises IDBM will be available only within the first twenty years of manufacture.

To qualify for investment deduction bonded manufacturers:

1. A licence must be secured from customs and excise to manufacture under bond.
2. Expenditure must be incurred on building and machinery for manufacture under bond.
3. Manufactured goods must be for export only and not for the local market.
4. Manufacture must continue for at least three years otherwise the allowance shall be withdrawn.

Shipping Investment Deduction (SID)

SID is granted where a resident ship owner incurs capital expenditure:

a) On purchase of new, unused power-driven ship of more than 495 tons; or
b) On purchase of and subsequent refitting for the purpose of shipping business of a used power-driven ship of more than 495 tons.

The rate of shipping investment deduction is 40% (2/5) of Qualifying cost granted in the first year of use.

Limitations

1. A ship only gets one SID
2. If ship is sold before 5 years of use, the SID earlier granted will be withdrawn and the deduction will be treated as taxable income for year the withdrawal of SID takes place.

3. Compensation by way of wear and tear allowance will be granted.

4 Mining Allowances

Capital allowances in respect of mining operations are available on capital expenditure incurred on any of the following:

1. Searching for, discovery of, testing or acquiring access rights to minerals
2. Acquisition of patent rights on or over the mineral deposits other than acquisition from person who has carried on mining in relation to such deposits.
3. Building machinery and other works which would have little or no value to such persons if the mine ceases to be worked
4. On development, general administration and management prior to commencement of production or during any period of non-production.

Note that cost of land does not qualify for any capital allowances.

Rates

Mining life is deemed to be seven years. However, if one considers that the life of his mine will be less than seven years, the person has a right to apply to the commissioner for enhanced rates. If the commission of Income Tax is satisfied that the mining life will not last seven years, he may increase the allowance to such amount as he may consider just and reasonable.

Thus, Mining allowance of 40% of capital expenditure is granted in the first year of operations and of 10% in each of the six subsequent years.

If the qualifying assets are sold before total capital allowance is used up an apportionment is made between the transferor and the transferee on the basis of the months held during the year.

No balancing allowances or charges arise on sale.

Illustration

A mining company incurred the following expenditure prior to mining operations:

i.	Search for minerals	359,00,000
	Discovery of the minerals	120,000
	Testing of the minerals	3,000,000
	Wining access to deposits	150,000
ii.	Acquisition of patent rights	100,000
iii.	Buildings, machinery other than those qualifying for wear & tear allowance	6,200,000
iv.	General administration before commencement	2,000,000
		11,929,000

Required

Compute mining allowance.

Solutions

MINING ALLOWANCES TO CLAIM

1st Year of mining operations	40%	4,771,600
2nd Year	10%	1,192,900
3rd Year	10%	1,192,900
4th Year	10%	1,192,900
5th Year	10%	1,192,900
6th Year	10%	1,192,900
7th Year	10%	1,192,900
Total Over Seven Years		11,929,000

Assessable persons

Section 44 of the Act provides that where under the Act the income of a person is chargeable to tax, that income shall be assessed on and tax thereon charged on that person. A person shall include an individual or body corporate. Thus, partnerships are not assessable as they are not separate legal entities. In essence thereof, the income from a partnership is indeed income of the partners as individuals and thus taxed in their own names.

Exceptions to section 44 of the Income Tax Act

Residence

Illustration

Mr Munene is employed by Miller Company limited as the Risk and Compliance Manager. He has presented the following information relating to his employment for the year ended 20xx.

- Basic salary 90,000 per month (PAYE 12,500)
- Allowances and reimbursements during the year from the employer
  Entertainment Allowance 120,000 (Self and Family)
  Business mileage 200,000
  House telephone bill 84,000
- He was provided with the following servants whose monthly wages were paid by the employer.

Servants	Monthly pay
Gardener	3100
Watchman	3400
Cook	4000

- The employer paid school fees for his children which amounted to 120,000 per annum. The fees were treated as allowable expenses in the company's' books.
- He contributes 5% of his basic pay to a registered retirement benefit scheme while the employer contributes an equal amount for him.
- The company operates a medical scheme for its senior employees during the year, Mr Munene received KShs 45,000 being reimbursement for medical bills paid for self and family.
- He purchased his residential house in the year 2008 by use of a 15 year mortgage from a building society recognized under the Income Tax Act. The total mortgage interest paid for the year amounted to KShs 40,000.
- He owns an attire shop managed by his wife. The shop recorded a net profit of 500,000 for the year after deducting KShs 600,000 wife's salary for the year.

Mr. Munene

20xx Taxable Income Computation

Employment Income			
Basic Salary			1085000
Entertainment Allowance			120,000
School fees			120,000
Telephone Bills			84,000
Medical benefits			45,000
Watchman	21,000		
	40,800		40,800
Gardener	21,600		
	37,200		37,200
Cook	27,000		
	48,000		48,000
			1575,000
Allowable deductions			
Pension contribution			
Actual contribution	5% * 1080,000 = 54,000		
30% Expected Limit	30% * 1575000 = 472500		54,000
Set limit	= 240,000		
Mortgage interest			
Actual contribution	40,000		
Set Limit	150,000		40,000
Business Income			
Reported Net Profit			500,000
Wifes' salary			600,000
Total taxable income			******
Tax computation			
1st Graduation		*10%	
2nd Graduation		*15%	
3rd Graduation		*20%	
4th Graduation		*25%	
5th Graduation		*30%	
Less			
Personal relief		(13944)	
PAYE		(150,000)	

Where an individual has two or more employers, the second and subsequent incomes are subjected to taxation at a flat rate of 30 percent, that is, we do not undertake the tedious graduation process of calculating the payable tax.

6.5 Value added tax (VAT)

The object of the tax is value added to the gross sum and the services in the production processes. The Act provides among the taxable persons to include, supplier or provider of taxable services e.g. professional firms. Section 6(1) VAT Act 1989, provides that tax is chargeable on "any supply made or provided in Kenya where it is a taxable supply made by a taxable person in the course of furtherance of any business carried on by him"

The VAT rate structure can broadly be summarised as:

1. Zero rate
2. General rate (currently 16%)
3. Specified rate (currently 12%)

VAT is calculated on the full money value paid i.e. value less discount allowed. Although Tax is due and payable immediately at the tax point, registered persons are required to remit their VAT collections latest by the last working day on or before 20th of the following month. Any payment of VAT in excess of KShs 20,000 must be made by a bankers cheque or a bank guaranteed cheque.

Remittances of VAT on due dates each month should be done by filling form VAT 3 which is the monthly VAT return .

7. Stamp duty

The object of the tax is the sales value on transferring property.

Currently, the stamp duty payable on transferring land in the rural areas is 2 % while the urban land attracts 4%.

8. Import duty

The imported goods are the object of the tax.

9. Excise duty

The object of the tax being the value of locally manufactured goods.

Shifting of Tax

This occurs when the burden of tax is shifted from one person to another. It occurs when tax is imposed on one person who then transfers the burden to another person. Tax shifting can either be backward or forward.

a) Forward shift

The burden of tax is transferred from the producer to the final consumer. This is possible where the demand for goods is inelastic e.g. essential goods.

b) Backward shift

The burden of tax is transferred from producer to the supplier e.g. raw materials. It occurs where the demand of goods is elastic e.g. luxurious goods.

Factors that determine the extent of shifting.

1) The nature of the market

In perfect markets there is a large number of sellers making it difficult to shift the burden of tax to the final consumer through price increase. In imperfect markets shifting the burden to the final consumer is easily achievable.

2) The profit margins or markup

If producers are making large profits or have high markups on goods they are less likely to transfer the tax burden to the final consumer.

3) Consumer bargaining power

If the consumer determines the prices of goods and services through market forces of demand and supply it is difficult for sellers to shift the burden to the consumers.

4) Number of competitors in the industry

If the competitors are many, it is difficult to shift the burden of tax to the consumer. In a monopolistic market where the number of competitors is small it is easy to shift the burden to the consumer.

5) Government policies on taxes.

In a market where the government controls the price of goods and services, it is difficult to shift the burden to the consumer.

Taxable Capacity

This is the ability of individuals to pay tax .It is used to measure an individual's ability to afford paying tax. It is indicated by the level of income available for taxation e.g. a person earning more than KShs 11,135 is liable to pay income tax in Kenya.

Factors influencing taxable capacity

1) Purpose of taxation`

If the purpose of a tax is to improve the general welfare of citizens, they are willingness to pay tax increases the taxable capacity.

2) Transparency and accountability

If taxes are used in a transparent and accountable manner, This shall increase the taxable capacity.

3) Popularity of government

If the government is popular with the electorate taxpayers the more wiling they are to pay taxes.

4) Size of population

A country with a high population has a high number of potential tax payers increasing the taxable capacity.

5) Levels of income

In countries where income levels of the majority is high, the taxable capacity is also high.

6) Distribution of national income

A country with a wide gap between the rich and the poor has a low taxable capacity since it has few rich individuals and millions of poor people.

Legal Structure

Notably, section 27 of the Income Tax Act (Cap. 470) permits incorporated businesses to alter the date to which the accounts are made provided six months notice is given to the commissioner of income tax and subject to his written approval.

Financial institutions and unincorporated businesses (partnerships and sole proprietorships) are required to have accounting periods ending on 31 December each year.

Section 15(4) of the Income Tax Act (Cap. 470). From 1 January 2010, tax losses for a year can only be carried forward for four years. If not utilised, the losses will be lost unless an application for the extension is made based on provision of evidence of inability to extinguish the deficit and approval received by the Minister. Previously, there was no time limit on the carry forward of tax losses.

Penalties

Section 54A(2) of the Income Tax Act stipulates failure to keep adequate books of account shall attract a penalty of KShs 20,000.

Omission, claim or gross negligence shall attract a penalty of an additional tax not exceeding twice the tax concealed. (Section 72(2)).

Offences under the Income Act for which no other penalty is specified are subject to a maximum fine of KShs 100,000 and/or imprisonment not exceeding six months.

Statutes

The Kenya Revenue Authority administers the following written laws relating to revenue:

- The Income Tax Act (Cap. 470)
- The Customs and Excise Act (Cap. 472)
- The Value Added Tax Act (Cap 476)
- The Road Maintenance Levy Fund Act 1993 (No. 9 of 1993)
- The Air Passenger Service Charge Act (Cap. 475)
- The Entertainment Tax Act (Cap. 479)
- The Traffic Act (Cap. 403)
- The Transport Licensing Act (Cap. 404)

- The Second Hand Motor Vehicle Purchase Tax Act (Cap. 484)
- The Widows and Children's Pensions Act (Cap. 195)
- The Parliamentary Pensions Act (Cap. 196)
- The Stamp Duty Act (Cap. 480)
- The Betting, Lotteries and Gaming Act (Cap. 131).
- The Directorate of Civil Aviation Act (Cap. 394).

Chapter Seven

Partnership Accounts

7.1 Introduction

In the industry we have most of the law firms as partnerships in addition to other business ventures.

All partners in a law firm (lawyers) need to understand what a partnership is all about in terms of sharing profits and losses, liabilities attaching, dissolution etc.

Not only does the knowledge help the lawyers in their respective firms but also aid them in their advisory capacity to clients in such relationships or affected otherwise.

A partnership is the relationship that subsists between persons carrying on a business in common with a view of making profit. This is based on the fact that human beings are social beings and will relate in one way or the other and for different purposes. The partners carry on business on behalf of each other and bear responsibility on behalf of each other too.

To ascertain the existence of a partnership four elements must be:

1) There must be two or more persons
2) There must be a business
3) The business must be carried out in common
4) The business should be carried out with a view to making and sharing profit

7.2 Nature and Purpose

A partnership agreement

The partnership is established on the mutual agreement of the concerned persons, which constitutes a contract. It is therefore preferable to have the contract in writing to avoid misunderstanding and disagreement.

A written agreement explicitly details the relationship between the parties.

Elements of the Partnership Agreement

1. Name and address of the partnership
2. Duration of partnership—Partners can agree to a specific termination date or include a general clause explaining that the partnership will exist until all partners agree to dissolve it or a partner dies.
3. Business purpose—some consultants recommend that partners keep this section somewhat vague in case opportunities for expansion arise as is the case in the company's objects, while others, such as Legal Handbook for Small Business author Marc J. Lane, feel otherwise: "Avoid any conflict in entrepreneurial goals. Since a general partnership obligates you for the business acts and omissions of your co-partners, it is wise to limit the scope of your business activities by contract."
4. Bank account information—this section should note which bank accounts are to be used for partnership purposes, and clearly highlight the partners who are the signatories.
5. Partners' contributions—Valuation of all contributions, whether in cash, property or services should expressed.
6. Partners' compensation—Determine in detail the ratio of sharing profits and the interval when profits (and salaries, if applicable) will be distributed.
7. Management authority—State the operational responsibilities of each partner, while determining key issues concerning;
    a. Will partners be able to make some decisions on their own?
    b. Decisions that require the unanimous consent of all partners.
    c. Voting rights of each partner and how will a tie of votes is resolved?
8. Circumstances under which new partners might be admitted into the partnership.
9. Work hours and vacation.
10. Business activities that partners will be allowed to carry out outside the partnership.
11. Disposition of partnership's name if a partner leaves.

12. Dispute resolution—Stipulates what kind of alternative dispute resolution mechanism will be utilized in the case of a conflict or disputes.
13. Miscellaneous provisions—this portion of the agreement may include the circumstances under which the agreement could be amended, for example.
14. Buy-Sell Agreement.

Note

Where no partnership agreement exists, expressed or implied;

1) Profits and losses are to be shared equally
2) There is to be no interest allowed on capital
3) No interest shall be charged on drawings
4) Salaries shall not be allowed

Creation

A partnership may be formed by any one of the following three methods:

1. A partnership from the onset of the business
2. By combination of two or more sole proprietorships
3. By conversion from a limited company

Dissolution

A partnership would be dissolved on the following grounds:

1. The expiration of the term for which the partnership was entered into, if any;
2. Upon attaining the objective for which the partnership was formed;
3. Death of a partner;
4. Bankruptcy of a partner;
5. Mental incapacity of a partner.

Basic Concepts

Partnerships will draw up Trading, Profit and Loss accounts and Balance Sheets as is the case with any trading concern. However, an additional section will appear at the bottom of the Profit and Loss A/C in which Profit division is carried out. This section is known as the appropriation section.

Such divided profits will then be credited in partner's current accounts. Any amounts withdrawn by partners will also appear in the current account on the debit side. Any balance in such current accounts will appear on the Balance Sheet.

Capital contributions

Capital is required to start the business as it ensures the flow of activities. In a partnership the partners shall contribute the necessary capital. However, they are not bound to contribute equal amounts; each shall contribute in accordance to their agreed capability.

Profit (or loss) sharing ratios

The partners have the discretion to share profits and losses in any ratio thereof agreed amongst them. It is common practice, for the ratios to be pegged on the amount of capital contributed. EG If Jade contributed 1 million while Ruby 2 million the common ratio would be assumed to be 1/3 and 2/3 respectively regardless that both parties shall be performing similar tasks in the firm.

Years	1	2	3	4	5	Total
	KShs	KShs	KShs	KShs	KShs	KShs
Net profit	100.00	150.000	180.000	240.000	300,000	970,000
Shared						
Jadel1/3	33.333	50.000	60.000	80.000	100,000	323,333
Ruby2/3	66.667	100.000	120.000	160.000	200,000	646,667

Interest on capitals

Where the partners undertake to carry out the tasks of equal value in the firm but the capital contributed by each partner is not equal, it is only equitable to grant interest on the partners' capitals.

The rate of interest is as a matter of agreement between the partners, but should in the least equal the return which they would have received if they would have invested the capital elsewhere.

Practically: Deduct the interest

Years	1	2	3	4	5	Total
	KShs	KShs	KShs	KShs	KShs	KShs
Net Profit	100,00	150,00	180,000	240,000	300,000	970,00

Interest on Capital:

Jade

Ruby

Remainder Shared

Jade 50%

Ruby 50%

Interest on drawings

The more the cash a firm has the better so as to invest it, take advantage of economies etc. Thus, it is prudent for the partners to withdraw as little as possible, only when necessary and as late as possible during the year.

To deter partners from withdrawing unnecessarily the concept of interest on drawings is introduced for each withdrawal in relation to time i.e. from the date of withdrawal to the end of the financial year. The rate should help achieve this objective without making it punitive.

The interest collected is summed up as profits and distributed amongst the partners as per the profit sharing ratio agreed.

Suppose jade and ruby have decided to charge interest on drawings at 5% per annum and the year ends 31st December. The following drawings are made:

Jade

Drawings		Interest
1 January 1 January 1 March 1 October	50,000 50,000 100,000 160,000	50,000 *5% 12 months = 30,000 50,000 *5% 11 months = 27,500 100,000 *5% 10 months = 50,000 50,000 * 5% 3 months = 24,000
	360,000	**131,500**

Ruby

Drawings		Interest
1 January 1 April 1 September 1 December	20,000 80,000 200,000 60,000	50,000 *5% 12 months = 30,000 50,000 *5% 9 months = 22,500 100,000 *5% 4 months = 20,000 50,000 * 5% 1 months = 8,000
	360,000	**80,500**

Note:

Where the information provides the specific month when a drawing was carried out, for example, the accounting year begins in January and ends in December. Jade withdrew 100,000 on 1 June. The interest rate on drawings is 5%, the computation shall taken the following format:

(100,000 x 5/100)6/12 =

a) Drawings = 100,000
b) Interest rate =5% or 5/100
c) Month of withdrawal = June, the 6th month in the accounting period provided
d) Number of months in the a/c period = 12 months (Jan to Dec)

Trading, profit and loss Account

Trading profit and loss for the year ended 31 December 2012		
Net profit		2,400,000
Interest on Drawings:		
Jade	131,500	
Ruby	80,500	212,000
		2,188,000

Less:			
Interest on Capital:			
Jade	200,000		
Ruby	100,000	300,000	
Salary (Ruby)		200,000	500,000
			1,688,000
Balance of profits shared:			
Jade 40%		844,000	
Ruby 60%		844,000	1,688,000

7.3 Partners current and capital accounts

Jade – Capital account

2012		KShs	2012		KShs
			Jan 1		*****

Ruby – Capital account

2012		KShs	2012		KShs
			Jan 1		*****

Jade – current account

2012		KShs	2012		KShs
Dec 31	Drawings	***	Dec 31	Profit and loss appropriation account	***
Dec 31	Profit and loss appropriation account	***		Interest on capital	***
	Interest on drawings	***	2013		
Dec 31	Balance c/d	***	Jan 1	Share of profits	***
				Balance b/d	****

Ruby – current account

2012		KShs	2012		KShs
Dec 31	Drawings	***	Dec 31	Profit and loss appropriation account	***
Dec 31	Profit and loss appropriation account	***		Interest on capital	***
	Interest on drawings	***	2013	Salary	***
Dec 31	Balance c/d	***	Jan 1	Share of profits	***
				Balance b/d	****

Balance sheet as at 31 December 2012

Capital accounts		Jade	*****	
		Ruby	*****	
				******
Current Accounts				
Interest on capital	Jade	Ruby		
Share of profits	**	**		
Salary	–	**		
	***	***		
Less drawings	(***)	(***)		
Interest on drawings	(**)	(**)		

Columnar form

Current Accounts

2012		Jade	Ruby	2012		Jade	Ruby
Dec 31	Drawings	★★★	★★★	Dec 31	Interest on capital	★★★	★★★
Dec 31	Interest on drawings	★★★	★★★		Share of profits	★★★	★★★
Dec 31	Balance c/d	★★★			Salary		★★★
		★★★★				★★★★	★★★★
				2013 Jan 1	Balance b/d	★★★	

Capital Account

2012		Jade	Ruby	2012		Jade	Ruby
				Jan 1	Bank	★★★	★★★

Question 1

A, B and C enter into a partnership contributing KShs 250,000, KShs 130,000 and KShs 120,000 respectively, and sharing profits and losses in the ration 5:3:2.

B and C are entitle to a salary of KShs 16,000 and KShs 14,500 per annum respectively. Interest on capital is to be allowed at 5% p.a.

and interest on drawings at 10% p.a. During the year, A withdrew KShs 40,000, B KShs 25,000 and C KShs 15,000. These drawings were made on 2nd October 2009.

Profit for the year ended 31 March 2010 amounted to KShs 71,500 prior to any of the above adjustments.

Required:

a) Prepare the capital A/C and current A/Cs for A, B and C, if the capital accounts are not fluctuating
b) Prepare a fluctuating capital account (and thus, no current account)

Solution

This requires an appropriation account to ascertain profit shares.

A, B and C

Appropriation account for the year ended 31 March 2010

	KShs	KShs	KShs
Net profit			71,500
Add interest on drawings:			
A (6/12 X 10% X 40,000)		2,000	
B (6/12 X 10% X 25,000)		1,250	
C (6/12 X 10% X 15,000)		750	4,000
			75,500
Less interest on capital			
A (250,000 X 5%)		12,500	
B (130,000 X 5%)		6,500	
C (120,000 X 5%)		6,000	
		25,000	
Salaries to partners: B	16,000		
: C	14,500		
		30,500	
			(55,500)
			20,000
Share of profit: A 5/10		10,000	
B 3/10		6,000	
C 2/10		4,000	20,000

a)Capital accounts

	A	B	C		A	B	C
	KShs	KShs	KShs		KShs	KShs	KShs
Balance c/d	250,000	130,000	120,000	Cash Book	250,000	130,000	120,000
				Balance b/d	250,000	130,000	120,000

Current Accounts

	A	B	C		A	B	C
	KShs	**KShs**	**KShs**		**KShs**	**KShs**	**KShs**
Interest on Drawings	2,000	1,250	750	Interest on Capital	12,500	6,500	6,000
Drawings	40,000	25,000	15,000	Salaries	-	16,000	14,500
				Share of Profits	10,000	6,000	4,000
Balance c/d		2,250	8,750	Balance c/d	19,500		
	42,000	**28,500**	**24,500**		**42,000**	**28,500**	**24,500**
Balance b/d				Balance b/d		2,250	8,750

a) Fluctuating capital accounts

	A	B	C		A	B	C
	KShs	**KShs**	**KShs**		**KShs**	**KShs**	**KShs**
Interest on Drawings	2,000	1,250	750	Cash Book	250,000	130,000	120,000
Drawings	40,000	25,000	15,000	Interest on Capital	12,500	6,500	6,000
				Salaries	-	16,000	14,500
Balance c/d	42,000	28,500	24,500	Share of Profits	10,000	6,000	4,000
	272,500	**158,500**	**144,500**		**272,500**	**158,500**	**144,500**

Note: When the details of capital accounts and current accounts are merged together, the resultant account is known as a fluctuating capital account.

7.4 Partners' Capital Account and Cash/ Bank Account

Settlement of Partners' Capital Accounts

After all the adjustments related to partners' capital accounts and transfer of profit or loss on realisation to the partners' capital accounts, the capital accounts are closed in the following manner:

(a) If the Partner's Capital Account shows a debit balance, the partner is to bring the necessary amount of cash. The following journal entry is made :
Bank/Cash A/c Dr.
To Partner's Capital A/c
(Cash brought by the partner)

(b) If the Partner's Capital Account shows a credit balance, he/she is to be paid off the necessary amount of money. The following journal entry will be made :
Partner's Capital A/c Dr.
To Bank/Cash A/c
(Cash paid to partner)

Preparation of Cash/Bank account

After closing the partners' capital accounts,a bank account is prepared and all entries pertaining to the bank/cash are posted in it including any cash brought in by the partner on the dissolution of firm. Partners' capital accounts are closed by making payment from the bank account and thereby bank account stands closed by making/receiving payment. In this way all the accounts stand closed. If cash/bank account does not show any balance, it implies that all the accounts of the dissolved firm are closed properly.

7.5 Changes in Ownership in Partnerships

These include:

a) Admission of a partner;
b) Retirement/Death of a partner;
c) Changes in agreement among existing partners;
d) Dissolution; and
e) Conversion into a limited liability company.

a) Admission of a partner entails addition of a capital column for the new partner and the following entries thereafter:

Dr Cash book
a. Cr Capital account (with cash received from the joining partner)

b) Retirement/death involves making entries to the reverse of those required for admission, i.e.

Dr Capital accounts
a. Cr Cash book (with the amounts paid to the retiring partner or beneficiaries of the demised partner).

However, both admission and retirement/death bring about the following additional issues:

I. Goodwill;
II. Revaluations;
III. Changes taking place part-way through the year in the instance that they arise during the year.

c) Goodwill will be recorded during any change in ownership as follows:

Dr Goodwill account
Cr Capital accounts (in old profit sharing ration)

Goodwill should be eliminated as soon as transition in ownership is complete by:

Dr Capital accounts (in new profit sharing ratio)
Cr Goodwill

This is of course, subject to continuance of the business. Goodwill will not be eliminated if there is no business continuance, e.g. dissolution.

d) Revaluations are usually carried out during changes in ownership – and any gains or losses there from transferred to partners' capital accounts are credits and debits respectively.

e) The conversion of a partnership into a limited company is essentially the purchase of the partnership by a limited company.

f) The accounting procedures to be followed are:-

I. Open a realisation account.
Dr: the assets (book value)
Dr: the account with expenses of realisation.
Cr: the various assets accounts.

II. Sales proceeds:
Dr : Cash;
Cr: realisation account.

III. Assets taken over by any partner;
Dr : partner's capital account;
Cr: realisation account with the agreed price.

IV. liabilities of the partnership (if not taken over by the buyer) are paid off:
Dr: Sundry Creditors accounts;
Cr: cash account.

V. Liabilities taken over (book value):
Dr: sundry Creditors account
Cr: realisation account.

g) The balance, if any, in the realisation account is the gain or loss on realisation; this should be divided between the partners in their profit sharing ratio and is transferred to their capital accounts.

h) Any advance made to the partnership by any partner is accounted for and paid off.

i) The net balance in the capital account will always be equal to the balance in the cash book. Partners are paid for any credit balance in their capital accounts; partners with debit balances will be required to pay to the firm a sum of money equal to the debit balance.

j) If a partner is unable to clear the deficiency in his capital account, the solvent partners will bear the deficiency among themselves in the proportion of their last agreed capital (Garner V. Murray) i.e the balance in their capital accounts before the dissolution of the partnership.

7.6 Dissolution

The term dissolution means coming to an end or discontinuation. The dissolution of a firm implies complete breakdown of the partnership relation among all the partners. Dissolution of the partnership (owing to retirement, death or insolvency of a partner), merely involves change in the relation of the partners but it does not end the firm; the partnership would certainly come to an end but the firm, the reconstituted one might continue under the same name. So the dissolution of the partnership may or may not include the dissolution of the firm but the dissolution of the firm necessarily means the dissolution of the partnership. On dissolution of the firm, the business of the firm ceases to exist since its affairs are would up by selling the assets and by paying the liabilities and discharging the claims of the partners. The dissolution of partnership among all partners of a firm is called dissolution of the firm.

(i) **Dissolution by Agreement**: A firm is dissolved in case all the partners give consent or as per the terms partnership agreement .

(ii) **Compulsory dissolution**: A firm is dissolved compulsorily in the following cases:

1. When all the partners or all excepting one partner becomes insolvent or of unsound mind.
2. When the business becomes unlawful.
3. When all the partners excepting one decide to retire from the firm.
4. When all the partners or all excepting one partner die.

A firm is also dissolved compulsorily if the partnership deed includes any provision regarding the happening of the following events:
- (a) expiry of the period for which the firm was formed,
- (b) completion of the specific venture or project for which the firm was formed.

(iii) **Dissolution by notice**: In case of a partnership at will, the firm may be dissolved if any one of the partner gives a notice in writing to the other partners.

(iv) **Dissolution by Cour**t: A court may order a partnership firm to be dissolved in the following cases:
- (a) When a partner becomes of unsound mind
- (b) When a partner becomes permanently incapable of performing his/her duties as a partner
- (c) When partner deliberately and consistently commits breach of agreements relating to the management of the firm;
- (d) When a partner's conduct is likely to adversely affect the business of the firm;
- (e) When a partner transfers his/her interest in the firm to a third party;
- (g) When the court regards d

Treatment of assets and liabilities

When the partners decide to discontinue the business of the firm, it becomes necessary to settle its accounts. For this purpose, it disposes off all its assets (except cash and bank balances) for satisfying all the claims against it. For this purpose a separate account called 'Realisation Account' is opened.

Realisation is an account in which assets excluding cash in hand and bank are transferred at their book value and all external liabilities are transferred at their book

It also shows what amount were realised on the sale of assets and which liabilities were discharged at what amount.

In order to record the disposal of assets and discharge of liabilities, the following journal entries are recorded:

1. *For Transfer of Assets*

Assets account is closed by transferring it to the Realisation Account at its Book Value.

Realisation A/c Dr.
To Assets A/c (Individually)
(Transfer of assets)

It is to be noted that the following items on the assets side of the Balance Sheet are not transferred to the Realisation Account :

(a) (i) Undistributed loss (i.e. Debit Balance of Profits and Loss account)
(ii) Fictitious assets or deferred revenue expenditures such as preliminary expenses .

All the above items are closed by transferring them to the partners' Capital Account in their profit sharing ratio. The Journal entry is made:

Partner's capital A/c Dr. (Individually)
To Profit & Loss A/c
To Fictitious Assets A/c
(Transfer of loss and fictitious Assets)

(b) Cash in hand, and Cash at Bank, will be the opening balance of the Cash/Bank account;

(c) Provisions and reserves against assets should be closed by crediting the Realisation Account.

The Journal entry is made :
Provision for Doubtful Debts A/c Dr.
Provision for Depreciation A/c Dr.
Any other Provision A/c Dr.
To Realisation A/c
(Transfer of provision on assets)

2. *For Transfer of Liabilities*

The accounts of various external liabilities are closed by transferring them to the Realisation Account. The loan given to the firm by a partner's wife treated as an external liability and is transferred to the credit of Realisation Account. The relevant Journal entry is as under.

External Liabilities A/c Dr. (Individually)
 To Realisation A/c
(Transfer of external liability)

Capital and Loan account of the partners' are treated separately and so are not transferred to the Realisation Account.

3. Treatment of accumulated reserves and profit/loss

Any balance of accumulated reserves (e.g. general reserves), Profit and Loss Account (Cr.), Reserve Fund and other reserves on the date of dissolution will be credited to the Partners' Capital accounts on the basis of profit sharing ratio. The following journal entry will be recorded:

Profit and Loss A/c Dr.
General Reserve A/c Dr.
Any Other Fund Dr.
 To Partners' Capital A/c (Individually)
(transfer of profit and reserve)

4. For Sale of Assets (for cash)

Bank/ Cash A/c Dr. (Realised Value)
 To Realisation A/c
(Sale of assets)

5. For Assets taken over by the partner

Partners' Capital A/c Dr.
 To Realisation A/c (Agreed Price)
(Assets taken over by partner)

Bank/Cash/Partners capital A/c Dr.
 To Partner's Loan A/c
(settlement of loan to a partner)

6. Settlement of loans given by the Partner

Partners' Loan A/c Dr.
 To Bank/Cash/Partners' capital A/c
(Settlement of loan given by the partner)

7. Payment of Liabilities in Cash

Realisation A/c Dr.
To Cash A/c
(Payment of liabilities)

8. Payment of Liabilities by the partner(s)

Realisation A/c Dr.
To Partner Capital A/c
(Liabilities taken over by partner)

Treatment of unrecorded assets and liabilities

There are instances where some assets that may have already been written off completely in previous years and thus, do not appear in the Balance Sheet but physically they still exist for operational purposes. For example, there is an old computer, which is still in working condition though its book value is zero. Similarly, there may be some liabilities, which do not appear in the Balance Sheet, but actually they are still there. For example, a bill discounted with bank, on dissolution it was dishonored and had to be taken up by the firm for payment purposes.

It is to be kept in mind that an unrecorded asset would never be transferred to the debit of the Realisation Account, because the amount realised from its sale is in nature of a gain and the Realization Account is only credited accordingly. Similarly, an unrecorded liability need not be transferred to Realisation.

Reason being that its payment is a loss and Realisation Account is only debited with the actual payment. In such cases, the following journal entries are made :

(a) When the amount realised from the sale of an unrecorded asset.

Cash/Bank A/c Dr.
To Realisation A/c
(Sale of unrecorded assets)

(b) When an unrecorded asset is taken over by a partner at an agreed value.

Partner's Capital A/c Dr.
To Realisation A/c
(Unrecorded assets taken by partner)

(c) When unrecorded liability has been discharged by the firm.

Realisation A/c Dr.

To Bank/Cash A/c

(Payment of unrecorded liabilities)

(d) When an unrecorded liability is discharged by a partner on behalf of the firm.

Realisation A/c Dr.

To Partner's Capital A/c

(Unrecorded Liabilities payment by partner)

Payment of Realisation Expenses

(a) When realisation expenses are paid by the firm (i.e. borne by the firm).

The following journal entry will be recorded:

Realisation A/c Dr.

To Bank/ Cash A/c

(Payment of realisation expenses)

(b) When Realisation expenses are paid by the partner on behalf of the firm (i.e. realisation expenses paid by the partner but borne by the firm). The following journal entry is made:

Realisation A/c Dr.

To Partners' Capital A/c

(Payment of realisation expenses by partner on behalf of firm)

(c) Realisation expenses paid by the partner and borne by the partner;

Partner's Capital A/c Dr.

To Cash/Bank A/c

(Realisation expenses paid and borne by partner)

Closing of Realisation Account

The balance in the realisation account would show either profit or loss on dissolution. If the total of the credit side is more than the debit side, then there is a profit and following journal entry is made :

Realisation A/c Dr. (Individually)

To Partner's Capital/ Current A/c (Individually)

(Profit on realisation transferred to capital accounts)

If, the debit side is more than credit side, then there is a loss on dissolution and following journal entry is made :

Partner's Capital/Current A/c Dr. (Individually)
To Realisation A/c
(loss on realisation transferred to capital account)

Format of Realisation account

Realisation account

Date	Particular	KShs	Date	Particular	KShs
	All assets A/c (at book value) Except cash and bank.			**All external liabilities A/c** (at book value)	
	Cash/bank A/c (payment of external liabilities) (Expenses on realisation)			**Cash /Bank A/c** (Amount realized on sale of various assets)	
	Partners Capital A/c (Any liability paid by partner) (Expenses on realisation paid by a partner)			**Partners Capital A/c** (If any asset is taken over)	
	(For transferring profit on realisation)			(For transferring loss on realisation)	

Question 2

Kamau, Patel and Ivov Co. Advocates

Kamau, Patel and Ivov Co. Advocates were in partnership sharing profits and losses in the ratio 5:3:2. The following trial balance has been extracted from their books of account as at 31 March 2011:

	KShs	KShs
Bank interest received		500
Capital accounts (as at 1 April 2010)		
Me		60,000
Myself		35,000
I		10,000
Carriage inwards	2,000	
Carriage outwards	4,000	
Cash at bank	5,200	
Current accounts:		
Me	2,100	
Myself	1,200	
I	900	
Discounts allowed	5,000	
Discounts received		8,500
Drawings:		
Me	20,000	
Myself	15,000	
I	12,000	
Motor vehicles		
At cost	1,200,000	
Accumulated depreciation (at 1 Jan 2009)		375,000
Office expenses	36,500	
Plant and machinery		
At cost	1,000,000	
Accumulated depreciation (at 1 Jan 2009)		200,000
Provision for bad and doubtful debts		
(at 1 Jan 2009)		320
Purchases	400,000	
Rent, rates, heat and light	16,000	
Sales		1,199,690
Stock (at 1 Jan 2009)	50,000	
Trade creditors		20,300
Trade debtors	18,500	
	X	x

Additional information

(1) Stock at 31 Dec 2010 was valued at KShs 35,000.

(2) Depreciation on the fixed assets is to be charged as follows:
Motor vehicles – 25% on the reducing balance
Plant and machinery – 20% on the original cost.
There were no purchases or sales of fixed assets during the year to 31 Dec 2010.

(3) The provision for bad and doubtful debts is to be maintained at 5% of the total trade debtors as at 31 Dec 2010.

(4) Rent of KShs 1, 000 was owing at 31 Dec 2010, and some office expenses amounting to KShs 1,400 had been paid in advance as at that date. These items had not been included in the list of balances shown in the trial balance.

(5) Interest on drawings and on the debit balance on each partner's current account is to be charged as follows:

	KShs
Kamau	2,000
Patel	1,500
Ivov	1,200

(6) According to the partnership agreement, I is allowed a salary of KShs 1, 200,000 per annum. This amount was owing to I for the year to 31 Dec 2010, and need to be accounted for.

(7) The partnership agreement also allows each partner interest on his capital account at a rate of 10% per annum. There were no movements on the respective partners' capital accounts during the year to 31 Dec 2010, and the interest had not been credited to them as at that date.

(8) On 1 Jan 2010, Pinto Ltd. agreed to purchase the business on the following terms:
   (a) Me purchased one of the partnership motor vehicles at an agreed value of KShs 250,000, the remaining vehicles being taken over by the company at an agreed value of KShs 325,000;
   (b) The company agreed to purchase the plant and machinery at a value of KShs 600,000 and the stock at a value of KShs 40,000;
   (c) The partners to settle the trade creditors: the total amount agreed with the creditors being KShs 19,500;
   (d) The trade debtors were not to be taken over by the company, the partners receiving cheques on 1 Jan 2010

amounting to KShs 12,000 in total from the trade debtors in settlement of the outstanding debts;

(e) The partners paid the outstanding office expense on 1 Jan 2010, and the landlord returned the rent paid in advance by cheque on the same day;

(f) As consideration for the sale of the partnership, the partners were to be paid KShs 58,000 in cash by Pinto Ltd., and to receive KShs 80,000 in KShs 1 ordinary shares in the company, the shares to be apportioned equally amongst the partners.

(9) Assume that all the matters relating to the dissolution of the partnership and its sale to the company took place on 1 Jan 2010.

You are required:

(a) to prepare:

(i) Kamau's, Patel's and Ivov's trading, profit and loss and profit and loss appropriation account for the year to 31 Dec 2010; and (**9 marks**)

(ii) Kamau's, Patel's and Ivov's current accounts (in columnar format) for the year to 31 Dec 2010 (the final balance on each account is to be then transferred to each partner's respective capital account); and (**3 marks**)

(b) to compile the following accounts:

(i) The partnership realisation account for the period up to and including 1 Jan 2010; (**5 marks**)

(ii) The partners' bank account for the period up to and including 1 Jan 2010; and (**3 marks**)

(iii) The partners' capital accounts (in columnar format) for the period up to and including 1 Jan 2010. (**5 marks**)

(**Total: 25 marks**)

Solution

(a)(i)

Kamau, Patel and Ivov Co. Advocates

Trading and profit and loss account for the year to 31 Dec 2010

	KShs	KShs
Sales		1,199,690
Opening stock	50,000	
Purchases	400,000	
Carriage inwards	2,000	
	452,000	
Less: Closings stock	75,000	
Cost of goods sold	377,000	
Gross profit		822,690
Other income		
Bank interest	550	
Discounts received	8,500	9,050
		831,740
Expenses		
Carriage outwards	4,000	
Depreciation		
Motor vehicles [(1,200, – 200) X 25%]	250,000	
Plant and machinery (1000 X 20%)	200,000	
Discounts allowed	5,000	
Bad and doubtful debts		
[(18,500 X 5%) – 320]	295	
Office expenses (36,500 - 1,400)	35,100	
Rent, rates, heat and light (16,000+ 1000)	17,000	
Net profit for the year		**511,395**
		320,345

Appropriation statement

	KShs	KShs
Net profit for year		**320,345**
Add: Interest on drawings		
Me	2,000	
Myself	1,500	
I	1,200	4,700
		315,645
Less: Interest on capital		
Me	6,000	
Myself	3,500	
I	1,000	
	10,500	
Salary I	120,000	
		(130,500)
		185,145
Profit sharing ratio: 5:3:2		
Me	92,572	
Myself	55,544	
I	37,029	
		185,145

Current accounts

	Me	Myself	I		Me	Myself	I
	KShs	KShs	KShs		KShs	KShs	KShs
Balance b/d	2,100	1,200	900	Appropriation accounts	6,572	57,544	156,829
Drawings	20,000	15,000	12,000				
Balances to Capital a/c	4,472	41,344	143,929				
	96,572	57,544	156,829		96,572	57,544	156,829

Realisation account

	KShs		KShs
Stock		Me – M.Vehicle	250,000
Motor vehicles (W1)	575,000	Trade creditors (W4)	500
Plant and		Pinto Ltd. (W5)	138,500
machinery (W2)	600,000	Capital Accounts:	
Trade debtors (W3)	5,575	Me	446,287
		Myself	267,773
		I	178,515
	1,181,575		**1,181,575**

Bank Account

2010 KShs		2010 KShs	
31 Dec 10 Balance b/d	5,200	1 Jan – rent & rates	1000
1 Jan 11 Trade debtors	12,000	Trade creditors	19,500
Office expense returned	1,400		
Pinto Ltd.	58,000		
Cash contributed by partners			
Me	588,815		
Myself	218,429		
I	48,586		
	932,430		**932,430**

(iii) Capital accounts

	Me	Myself	I		Me	Myself	I
	KShs	KShs	KShs		KShs	KShs	KShs
Motor vehicle	250,000			Balance b/d	60,000	35,000	10,000
Shares	27,000	27,000	27,000	Current account	74,472	41,344	143,929
Realisation	446,287	267,773	178,515	Bank (Balance)	588,815	218,429	48,586
	723,287	**294,773**	**202,515**		**723,287**	**294,773**	**202,515**

Workings

(W1) **Motor Vehicles Account**

	KShs		KShs
Balance b/d	1,200,000	Accumulated depreciation b/d	375,000
	1,200,000	Depreciation for 2010	250,000
		Realisation	575,000
			1,200,000

(W2) **Plant and machinery account**

	KShs		KShs
Balance b/d	1,000,000	Accumulated depreciation b/d	200,000
	1,000,000	Depreciation for 2010	200,000
		Realisation	600,000
			1,000,000

(W3) **Trade debtors' account**

	KShs		KShs
Balance b/d	18,500	Balance b/d Provision for bad and Doubtful debts	925
		Bank	12,000
		Realisation	5,575
	18,500		18,500

(W4) **Trade creditors' account**

	KShs		KShs
Bank	19,500	Balance b/d	20,300
Realisation	800		
	20,300		20,300

(W5) **Consideration**

	KShs
Cash	58,000
Shares: 80,000 KShs 1 shares	80,000
	138,000

Question 3

Moja, Tatu and Tano are in partnership sharing profit in the proportion of ½, ⅓, ⅙ respectively. They dissolve the partnership of the 31 December 2006, when the balance sheet of the firm stood as under:

Balance sheet as on 31 December 2006

Fixed Assets		
Freehold property	90,000	
Machinery	48,000	
Capital Investment		42,000
Current assets		
Sundry debtors	58,000	
Stock	39,500	
Bank	37,500	
	315,000	
Current Liabilities		
Bills payable	25,000	
Sundry Creditors	30,000	
Moja's loan	40,000	

Capital	
Tatu	90,000
Moja	75,000
Tano	55,000
	315,000

Question:

The last balance sheet of jade and ruby who share profits ⅔rds & ⅓rd respectively is as follows. On this date they shall dissolve the partnership.

Statement of financial performance

- The financial performance of an enterprise is primarily provided in the statement of financial performance (income statement or profit and loss account). The elements of an income statement or the elements that measure the financial performance are as follows:

Revenue: increases in economic benefit during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in increases in equity. However, it does not include the contributions made by the equity participants, i.e., proprietor, partners and shareholders.

-Expenses: decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrence's of liabilities that result in decreases in equity.

Revenues and expenses are measured in nominal monetary units under the Historical Cost Accounting model and in units of constant purchasing power (inflation-adjusted) under the Units of Constant Purchasing Power model.

Income statement

Income	Expenditure

Statement of financial position

The financial position of an organization/firm is primarily provided in the statement of financial position. The elements include:

Asset: An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.

-Liability: A liability is a present obligation of the enterprise arising from the past events, the settlement of which is expected to result in an outflow from the enterprise' resources, i.e., assets.

-Equity: Equity is the residual interest in the assets of the enterprise after deducting all the liabilities under the Historical Cost Accounting model. Equity is also known as owner's equity. Under the units of constant purchasing power model equity is the constant real value of shareholders´ equity.

Balance sheet

Fixed Assets	**KShs**	**KShs**
Plant		
Equipment and Machinery		
Goodwill		
Current Assets		
Stock		
Prepayments		
Long-term Liabilities		
12% Treasury bond		
Current Liabilities		
Creditors		
Accrual		
Authorized share capital		

Question One

Kyumu, Kyalo and Kyimi were in partnership, sharing profits and losses, Kyumu 60%, Kyalo 30% and Kyimi 10%. The partnership deed provided the following:

(i) Interest at the rate of 10% per annum shall be allowed on fixed capital accounts balances. Interest will not be allowed on current accounts but 8% per annum is to be charged on any debit balance at the start of the year.

(ii) Goodwill is to be valued at the average annual profits of the three years immediately preceding the balance sheet date.

The following are particulars of partners' accounts:

	"Fixed" Capital At 31 Dec 2010	Balances on Current Account at 31 Dec 2010
	KShs	KShs
Kyumu	180,000	50,000 Cr
Kyalo	90,000	10,000 Cr
Kyimi	30,000	12,000 Cr
Kyalo	90,000	10,000 Cr
Kyimi	30,000	12,000 Cr

The partners agreed to take Kilonzo, a son of Kyumu, into partnership as on 1 January 2011 and on that day he introduced KShs 35,000 in cash which included his "fixed" capital of KShs 30,000. He is to receive a salary of KShs 15,000 per annum in addition to his share of the profit. Kyumu personally guaranteed that the aggregate of Kilonzo's salary and share of profit shall be not less than KShs 30,000 per annum.

Profit sharing ratios are to be Kyumu 30%, Kyalo 30%, Kyimi 30% and Kilonzo 10%. Agreed profits for goodwill purpose for the past four years are as follows:

	KShs
2007	163,370
2008	102,550
2009	107,580
2010	141,640

No account for goodwill is to be maintained in the books, adjusting entries for transactions between the partners being made in their current accounts.The draft accounts for the year ended 31 December 2011, before taking into account Kilonzo's salary or interest on partners' accounts, show a profit of KShs 176,400. Partners' drawings during the year are Kyumu KShs 63,000, Kyalo KShs 49,000, Kyimi KShs 49,000 and Kilonzo (including salary) KShs 21,930.

Required:

(a) A statement showing the sharing of profit for the year ended 31 December 2011.

(b) The partners' current accounts for the year ended 31 December 2011, recording therein the entries necessary upon admission of Kilonzo as a partner.

(20 marks)

(CPA)

Question

Janne, Jeanne and Jannet are in partnership sharing profits and losses in ratio the 2:1:1. The balance sheet of the firm as at 30 April 1989 was as follows:

	KShs	KShs		KShs	KShs
Capital Accounts			**Fixed assets**		
Janne	411,000		Land and building		
Jeanne	260,000		at cost		780,000
Jannet	340,000	1,011,000	Furniture and fittings		124,000
			Less: Depreciation		
				12,400	111,600
					891,600
Current Liabilities			**Current assets**		
Bank overdraft	16 600		Stock	176,000	
Creditors	54 000	70,600	Debtors	14,000	190,000
		1,081,600			1,081,600

On 30 April 2009,the partners agreed to dissolve the partnership. Jeanne communicated that she would carry on business as a sole proprietorship therefore would take over the furniture and fittings, stocks and debtors at valuations of KShs 115,000, KShs 200,000, and KShs 10,000 respectively. She also agrees to acquire the land and building at a cost of KShs 1,200,000 and obtains a bank loan of KShs 1,000,000 which is paid to the partnership. The balance owing by Jannet is charged against Janne's capital account as the two parties have agreed that Jannet will repay the loan to Janne over a period of twenty-four months at an interest rate of 10% p.a. Realisation expenses amounting to KShs 22,300 are paid in cash and the creditors of the firm are paid in full.

Required:

Prepare the ledger accounts of the partnership in order to close off the books as at 30 April 2009.

(18 marks)

(**CPS)**

Question

(a) Mwenda, Ndungu and Rono have carried on partnership for several years, sharing profits and losses

Equally after allowing for annual salaries as follows:

	KShs
Mwenda	150,000
Ndungu	90,000
Rono	90,000

They decided to convert the partnership into a limited company, Nanu Ltd, as at 30 November 2008, on the following terms:

(i) Goodwill to be valued at KShs 2,000,000.

(ii) Other assets to be valued as follows:

	KShs
Freehold property	22,700,000
Furniture and fittings	1,120,000
Motor vehicles	2,400,000

(iii) Each partner is to become a director of the company at the same salary as previously allowed in the partnership.

(iv) Ndungu's loan is to be converted into share capital at par.

(v) Shares are to be issued to each partner at par in respect of the amounts of their equity holding at 30 November 2008. The company was incorporated on 14 December 2008.

(vi) The financial year of the partnership ends on 31 May. No action has been taken to carry out the terms of the conversion of the partnership into the limited company in the books of account.

Trial balance as at 31 May 2009

	KShs	KShs
	'000'	'000'
Capital Accounts at 1 April 2009		1,800
Mwenda		900
Ndungu		600
Rono		
Stocks 31 May 2009	1,680	
Cost of sales	4,200	
Sales		10,315
Administrative expenses	1000	
Selling expenses	500	
Accounts and audit expenses	80	
Incorporation expenses	50	
Drawings during the year:		
Mwenda	120	
Ndungu	80	
Rono	60	
Freehold property at cost	5,160	
Furniture and fittings at cost	1,200	
Accumulated depreciation		720
Accounts receivable and payable	980	640
Prepayments and accruals	90	45
Loan – Ndungu (10% interest)		900
Motor Vehicles at cost	1,200	
Accumulated depreciation		360
Bank account		120
	16,400	16,400

Additional information:

1. The sales during the second half of the year were 60% of the total sales though the gross profit percentage remained the same throughout the year.
2. The selling expenses were proportional to the sales for each period. All other overhead expenses were incurred evenly throughout the year.
3. Salary drawings were made evenly. Drawings made after incorporation were to be treated as directors' salaries.
4. There were no purchases or sales of fixed assets during the year. Depreciation is to be provided on cost as follows:

Furniture and fittings	10% p.a
Motor vehicles	20% p.a

5. No dividends are paid or proposed but it is decided to write off the preliminary expenses and also KShs 350,000 of the goodwill.

Required:

(i) Prepare the Trading and Profit and Loss Account for Nanu Ltd. for the six months ended 31 May 2009 and a balance sheet at that date.

(ii) Show calculation of the amount of shares to be issued to each partner. (20 marks)

(CPS)

A and B Advocates and C and D Advocates were practicing firms of advocates. On 1 January 2011, they agreed to amalgamate the partnerships into one firm. Able and Mine Advocates.

The accounts of the separate partnerships have been prepared annually to 31 December 2010.

The agreed profit and loss sharing ratios in the old and new firms were as follows:

	A	B	C	D
Old firms	3	2	2	1
New firm	4	3	2	1

The balance sheets extracts of the partnerships as at 31 December

2010 were as follows:

	A and B Advocates KShs '000'	C and D Advocates KShs '000'
Non-current assets		
Motor vehicles	9,200	7,200
Office equipment	6,000	4,500
	15,200	11,700
Goodwill	7,000	5,000
Current assets:		
Investments	6,500	1,000
Accounts receivable	18,000	9,000
Cash	4,500	3,000
	29,000	13,000
Total assets		
Capital and Liabilities:	51,200	29,700
Capital accounts:		
A		
B	35,000	–
C	17,200	–
D	–	13,000
	–	10,200
	32,200	23,200
Current liabilities:		
Client account	6,000	–
Accounts payable	3,000	5,500
Bank overdraft	–	1,000
	9,000	6,500
Total capital and liabilities	51,200	29,700

Additional Information:

1. Provision for bad and doubtful debts to be made at 5% of the accounts receivable.
2. Able and Mine Advocates was to take over the assets of the old partnerships at the following agreed values:

A and B Advocates	C and D Advocates	
Motor vehicles	8700	6800
Office equipment	5800	3200
Goodwill	7300	5300

3. The investments of A and B Advocates were sold on 21 February 2011 for KShs 8,500,000.
4. The capital for Alphabet Co. Advocates amounted to KShs 75,000,000 which was contributed by the partners in their profit sharing ratios, any adjustments being made in cash.
5. The client account and the accounts payable were settled immediately on amalgamation.

Required:

Prepare the following accounts to record the above transactions:

(i) Realizing accounts.
(ii) Capital accounts.
(iii) Cash accounts.
(iv) Alphabet Co. Advocates account.

Question

Batian and Lenana are equal partners in a firm. They decided to dissolve the partnership on December 2011 when the balance sheet stood as under:

Extract from a Balance sheet as at December 2011

	KShs	KShs
Fixed Assets		
Leasehold land		1200,000
Plant		940,000
Current Assets		
Cash at Bank	22,000	
Sundry Debtors	24,000	
Stock	84,000	
Furniture	50,000	
Current Liabilities		
Sundry creditors	54,000	
Reserve fund	20,000	
Loan	80,000	
Capital		
Batian		1,200,000
Lenana		2,400,000

Assets were realized as follows:

	Kshs
Leasehold land	144,000
Furniture	45,000
Stock	81,000
Plant	96,000
Sundry debtors	21,000

The creditors were paid 51,000 (in full settlement).

Expenses of realisation amounted to 6,000.

Required:

Prepare Realisation account, Bank account, and Partners' capital accounts to close the books of the firm.

Chapter Eight

Interpretation of Financial Statements

8.1 Introduction

Introduction interpretation of financial statements.

Unlike the many ways in which reported earnings can be presented, there is little a company can do to manipulate its cash situation. Barring any outright fraud, the cash flow statement tells the whole story. The company either has cash or it does not. Lawyers need to have an understanding of the cash flow statement, in order to understand the overall health of any company/entity.

Interpretation is a function of giving meaning. In law the interpretation of statutes is done by the courts to give meaning to the intention of the law maker (Parliament).In interpreting, the courts apply various rules and assumptions.

In financial reporting, an analysis is carried out to help the user appreciate the financial implication of the operating, financing and investing activities in the organization.This is achieved by application of various principles in conformity to the reporting standards.

8.2 Nature

What is a financial statement?

They include:

- The income statement also known as the profit and loss or statement of financial results
- The balance sheet also known as the statement of financial position
- The cash flow statement
- The statement of retained earnings also known as the statement of changes in equity or the statement of total recognized gains and losses

Objective of financial statements

A financial statement should reflect true and fair view of the business affairs of the organization. As these statements are used by various constituents of the society/regulators, they need to reflect true view of the financial position of the organization. It is very important to check the financial position of the business for a specific period.

On 6 September 2007, the IASB issued a revised IAS 1 Presentation of Financial Statements. The main changes from the previous version are to require that an entity must:

- present all non-owner changes in equity (that is, 'comprehensive income') either in one Statement of comprehensive income or in two statements (a separate income statement and a statement of comprehensive income). Components of comprehensive income may not be presented in the Statement of changes in equity.
- present a statement of financial position (balance sheet) as at the beginning of the earliest comparative period in a complete set of financial statements when the entity applies the new standard.
- present a statement of cash flow.
- make necessary disclosure by the way of a note.

The revised IAS 1 is effective for annual periods beginning on or after 1 January 2009. Early adoption was permitted.

On 16 June 2011, the IASB issued amendments that will improve and align the presentation of items of other comprehensive income (OCI) in financial statements prepared in accordance with (IFRs) and those prepared in accordance with GAAP.

The amendments to IAS 1 presentation of financial statements require companies preparing Financial Statements in accordance with IFRs to group together items with OCI that may be reclassified to the profit or loss section of the income statement.The amendment also reaffirm existing requirements that items in OCI as profit or loss should be presented as either a single statement or two conclusive statements.

Qualitative characteristics of financial statements

Qualitative characteristics of financial statements include:

Content

- Reliability – Information that is complete and faithful representation free from material error, neutral, complete, and prudence.
- Relevance – Information that has the ability to influence decisions has predictive value, and confirmatory value.

Presentation

- Comparability – Similarities and differences can be discerned and evaluated.
- Understandability – The significance of the information can be easily and clearly perceived by the users.

Elements of financial statements (IAS 1 article 10)

- The financial position of an enterprise is primarily provided in the Statement of financial position. The elements include:
  -Asset: An asset is a resource controlled by the enterprise as a result of past events from which future economic benefits are expected to flow to the enterprise.
  -Liability: A liability is a present obligation of the enterprise arising from the past events, the settlement of which is expected to result in an outflow from the enterprise' resources, i.e., assets.
  -Equity: Equity is the residual interest in the assets of the enterprise after deducting all the liabilities under the Historical Cost Accounting model. Equity is also known as owner's equity. Under the units of constant purchasing power model equity is the constant real value of shareholders´ equity.
- The financial performance of an enterprise is primarily provided in the statement of comprehensive income (income statement or profit and loss account). The elements of an income statement or the elements that measure the financial performance are as follows:
  -Revenues: increases in economic benefit during an accounting period in the form of inflows or enhancements of assets, or decrease of liabilities that result in increases in equity. However, it does not include the contributions made by the equity participants, i.e., proprietor, partners and shareholders.

-Expenses: decreases in economic benefits during an accounting period in the form of outflows, or depletions of assets or incurrence's of liabilities that result in decreases in equity.

Revenues and expenses are measured in nominal monetary units under the Historical Cost Accounting model and in units of constant power purchasing model (inflation-adjusted) under the units of constant power purchasing model..

- Statements of changes in equity
- Statements of cash flows
- Notes to the financial statements

Recognition of elements of financial statements

An item is recognized in the financial statements when:

- it is probable future economic benefit will flow to or from an entity.
- the resource can be reliably measured – otherwise the stable measuring unit assumption is applied under the Historical Cost Accounting model: i.e. it is assumed that the monetary unit of account (the functional currency) is perfectly stable (zero inflation or deflation); it is simply assumed that there is no inflation or deflation ever, and items are stated at their original nominal Historical Cost from any prior date: 1 month, 1 year, 10 or 100 or 200 or more years before; i.e. the stable measuring unit assumption is applied to items such as issued share capital, retained earnings, capital reserves, all other items in shareholders´ equity, all items in the Statement of Comprehensive Income (except salaries, wages, rentals, etc., which are inflation-adjusted annually), etc.

Under the Units of Constant Purchasing Power model, all constant real value non-monetary items are inflation-adjusted during low inflation and deflation; i.e. all items in the Statement of Comprehensive Income, all items in shareholders´ equity, Accounts Receivables, Accounts Payables, all non-monetary payables, all non-monetary receivables, provisions, etc.

Measurement of the elements of financial statements

Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognized and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.

A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:

(a) Historical cost.

Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

(b) Current cost.

Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.

(c) Realizable (settlement) value.

Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

8.3 Statement of cash flow

This is a summary of receipts and disbursements of cash for a particular period time. Also explains reasons for the changes in cash position of the firm.

In the past, the importance of cash to the healthy growth, or even survival of a firm has not been fully appreciated. This has resulted in several business failures – some having recorded healthy profits and asset bases (on the balance sheet); however, experiencing liquidity problems.

Users of financial statements need to be able to assess the cash and cash related matters of an entity. Such information is provided to users in the form of a cash flow statement.

The cash flow statement is a primary statement, i.e. it gets the same priority as the profit and loss and balance sheet in terms of prominence in presentation.

Cash flows are cash inflows and cash outflows. Transactions which increase the cash position of the entity are called inflows while those that decrease the cash position are referred to as cash outflows. Cash flow statements traces the various the various sources which bring in cash such as operating activities, sale of assets, issue of share capital and debentures etc. while those that cause outflow as loss from operations, purchase of assets, redemption of debentures or preference shares etc.

The cash flow statement serves a number of objectives

1) Cash flow statement aims at highlighting the cash generated from operating activities.
2) Cash flow statement helps in planning the repayment of loan schedule and replacement of fixed assets, etc.
3) Cash is the centre of all financial decisions. It is used as the basis for the projection of future investing and financing plans of the enterprise.

4) Cash flow statement helps to ascertain the liquid position of the firm in a better manner. Banks and financial institutions mostly prefer cash flow statement to analyze liquidity of the borrowing firm.
5) Cash flow Statement helps in efficient and effective management of cash.
6) The management generally looks into cash flow statements to understand the internally generated cash which is best utilized for payment of dividends.
7) It is very useful in the evaluation of cash position of a firm.

Methods of preparing cash flow statements.

A cash flow statement is simply a summary of the cashbook drafted using standard formats. The standard format requires the cash movement to be summarized in the cash flow statement in three categories:

a) Operating activities
b) Investing activities
c) Financing activities

Operating activities

The cash flows arising from operating activities is an indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to maintain the operating capability of the firm, repay loans, pay dividends and make new investments.

Cash flows from operating activities are derived from the primary revenue-producing activities of the firm. Cash flows from operating activities include:

a) Cash receipts from the sale of goods and the rendering of services;
b) Cash receipts from royalties, fees, commissions and other revenue;
c) Cash payments to suppliers for goods and services;
d) Cash payments to and on behalf of employees;
e) Cash receipts and cash payments of an insurance firm for premiums and claims, annuities and other policy benefits;
f) Cash receipts and payments from contracts held for dealing or trading purposes.
g) Cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities; and

Some transactions, such as the sale of an item of plant, may give rise to a gain or loss which is included in the determination of net profit or loss.

NB The cash flows relating to such transactions are cash flows from investing activities.

Investing Activities

These cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Cash flows arising from investing activities include:

a. Cash payments to acquire property, plant and equipment, intangibles and other long-term assets. These payments include those relating to capitalized development costs and self-constructed property, plant and equipment;
b. Cash receipts from sales of property, plant and equipment, tangibles and other long-term assets;
c. Cash payments to acquire equity or debt instruments of other firms and interests in joint ventures (other than payments for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
d. Cash receipts from sales of equity or debt instruments of other firms and interests in joint ventures (other than receipts for those instruments considered to be cash equivalents and those held for dealing or trading purposes);
e. Cash advances and loans made to other parties (other than advance and loans made by a financial institution);
f. Cash receipts from the repayment of advances and loans made to other parties (other than advances and loans of a financial institution);
g. Cash payments for future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the payments are classified as financing activities; and
h. Cash receipts from future contracts, forward contracts, option contracts and swap contracts except when the contracts are held for dealing or trading purposes, or the receipts are classified as financing activities.

Financing Activities

These are cash flows arising from financing activities. It is important to maintain a separate disclosure to aid predict claims on future cash flows by providers of capital to the firm. Cash flows arising from financing activities include;

(a) Cash proceeds from issuing shares or other equity instruments;
(b) Cash payments to owners to acquire or redeem the firm's shares
(c) Cash proceeds from issuing debentures, loans, notes, bonds mortgages and other short or long-term borrowings;
(d) Cash repayments of amounts borrowed; and
(e) Cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease.

The first category (operating activity) cash flows may be arrived at by two methods;

(a) The direct method – whereby major classes of gross cash receipts and gross cash payments are disclosed; or
(b) The indirect method – whereby the net profit or loss is adjusted for the effects of transactions of a non-cash nature and accruals/ prepayments

Even though both methods lead to the same end results, the direct method is more recommended as it provides more information to the user of the financial statements.

There are two methods of preparing the Cash Flow Statement. Both methods give the same results in respect of the final total as well as sub-totals of the three sections – operating, investing and the financing. They differ only in the manner the information regarding cash flow from operating activities is presented.

Cash Flow Statement (Direct Method)

for the year ended, March 20xx

(A) *Cash flow from operating Activities*

Cash receipts from Debtors		xxx
Cash payment for		
Cash paid to suppliers	(xxx)	

General expenses	(xxx)
Cash from operating activities	(xxx)
Taxes paid	(xxx)
Net Cash from operating activities	(xxxx)

(B) *Cash flow from Investing Activities*

Purchase of fixed Assets	(xxx)
Net cash used in investing Activities	(xxx)

(C) *Cash flow from financing Activities*

Proceeds from Raising secured loans	xxx
Dividend paid	(xxx)
Net cash from Financing Activities	xxx

Net Decrease in cash (– 3000 – 49000 + 39000) (13,000)

[A + B + C]

Cash flow Statement (Indirect Method)

For the year ended 20XX

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(A) *Cash flow from Operating Activities* :

Net profit as per Profit and Loss A/c	XXX
Add : Provision for Tax	XXX
Net profit before Tax	XXX
Add : Depreciation	XXX

Operating profit before working

Capital Changes

Add : Decrease in Current Assets or	
Increase in Current liabilities	
Increase in Creditors	XXX
Less : Increase in current assets or	
Decrease in Current liabilities	
Increase in Debtors	XXX
Increase in Inventory	XXX
Increase in prepaid expenses	XXX
Cash from Operating Activities	XXX
Taxes paid	(XXX)
Net cash from Operating Activities	(XXX)

(B) *Cash flow from Investing Activities :*

Purchase of Fixed Assets (See fixed assets)	(XXX)
Net cash used in Investing Activities	(XXX)

(C) *Cash Flow from financing Activities*

Proceeds from Raising Secured loan	XXX
Dividend paid	(XXX)
Net Cash flow from Financing Activities	XXX
Net Decrease in Cash a Cash equivalent	XXX

Illustration 1

The balance sheet of Walmark Ltd for the years ended 31 December, 2010 and 31 December 2011 were summarised and shown below:

	2011 KShs (000)	2010 KShs (000)
Fixed assets (at written down values)		
Premises	10,000	10,000
Fixtures	17,000	11,000
Vehicles	12,500	8,000
Current assets		
Stock	17,000	14,00
Debtors	8,000	6,000
Bank and cash	23,000	29,500
	87,500	78,500
Ordinary shares of KShs 1 per share	60,000	50,000
Reserves		
Profit and Loss	5,000	4,000
Creditors due in less than one year		
Trade creditors	4,000	2,500
Taxation	1,500	1,000
Proposed dividends	2,000	1,000
Creditors due in more than one year		
10% debentures	15,000	20,000
	87,500	**78,500**

Note: The 10% debentures were redeemed and cancelled on 31 December 2011

The profit and Loss account for the year ended 31 December 2011 was summarised thus:

	KShs(000)	KShs(000)
Turnover		36,250
Cost of sales		(21,750)
Gross profit		14,500
Profit on disposal of vehicles		700
		15,200
Less:		
Wages and salaries	1,600	
Other (cash) expenses	3,600	
Depreciation	3,500	
Debenture interest	2,000	
		10,700
Profit before tax		4,500
Less: Tax		1,500
Profit after tax		3,000
Less: Proposed dividends		(2,000)
Retained profit: for year		1,000
Brought forward		4,000
Carried forward		5,000

Separate bank and cash accounts for the year ended 31 December 19X2 were summarised as shown below:

	Bank KShs (000)	**Cash KShs (000)**		**Bank KShs (000)**	**Cash KShs (000)**
Opening balance b/d	25,300	4,200	Payment to trade creditors	23,250	-
Receipts from debtors	30,500	3,750	Wages, salaries	700	900
Receipts from fixed asset disposals – vehicles	1,200	500	Other expenses	2,400	1,200
Ordinary share issue	10,000	-	Debenture interest	2,000	
Transfer from cash	4,650	-	Fixed assets	7,000	-
			Fixtures	8,000	-
			Vehicles	1,000	
			Tax paid	1,000	
			Dividends paid	5,000	
			10% debentures: redeemed		4,650
			Transfer to bank	21,300	1,700
			Closing balances c/d		
	71,650	**8,450**		**71,650**	**8,450**
Opening balances b/d	21,300	1,700			

Solution

Walmark Ltd

Cash flow statement for the year ended 31 December 2011 (Direct Method)

	KShs(000)	KShs(000)
Operating activities		
Cash receipts from customers (30,500 + 3,750)		34,250
Cash paid to suppliers and employees (23,250 + 700 + 900)		(24,850)
Other cash payments (2,400 + 1,200)	(3,600)	
Cash generated from operations	5,800	
Tax paid	(1,000)	
Debenture interest paid	(2,000)	
Net cash inflow from operating activities		2,800
Investing activities		
Payments to acquire fixtures	(7,000)	
Payments to acquire vehicles	(8,000)	
Proceeds on disposal of vehicles	1,700	
Net cash outflow from investing activities		(13,300)
Financing Activities		
Ordinary share issue	10,000	
Redemption of debentures	(5,000)	
Dividends paid	(1,000)	
Net cash inflow from financing activities		4,000
Net change in cash and cash equivalents		(6,500)
Cash and cash equivalents b/f (25,300 + 4,200)		29,500
Cash and cash equivalents c/f (21,300 + 1,700)		23,000

Note:

1) When all cash movements have been brought in, the opening cash is added thereon to generate the closing cash

2) Under the direct method, the cash flow statement has been drawn up from the cash book only.

3) The term "cash and cash equivalents" refers to:
   a) Cash in hand
   b) Cash at bank
   c) Short-term investments

For the solution using the indirect method, no reference to the cash book is made. Information provided to enable preparation of the cash flow statement under this method consists:
   (i) Beginning of the year balance sheet
   (ii) End of year balance sheet
   (iii) A profit and loss account for the year
   (iv) Additional information
   (v) Thus accounts need reconstruction to obtain required values for the cash flow statement to be drawn up.

Walmark Ltd

Cash flow statement for the year ended 31 December 2011 (Indirect method)

	KShs(000)	KShs(000)
Operating activities		
Net profit before tax	4,500	
Adjustment for items not involving movement of funds		
Depreciation	3,500	
Profit on disposal of vehicles	(700)	
	7,300	
Adjustment for working capital items		
Increase in stock	(3,000)	
Increase in debtors	(2,000)	
Increase in creditors (trade)	1,500	
Cash generated from operations	3,800	
Taxation paid	(1,000)	
(Net cash inflow from operating activities)		2,800
Investing activities		
Payments to acquire fixtures	(7,000)	
Payments to acquire vehicles.	(8,000)	
Proceeds on disposal of vehicles	1,700	
Net cash outflow from investing activities		(13,300)
Financing activities	10,000	
Ordinary share issue Redemption of debentures	(5,000)	
Dividends paid.	(1,000)	4,000
Net change in cash and cash equivalents		(6,500)
Cash and cash equivalents b/f (25,300 + 4,200)		29,500
Cash and cash equivalents c/f (21,300 + 1,700)		23,000

(Adapted from CPA June 97)

Limitations of cash flow statement

A cash flow statement is very useful as it serves many purposes. But it is necessary to take certain precautions while making use of this important tool. The reason is that misleading conclusions might be found by not properly relating net income figure to the cash flow.

Some of the significant limitations of Cash Flow Statement are given below:

a) It is very difficult to precisely define the term 'cash'
b) There are controversies over a number of items like cheques, stamps, postal orders etc. to be included in cash or not.
c) As the present business moves from the cash basis to accrual basis, the prepaid and credit transactions might be represented an increase in working capital and it would be misleading to equate net income to cash flow because a number of non cash items would affect the net income.

8.4 Ratio Analysis

Financial analysis and interpretation of accounts

- Show relationships between financial figures
- Compare performance of the business past accounting years (trend analysis)
- Compare performance of the business with other similar businesses (in the same industry) or with the industry average.

Ratios can be categorized into:

(1) Liquidity ratios

These are the ratios that show the firms ability to meet its short-term maturing liability

Liquidity:

Current Ratio	Current assets / Current liabilities	Measures the ability of a firm to meet needs for cash as they arise
Quick/ acid-test	Current assets– inventory / Current liabilities	Measures short-term liquidity by eliminating inventory which is the least liquid current asset
Average collection period	Net accounts receivable / Net sales/365	Shows the number of days required to convert receivables into cash
Number of days inventory is held	Number of units in inventory x 365 ÷ Annual usage in number of units	Shows the number of days required to sell the inventory
Number of days payables are due	total supplier purchases / (Beginning accounts payable + Ending accounts payable) / 2	Shows the number of days required to pay the suppliers
Cash conversion	Average collection period +number of days inventory is held-days accounts payable are outstanding	Shows the number of days in the normal operating cycle

(2) Leverage/gaining ratio

This is a ratio that shows the extent to which the firm is financed by non-owner supplied funds.

Debt ratio	Total liabilities / Total assets	Shows the ratio of all assets financed with debt
Long-term debt	Long-term debt / Long-term debt +stockholders' equity	Measures the degree to which long-term debt is used for long-term financing
Debt to equity ratio	Total liabilities / Stockholder' equity	Measures debt relative to equity base
Financial leverage ratio	Return on equity / Adjusted return on assets	Shows how successful a firm is in employing debt
Times interest earned	Operating profit / Interest expense	Shows how many times interest payments are covered by operating earnings.

(3) Activity/turnover ratios

These show the efficiency with which the firm uses its various assets to generate sales revenue.

Accounts receivable turnover	Net sales / Net accounts receivable	Shows how many times receivables are collected during a year, on average
Rate of Inventory turnover	Cost of goods sold / Accounts payable	Measures efficiency of the firm in managing
Rate of Accounts payable turnover	Cost of goods sold / Accounts payable	Measures efficiency of the firm in paying payables
Rate of Fixed asset turnover	Net sales / Net property, plant &equipment	Measures how efficient the firm is in managing fixed assets
Total asset turnover	Net sales / Total assets	Measures the overall efficiency of the firm in managing all assets

(4)(a) Profitability in relation to sales ratio

These are ratios that show the firm's ability to control various decisions productions, operating and financing decisions.

Gross profit margin	Gross profit / Net sales	A measure of how well a company control its costs
Operating profit margin	Operating profit / Net sales	It measures the profitability of an entity particularly with regard to cost control. It is lower than gross profit since selling, administrative and other expenses are included along with costs of goods sold.
Net profit margin	Net profit / Net sales	Measure profit after elimination of all expenses & revenues
Cash flow margin	Cash flow from operating activities / Net sales	Measures the ability of a firm to generate cash from sales

(b) Profitability in relation to investment ratio

These show the efficiency with which the firm uses its various funds to generate profits

Return on equity	$\frac{\text{Net earnings}}{\text{Stockholders' equity}}$	Measures the rate of return on owners equity
Return on total assets	$\frac{\text{Net earnings}}{\text{Total assets}}$	Measures overall efficiency of a firm in managing assets& generating profits
Cash return on assets	$\frac{\text{Cash flow from operating activities}}{\text{Total assets}}$	Measures the return on assets on a cash basis

(5) Evaluation/equity ratios

These ratios show overall performance of the company. They can be used to indicate the theoretical value of the company's securities. For this reason, evaluation rations are very important to current investors and prospective investors.

Illustration

The following is a summarized Profit and Loss account of Keriako Ltd. For the year ended 31 December 2XXX and the balance sheet as that date.

Profit And Loss A/C

		KShs	KShs
Sales			850,000
Less Cost of Sales			
Opening stock		99,500	
Purchases	559,500		
	14,250		
	659,000		
Less closing stock	149,000	510,000	
Gross Profits			340,000
Less operating expenses			
Selling and distribution		30,000	
Depreciation		10,000	
Administration Expenses		135,000	175,000
EBIT			165,000
Less interest (financing) expenses			15,000
Earnings before taxes(EBT)			150,000
Taxes at 50%			(75,000)
Net income after taxes			75,000
Less ordinary dividend Sh. 075 per share			15,000
Retained profits			60,000

Balance Sheet

	KShs		KShs
Land and Buildings	250,000	Issued Capital	
Plant and Machinery (net)	80,000	(20,000 shares of	200,000
		KShs 10 each)	
Inventories	149,000	Reserves	90,000
Debtors	75,000	Retained profits	60,000
	71,000	Long-term debt	100,000
Less provision for bad debts	30,000		
Cash	4,000	Current Liabilities	130,000
	<u>580,000</u>		<u>580,000</u>

Ratios computed

i) Current ratio = $\frac{\text{Current assets}}{\text{Current Liabilities}}$

$\frac{250}{130} = 1.92:1$

The firm has short term financial strength. The acceptable current rations are between 1.5 and 3 for healthy business.

Quick (acid test) ratio = $\frac{\text{current assets – stock}}{\text{Current liabilities}}$

$\frac{250 - 149}{130}$

$= 0.78:1$

This is a more refined measure of liquidity as it excludes stocks which are not easily convertible to cash.

The company is not in a position to pay their current liabilities since the ratio is below 1 and should be looked at with extreme caution.

$$\text{Cash ratio} = \frac{\text{cash + marketable securities (short-term securities)}}{\text{Current Liabilities}}$$

$$= \frac{30{,}000}{130{,}000}$$

$$= 0.23 : 1$$

The company is not in a position To pay all its current liabilities in the immediate short-term.

A cash ratio of 1.00 and above means that the business will be able to pay all its current liabilities in the immediate short-term.

However, due to businesses strategically utilising funds to ensure no funds lie idle, the normal value of cash ratio is somewhere below 1.00.

$$\text{Net working capital ratio} = \frac{\text{Net working capital (NWC)}}{\text{Net assets}}$$

$$NWC = CA - CL$$

$$= \frac{250 - 130}{580 - 130}$$

$$= 0.27 : 1$$

ii) Leverage ratios (given in %)

a) Debt ratio = $\frac{\text{Total liabilities}}{\text{Total assets}}$

Measures the proportion of total assets supplied by non-owner funds

$$= \frac{100 + 130}{580}$$

$$= 0.4 \text{ or } 40\%$$

b) Debt equity ratio = $\frac{\text{Total liability}}{\text{Net worth (NW = TA – TL)}}$

This ratio measures the amount of non-owner supplied funds for every shilling from the owner.

$$= \frac{230}{580 - 230}$$

$$= 0.66 = 66\%$$

c) Long-term debt ratio = $\frac{\text{Long-term liabilities}}{\text{Net Assets}}$

$$= \frac{100}{450}$$

$$= 22\%$$

This measures the proportion of permanent assets financed by non-owner supplied funds.

Note: The higher the ratio, the higher the gearing ratio.

d) Time interest earned =

$$\frac{\text{Earning before interest (operating profits) + taxes + depreciation}}{\text{(interest + coverage ratio) Interest expenses}}$$

The ratio measures the number of times interest expense is covered by operating profit. The higher the ratio, the lower the leverage position.

$$= \frac{(165 + 10)\ 000}{15{,}000}$$

$$= 11.7 \text{ times}$$

Gearing ratio and liquidity ratios can be used to measure the financial risk of the company. The higher the liquidity ratios, the lower the financial risk.

(a) The higher the gearing ratio, the higher the financial risk, (the ability to pay the short-term liabilities).

$$\text{Stocks turnover} = \frac{\text{cost of sales}}{\text{Average stocks}}$$

$$\text{Average stock} = \frac{\text{Opening stock + closing stock}}{2}$$

$$= \frac{510}{\frac{99 - 5 + 149}{2}}$$

$$= 4.1 \text{ times}$$

Told 360. If not told, assume 360 days.

$$\text{Inventory conversion period} = \frac{\text{No of days in the year}}{\text{Stock turnover}}$$

$$= \frac{360}{41}$$

$$= 8.78 \text{ days}$$

Number it takes to convert raw materials to finished goods + makes sales

(b) $$\text{Debtors turnover} = \frac{\text{Credit sales}}{\text{Average debtors}}$$

$$= \frac{80\% \text{ X } 850}{\frac{(89 + 71)}{2}}$$

$$= 8.5 \text{ times}$$

$$\text{Average collection period} = \frac{\text{360 days in a year}}{\text{Debtors turnover}}$$

$$= \frac{360}{8.5}$$

$$= 42.4 \text{ days}$$

It shows the number of days the company takes to cover what is due from customers.

(c) (i) creditors' turnover = $\frac{\text{credit purchases}}{\text{average creditors}}$

$$= \frac{559{,}500}{130{,}000}$$

$$= 4.3 \text{ times}$$

(ii) Payables deferral period = $\frac{\text{No of days in the year}}{\text{Creditors turnover}}$

$$= \frac{360}{4.2}$$

$$= 85.7$$

$$= \frac{\text{Average Payables}}{\text{Purchases per day}} \quad \text{or} \quad \frac{\text{Average Payables}}{\text{Cost of Goods sold/365}}$$

The company takes about 85 to 86 days to pay the creditors.

Working capital (cash conversion) cycle

Average collection period

Inventory conversion period

Purchase of raw Materials	Payment of payables	Sales of finished goods	Collection of receivables	Payables deferral period

Cash conversion period

Cash conversion cycles = Inventory conversion Period + Average collection period - Payables deferral period

= 87.8 + 42.4 - 85.7

= 44.5 days

Turnover = $\frac{360}{\text{Cash conversion cycle}}$

$\frac{360}{44.5}$ = 8.1 times

Fixed asset turnover = $\frac{\text{Sales}}{\text{Average fixed assets}}$

= $\frac{850}{(340 + 330)\ ½}$

= 2.54 times

Total asset turnover = $\frac{\text{Sales}}{\text{Total assets}}$

= $\frac{850}{580}$

= 1.47 times

The rate at which the company is using fixed assets, (total) to make sales revenue.

Availability in relation to sales

Gross profit margin = $\frac{\text{Gross profit}}{\text{Sales}}$

= $\frac{340}{850}$

= 40%

Gross profit margin measures the firm's ability to control production decisions.

b)(i) Operating margin = $\frac{\text{operating profit (EBIT)}}{\text{Sales}}$

= $\frac{165}{850}$

= 19%

$$\text{Operating ratio} = \frac{\text{Total expenses (production + operating)}}{\text{Sales}}$$

$$= \frac{510 + 175}{850}$$

$$= 81\%$$

Operating ratio + Operating ratio should be equal to 100%

(profit) expenses = sales

The two ratios measure the firm's ability to control growth, production and operating decisions.

$$\text{Net profit margin} = \frac{\text{Net profit after taxes}}{\text{Sales}}$$

$$= \frac{75{,}000}{850{,}000}$$

$$= 9\%$$

This measures firm's ability to control production, operating and financing decisions. Profitability in relation to investments:

(a) return of investment $= \dfrac{\text{Net profit after taxes}}{\text{Total assets}}$

$$= \frac{75{,}000}{580{,}000}$$

$$= 13\%$$

The ratio measures the efficiency in which the company uses it's funds to generate a return to the owner of the company.

$$\text{Return on capital employed} = \frac{\text{Net profit after taxes}}{\text{Net Assets}}$$

$$= \frac{750{,}000}{450{,}000}$$

$$= 17\%$$

This ratio shows the efficiency with which the company uses permanent funds to generate a return to their owners.

Return on equity = $\frac{\text{Earnings attributable to shareholders}}{\text{Net worth}}$
(Return on net work)

$= \frac{75,000}{350,000}$

$= 21\%$

This is the efficiency with which the company uses owner supplied funds to generate a return to the owners.

EVALUATION (equity) RATIO

Earnings/Share ratio (EPS) = $\frac{\text{Earnings attributable to equity holders}}{\text{Number of common shares outstanding}}$

This shows the returns that the shareholders expect to receive from the company in form of earnings for every share held.

Outstanding shares are the ones that have been sold to the public. If some have been repurchased by the issuing company are known as the treasury stock. This is not allowed in Kenya due to the efficiency of the markets in Kenya. It is a safeguard against arbitral profits.

$= \frac{75,000}{20,000}$

= KShs 3.75

(b) Earning yield = $\frac{\text{Earning per shares}}{\text{Market price/share}}$

This ratio shows the amount of money the shareholders expect to receive for every share invested in the company. This is used to compare different company securities. The higher the earning yield, the better the firm.

E.g	A	B
	EPS	5
	MPS	

(c) Dividends/Share (DPS) = $\frac{\text{Total common dividend}}{\text{Number of common shares outstanding}}$

This measure the amount the shareholders expect to receive in form of dividend for every share held in the company.

$$= \frac{15{,}000}{20{,}000}$$

$$= 0.75$$

(d) Dividend yield (DY) = $\frac{\text{DPS}}{\text{MPS}}$

$$= \frac{0.75}{15}$$

$$= 0.05$$

This ratio expresses the amount the shareholder expects to receive in form of dividends for everys hare invested in the company.

(e) Dividend pay-out ratio = $\frac{\text{DPS (Dividend/Share)}}{\text{EPS (Earning/Share)}}$

This ratio shows the proportion of earning paid out by dividends by the company.

$$= \frac{0.75}{3.75}$$

$$= 20\%$$

(f) Retention ratio = 1 - Dividend pay-out ratio (DPR)

OR

$$= \frac{\text{Retained earnings}}{\text{Earnings attributable to equity holders}}$$

(i) $1 - 0.2 = 0.8$ or 80%

(ii) $\frac{60{,}000}{70{,}000}$

$= 80\%$

This shows the proportion of profit retained by the company.

(g) Price-earning ratio $= \frac{MPS}{EPS}$

$= \frac{15}{3.75}$

$= 4$

This ratio is the risk of buying the shares. The lower the ratio, the lower the risk. This also shows the number of years it takes to recover the investment, i.e. the payback period.

This ratio can be used to classify companies into equivalent risk classes. The assumption that the companies in the same industry have the same price-earning ratio holds. The ratio is assumed to remain constant throughout.

(h) Book value per share $= \frac{\text{Net worth}}{\text{Number of common shares outstanding}}$

$= \frac{350{,}000}{20{,}000}$

$= 17.50$ KShs

This ratio measures the amount the shareholders would get for every share held if the company was liquidated and the assets sold at the book value.

(i) Market book value/share $= \frac{\text{Market price/share}}{\text{Book value/share}}$

$= 0.86$

This ratio measures the value the market attaches to the firm as a going concern. It measures the company's goodwill. If the ratio is less than one, then the company has negative good will. Such a company should not be held as a going concern.

8.5 Trend analysis and cross-sectional analysis.

1. Trend Analysis

This is a comparison of the firm's performance over time. It is mainly determined whether the company is progressing as expected. It could also be used to determine the accuracy of past forecasts.

2. Cross sectional analysis

This is a comparison of the firm's performance with other firms in the same industry. It is important as it helps the firm in carrying out a SWOT analysis. (Strength, Weaknesses, Opportunities, Threats).

Illustration

The comparative ratios of ABC are given below:

	2009	2010	2011
Current ratio	2.74	2.51	1.89
Quick ratio	1.56	1.07	0.53
Stock turnover	3.00	2.88	2.00
Debtors turnover	12.09	13.08	20.00
Gross profit margin %	39.9	42.8	49.9
Net profit margin %	6.4	4.2	6.5
Operating expense ratio	34.5	36.2	37.2

Carry out a trend and cross-sectional analysis.

Trend analysis

1. Liquidity position

The company's liquidity has been decreasing as shown by both the current ratio, which decreased from 2.74 in 2009 to 1.89 in 2011, and the quick ratio, which also decreased from 1.56 to 0.53 in 2011.

Possible Causes:

a. An increase of liabilities over time
b. A decrease in current assets over time

c. A decrease in the company's ability to meet its short term obligation thus an increase in its financial risk due to current liabilities increasing faster than the increase in current assets.

2. Activity position

The company's activity has decreased as shown by the stock turnover, which decreased from 3.0 to 2.00 in 2009 to 2011, however, the debtors turnover shows a slight decrease in 2010 before a significant increase in 2011.

Possible Causes:

a. Non utilization of the company's resources effectively to generate increased sales revenue.
b. Stringent credit policy, which discouraged credit sales and therefore resulting in the increase in the stocks held.

3. Profitability position

It shows a slight increase as shown by the gross profit margin which increased from 39.9% in 2009 to 49.9 in 2011. However, the net profit margin shows a significant decrease from 6.4% before recovering slightly to 6.5% in 2011

Possible Causes:

a. The company not fully utilizing its resources to generate higher sales revenue.
b. The operating expenses are increasing rapidly.
c. Difficulty or unable to control operating and financing decision.

Cross sectional analysis

We compare the industrial performance with that of the company. In carrying out the analysis a report of whether the company is above or below average must be determined.

Illustration

The comparative ratios of ABC are given below:

	2009	2010	2011	Average (Industry Performance)
Current ratio	2.74	2.51	1.89	2.50
Quick ratio	1.56	1.07	0.53	1.00
Stock turnover	3.00	2.88	2.00	5.6
Debtors turnover	12.09	13.08	20.00	14.5
Gross profit margin %	39.9	42.8	49.9	41.7
Net profit margin %	6.4	4.2	6.5	3.2
Operating expense ratio	34.5	36.2	37.2	36.5

The company's liquidity position is below industry coverage shown by both the current and acid tests which are below the industrial coverage. This applies that the companies is bound to meet it's short-term liabilities is less than that in the industry. The activity position is below the industrial average as shown by the stocks turnover which is less than ½ the industrial coverage. However, the debtors' turnover is significantly higher than the industrial coverage. By computing the average collection period of the firm and comparing it to the industry, we may confirm that the company is applying a very stringent credit policy compared to other companies in the industry

The company's profitability is higher than the industry average as shown by the Gross and Net profit margin. However, the company is incurring higher operating expenses than average firms in the industry. Therefore, although the company is able to make the production and financing decision better than industrial average. It has been unable to do so in the operations.

On the overall, the company is a high risk, high return company.

Users of Financial Statement

1. **Shareholders** – They own the company's share and regardless that they are interested in its going concern due to their objective of maximizing their wealth the company's profitability is key.

2. **Prospective investors** – They are interested in the theoretical value of the company and evaluation ratio.

3. **Employees -** They work for the company and are interested in their job security, thus the going concern of the company is tantamount.

4. **Debt-holders** – They provide long term funds and they are concerned with the going concern of the company, its profitability and gearing ratios.

5. **Creditors** – These are providers of short-term funds. They are concerned with the liquidity of the company and its gearing position.

6. **Customers** – They are interested in the supplies they get thus the going concern of the company to them is key.

7. **Government** – They are interested in the taxable income and whether it is operating as per the rules and regulations set forth and the GDP of the economy.Their main concern is the profitability levels.

8. **Financial analysts** – These are experts who study the financial position of the company. They are concerned with all aspects of the firm.

9. **Society in general** – They are concerned with the social responsibility of the company to the society.

10. **Lawyers** – The statements provide financial information. This information provides a basis for:

    1. Computing rates of return;
    2. Evaluating capital structures of an entity;
    3. Assessing the liquidity of and financial flexibility of the enterprise.

Clients often retain the services of an advocate with the expectation that the lawyer "learned" understands the issues, financial included.

The assumption is that he understands financing and is able to interpret and convey the meaning of the financial reports to the client.

Therefore, regardless that the accountant has the primary obligation to make and analyze financial reports, a lawyer must develop a habit of analyzing systematically the financial reports.

Limitations of financial ratios

(i) It is impossible to carry out cross-sectional analysis on industries with only one monopolistic firm. E.g. Kenya Power & Lightning Corporation.

(ii) Different firms use different accounting policies and methods and this makes industrial analysis difficult.

(iii) Ratios are compiled at a point in time and suffer from short-term changes. They are therefore used for short-term planning and not long-term planning.

(iv) It is hard to categorize firms in industrial classification, mainly due to diversification. This makes cross-sectional analysis very hard.

(v) It is hard to categorize firms in industrial classification, mainly due to diversification. This makes cross-sectional analysis very hard.

(vi) Information used to compute ratios is derived from historical data and therefore are not accurate indicators of the future.

8.6 Valuation

Valuation is the process of estimating what something is worth. Items that are usually valued are a financial asset or liability. Valuations can be done on assets (for example, investments in marketable securities such as stocks, options, business enterprises, or intangible assets such as patents and trademarks) or on liabilities (e.g., bonds issued by a company).

Valuations are required for a number of reasons: investment analysis, merger & acquisition, capital budgeting, financial reporting, taxable events and in litigation.

Valuation of financial assets is done using one or more of these types of models:

1. Absolute value models that determine the present value of an asset's expected future cash flows. These models are classified into two: Single period models e.g. Gordon model and Multi-period model e.g. the discounted cash flow model.
2. For some types of financial assets e.g. Put options, Call options, Employee stock options, warrants etc the option pricing models are used. The most common option pricing models are the Black & scholes - Merton (Robert C Merton) models and lattice models.
3. Relative value models which determine the value based on the market prices of similar assets.

Common terms for the value of an asset or liability are fair value, fair market value and intrinsic value.

Business valuation

Businesses may be valued for various purposes such as mergers and acquisitions, sale of securities, financial facility acquisition and taxable events. For a privately owned company to be accurately valued, the firm's historic financial information should be reliable

Businesses may be valued for various purposes such as mergers and acquisitions, sale of securities, and taxable events. An accurate valuation of privately owned companies largely depends on the reliability of the firm's historic financial information, private firms do not have government oversight unless operating in a regulated industry and are usually not required to have their financial statements audited.

Public companies on the other hand subject their financials to be audited by Certified Public Accountant (Kenya).Public firms tend to want higher profits to increase their stock price. Therefore, a firm's historic financial information may not be accurate and can lead to an over or undervaluation. In an acquisition, a buyer often performs due diligence to verify the seller's information.

Financial statements prepared in accordance with generally accepted accounting principles (GAAP) show many assets based on their historic costs rather than at their current market values. For instance, a firm's balance sheet will usually show the value of land it owns at the price the firm paid for it rather than at its current market value. But under GAAP requirements, a firm must show the fair values (which usually approximates market value) of some types of assets such as financial instruments that are held for sale rather than at their original cost.

Reporting asset values on financial statements at fair values gives managers ample opportunity to tip asset values upward to artificially increase profits and their stock prices. Managers may be motivated to alter earnings upward so they can earn bonuses. Despite the risk of manager bias, shareholders and other stakeholders prefer to know the market values of a firm's assets rather than their historical costs because current values give them better information to make effective decisions.

This method estimates the value of an asset based on its expected future cash flows, which are discounted to the present (i.e., the present value). This concept of discounting future money is commonly known as the time value of money. The size of the discount is based on an opportunity cost of capital and it is expressed as a percentage. The percentage may be referred to as a discount rate.

Illustration (Opportunity cost)

Person A has 50,000 to invest can make only one 50,000 investment even when presented with two or more investment choices. If this person is later offered an alternative investment choice, the investor has lost the opportunity to make that second investment since the 50,000 is spent to buy the first opportunity. This illustrates that money is limited and people make choices in how to spend it. By making a choice, they give up other opportunities.

In finance theory, the amount of the opportunity cost is based on a relation between the risk and return of some sort of investment. Classic economic theory maintains that people are rational and averse to risk. They, therefore, need an incentive to accept risk. The incentive in finance comes in the form of higher expected returns after buying a risky asset. In other words, the more risky the investment, the more return investors want from that investment.

For a valuation using the discounted cash flow method;

1. Estimate the future cash flows from the investment
2. Estimate a reasonable discount rate after considering the riskiness of those cash flows and interest rates in the capital markets.
3. Compute the present value of the future cash flows.

Comparable company analysis

This method determines the value of a firm by:

i. Comparing the prices of similar companies that sold either shares, stocks or the firm entirely in the market. The observed prices serve as valuation benchmarks.
ii. From the prices observed, calculate the price multiples such as the price-to-earnings or price-to-book value ratios.
iii. One or more price multiples are used to value the firm. For example, the average price-to-earnings multiple of the guideline companies is applied to the subject firm's earnings to estimate its value.

Many price multiples can be calculated. Most are based on a financial statement element such as a firm's earnings (price-to-earnings) or book value (price-to-book value).

Net asset value method

This method is known as the net asset value or cost method. For value estimation the assets and liabilities of the business are core. At a minimum, a solvent company can close shop, sell off the assets, and pay the creditors. Any cash that would remain establishes a floor value for the company.

Ideally, the discounted cash flows of a well-performing company exceed this floor value. However, some companies make more financial sense dead than alive. This method can also be used to value heterogeneous portfolios of investments, as well as non-profit companies for which discounted cash flow analysis is not relevant.

Excess earnings method.

Under this method, five steps are carried out:

i. Identifies the value of tangible assets,
ii. Estimate an appropriate return on those tangible assets
iii. Subtract that return from the total return for the business, leaving the "excess" return, which is presumed to come from the intangible assets.
iv. An appropriate capitalization rate is applied to the excess return, resulting in the value of those intangible assets.
v. That value is added to the value of the tangible assets and any non-operating assets, and the total is the value estimate for the business as a whole.

Valuation analysis aids in a number of instances mainly:

I. Accounting
II. tax assessment,
III. Succession (testate and intestate)
IV. Business Analysis etc

Valuations are as at specific dates as it varies from time to They may be mark-to-market estimates of the current value of assets or liabilities as of this minute or this day for the purposes of managing portfolios and associated financial risk (for example, within large financial firms including investment banks and stockbrokers) or as at the end of a financial period. It majorly depends on the reason for the valuation in the first place.

Some balance sheet items are much easier to value than others. For quoted companies that publicly trade stocks and bonds have prices that are quoted frequently and are readily available thus valuation is easy. On the other hand, unlisted firms are quite difficult to value. Additionally, financial instruments that have prices that are partly dependent on theoretical models of one kind or another are difficult to value. For example, options are generally valued using the Black & scholes model while the liabilities of life assurance firms are valued using the theory of present value. Intangible business assets, like goodwill and intellectual property, are open to a wide range of value interpretations.

It has been noted that valuation is both an art and a science because it requires judgment and assumptions:

- There are different circumstances and purposes to value an asset e.g. mergers & acquisitions, distressed firm, tax purposes, financial reporting etc. Different purposes may require different valuation methods or different interpretations of the method results . Where the valuation is for the purpose of a merger or acquisition the respective businesses make available further detailed financial information, upon execution of a non disclosure agreement.
- Limitations are inherent to all valuation models due to either the degree of complexity, relevance of observations, mathematical form applied etc.
- Significant variations of the inputs (model) may arise can vary because of necessary judgment and differing assumptions.
- Users of valuations benefit when key information, assumptions, and limitations are disclosed to them. Then they can weigh the degree of reliability of the result and make their decision.

Valuation of a suffering company

The various valuation approaches i.e. income, asset or market based may require additional adjustments in instance which may involve:

- excess or restricted cash
- other non-operating assets and liabilities
- lack of marketability discount of shares
- control premium or lack of control discount
- excess salaries in the case of private companies.

There are other adjustments to the financial statements that have to be made when valuing a distressed company. Andrew Miller identifies typical adjustments used to recast the financial statements that include:

i. Working capital adjustment
ii. Cost of goods sold
iii. Deferred capital expenditures
iv. Non-recurring professional fees and costs
v. Certain non-operating income/expense items.

Valuation of intangible assets

Valuation models can also be used to value intangible assets such as patents, copyrights, software, trade secrets, and customer relationships. For financial reporting and transactional activity concerning intellectual property, valuation of intangible assets is necessary. Since few sales of benchmark intangible assets can ever be observed, one often values these sorts of assets using either a present value model or estimating the costs to recreate it.

Stock markets give indirectly an estimate of a corporation's intangible asset value by adding up the difference between its market capitalization and its book value (include tangible assets only).

Question

(b) In the context of the International Accounting Standards Board's Framework for the Preparation and Presentation of financial statements, identify and briefly explain any four qualitative characteristics of financial statements.

(c) Briefly explain the importance of a cash flow statement to a business entity.

(d) Prepare a cash flow statement for Ragz Ltd. for the year ended 31 March 2010 in accordance with IAS 7 (Revised) and comment on the position revealed. The financial statements listed below were prepared from the books of Ragz Ltd. In respect of the year ended 31 March 2010

Balance Sheet as at 31 March 2010

	2009		2010	
	KShs (000)	KShs (000)	KShs (000)	KShs (000)
Ordinary share capital of Sh.10	50,000		60,000	
Share premium account	5,400		6,200	
Profit and Loss account	55,400		66,200	
Shareholders' funds		88,000		100,000
Debenture stock, 12%		18,000		18,000
(2008–2010)				
Owings on finance lease		20,000		32,000
		126,000		**150,000**
Represented by:				
Fixed assets: at cost	21,000		38,000	
Accumulated depreciation	(9,182)		(35,536)	
		11,818		2,464
Current assets: Stock	49,000		66,000	
Debtors	30,000		39,000	
Cash	20,000		25,000	
	99,000		130,000	
Current Liabilities:				
Creditors	8,000		5,400	
Finance lease obligations	1,200		1,600	
Taxation	882		536	
Proposed dividends	4,100		8,200	
Bank overdraft	1,000		1,800	
Net assets	15,182	126,000	17,536	150,000

Profit and Loss account for the year ended 31 March 2010

	KSh '000'	KSh '000'
Turnover		1,200,000
Profit for the year		31,248
After charging:		
Depreciation	29,774	
Interest	6,518	
Directors' remuneration	4,200	
Auditor's fees	840	
Investment income: interest receivable		1,200
Taxation		(8,474)
Profit after tax		....
Dividends: Interim paid	(5,600)	
:Final proposed	(9,400)	15,000
Retained profit for the year		....

The following additional information is provided:

1. On 18 October 2009, a bonus issue of one share for every four held was made. Two months later, shareholders were offered the right to purchase one share for every six shares held at a price of KShs 14 per share. The market price was KShs 16 per share.
2. The debenture holders have the option of converting their stock into ordinary shares at par value.
3. Fixed assets which had cost KShs 8,000,000 and in which accumulated depreciation on 2 April 2009 was KShs 3,420,000 were sold during the year at a profit of KShs ,000; this profit is included in the profit for the year. The company acquired some fixed assets from ART (Ltd). on a finance lease for KShs 8,218,000. The assets were capitalised.

4. The composition of the interest charge shown in the profit and loss account is as follows:

	KShs '000'
Interest on bank overdraft	1558
Finance charges on finance leases	2,800
Interest on 12% debentures	2,160
	6,518

(Total: 20 marks)

(e) The summarized accounts of Mhariri Ltd. for the year ended 31 March 2010 and 2011 are as follows:

	2011		2010	
	KShs '000'	KShs '000'	KShs '000'	KShs '000'
Balance Sheet				
Investments at cost	12,000		12,000	
Land	15,000		12,00	
Plant and machinery, at cost	4,400		4,000	
Accumulated Depreciation:		2,000		1,600
Buildings, at cost	12,000		12,000	
Plant and machinery		1,800		1,800
Stock	10,000		11,000	
Debtors		11,000		10,400
Bank	–		–	
	64,400		**61,400**	
Ordinary shares KShs 20 each		7,000		5,000
Share premium	3,200		3,000	
Revaluation reserve	6,000		7,000	
Profit and Loss Account	3,000		10,000	
10% Debentures	20,000		17,000	
Creditors	15,000		12,000	
Proposed Dividend	5,000		5,000	
Bank Overdraft	1,000		500	
	64,400		61,400	
Profit and Loss Account				
Sales	60,000		62,000	
Cost of Sales	34,000		30,000	
	26,000		32,000	
Expenses	16,000		15,000	
	10,000		17,000	
Dividends	7,000		7,000	
	3,000		10,000	

Required:

(a) Calculate for Mhariri Ltd. for 2010 and 2011 the following ratios:

(1) Gross profit percentage
(2) Net profit percentage
(3) Debtors turnover
(4) Creditors turnover
(5) Current ratio
(6) Quick assets (acid test) ratio
(7) Dividend cover
(8) Gearing ratio
(9) Return on capital employed

Solution

	2011	**2010**
Gross Profit % = Gross Profit / Net Sales	26 / 60 = 43%	32 / 62 = 51.6%
Net profit % = Net profit / Net Sales	10 / 60 = 16.7%	17 / 62 = 27%
Debtors Turnover = Net Sales / Net a/c Receivable	60 / 11 = 5.5	62 / 10.4 = 6
Creditors Turnover = Current Assets / Current Assets	21 / 21 = 1	20.4 / 17.5 = 1.2
Quick Assets (acid test) ratio = Current Assets - Stock / Current Liabilities	21 - 10 / 21 = 524	20.4 - 10.4 / 17.5 = 571
ROCE = Net Profit / Capital employed x 100	10,000 / 7,000 = 143%	17,000 / 5,000 = 340%
Gearing Ratio = Long-term Loans + Preference Shares / Total Shareholder funds + Long-term Loans + Preference Share	20,000 / 19,200 = 104.2%	17,000 / 25,000 = 68%
Dividend Cover = Net profit after Tax & Preference Shares / Ordinary Dividends paid & proposed	10,000 / 3,000 =	17,000 / 10,000 =

Chapter Nine

Computerised Accounting

9.1 Introduction

The adjunct of time, constancy of purpose in line with continuous improvement is the sought ingredient to success. This is in tandem to proper time management and quality goods and services. The manual method of keeping and maintaining records in business is rapidly being found unmanageable and thus with the introduction of computers it is being gradually replaced.

A computerised accounting system is an accounting information system that processes the financial transactions and events in accordance to Generally Accepted Accounting Principles (GAAP) to produce reports as per user's requirements.

Transaction processing system (TPS) is the first stage of computerised accounting system. The purpose of any TPS is to record, process, validate and store transactions that occur in various functional areas of a business for subsequent retrieval and usage.

TPS involves following steps in processing a transaction: Data Entry, Data Validation, Processing and Revalidation, Storage, Information and Reporting.

Computer and Computerised Accounting System

It is one of the transaction processing systems which are concerned with financial transactions only. When a system contains only human resources it is called manual system; when it uses only computer resources, it is called computerised system and when it uses both human and computer resources, it is called computer-based system.

Accounting Packages

Some of the necessary accounting packages to aid a lawyer implement a computerised accounting environment include:

a) Spreadsheets

This is a computer application program. It operates on data presented in cells organized in rows and columns. It's used for organization and analysis of information in tabular form. It is quite useful in what if analysis since a user is able to make changes in the saved values and observe the effects on the calculated values. This is possible due to their inherent fundamental operations of arithmetic and mathematical function.

They were developed for bookkeeping / accounting tasks but with time they are now extensively used.

b) Excel

This is an application written and distributed by Microsoft windows. It has the basic features of a spreadsheet, however in addition it can display charts, graphs etc. It also has a number of interactive features allowing user interfaces that allow decision support systems. Ideally, it is a commercial spreadsheet.

c) Quick Books

This is an accounting software developed and marketed by intuit.

A very popular software among small business owners who have no formal accounting training. It aids the users to undertake double entry accounting functions, carry out an audit trail etc.

d) Sage

A mathematics software written mostly in python and cython. It covers most aspects of mathematics e.g. Algebra, Calculus, Number theory etc.

e) Pastel

An accounting package developed by softline pastel 1989.

9.2 Justification/Rationale for computerized accounting system

The need for computerised accounting arises from the gnawing intent to improve and the realization that time is of essence and thus need for efficiency (speed, accuracy and lower cost of handling the business transactions).

1) Numerous Transactions

The computerised accounting system is capable of handling large number of transactions with speed and accuracy.

2) Instant Reporting

The computerised accounting system is capable of offering quick and quality reporting because of its speed and accuracy.

3) Reduction in paper work

A manual accounting system requires large physical storage space to keep accounting records/books and vouchers/ documents. The requirement of stationery and books of accounts along with vouchers and documents is directly dependent on the volume of transactions beyond a certain point. There is a dire need to reduce the paper work and dispense with large volumes of books of accounts. This can be achieved by introducing computerised accounting system.

4) Flexible reporting

The reporting is flexible in computerised accounting system as compared to manual accounting system. The reports of a manual accounting system reveal balances of accounts on periodic basis while computerised accounting system is capable of generating reports of any balance as when required and for any duration which is within the accounting period.

5) Accounting Queries

There are accounting queries which are based on some external parameters. For example, a query to identify customers who have not made the payments within the permissible credit period can be easily answered by using the structured query language (SQL) support of database technology in the computerised accounting system. But such an exercise in a manual accounting system is quite difficult and expensive in terms of manpower used. It will still be worse in case the credit period is changed.

6) On-line facility

Computerised accounting system offers online facility to store and process transaction data so as to retrieve information to generate and view financial reports.

7) Scalability

Computerised accounting systems are fully equipped with handling the growing transactions of a fast growing business firm. The requirement of additional manpower in Accounts department is restricted to only the data operators for storing additional vouchers. There is absolutely no additional cost of processing additional transaction data.

8) Accuracy

The information content of reports generated by the computerised accounting system is accurate and therefore quite reliable for decision making.

In a manual accounting system the reports and information are likely to be distorted, inaccurate and therefore cannot be relied upon.

It is so because it is being processed by many people, especially when the number of transactions to be processed to produce such information and report is quite large.

9) Security

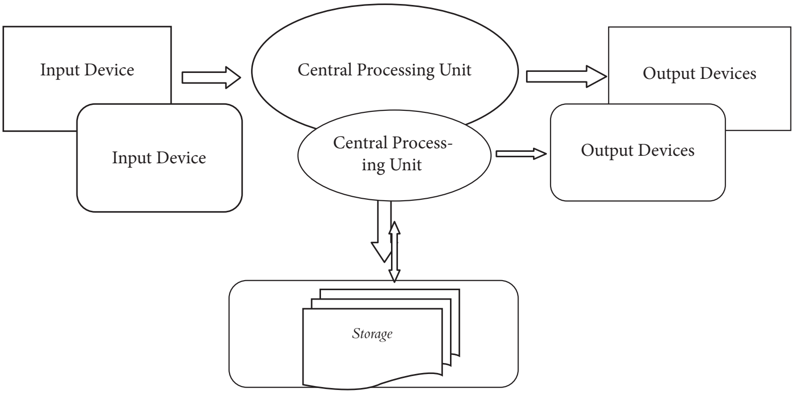
Under manual accounting system it is very difficult to secure such information because it is open to inspection by any eyes dealing in the accounts department or the archiving staff.

9.3 COMPONENTS OF A COMPUTERIZED ACCOUNTING SYSTEM

Computer is a device that accepts data, stores data, processes data as desired, retrieves the stored data as and when required and prints the result in desired format.

A computer consists of the major components i.e., Input Unit, Central Processing Unit and Output Unit.

Diagrammatically, these components may be presented as follows:



1) Input Unit

Input unit is controlling the various input devices which are used for entering data into the computer. The mostly used input devices are keyboard, mouse, and scanner. Other such devices are magnetic tape,

Magnetic disk, light pen, bar code reader, smart card reader, etc. Besides, there are other devices which respond to voice and physical touch. Physical touch system is installed at airport for obtaining the online information about departure and arrival of flight. The input unit is responsible for taking input and converting it into binary system.

2) Central Processing Unit (CPU)

The CPU is the control centre for a computer. It guides, directs and governs its performance. It is the brain of the computer. The main unit inside the computer is the Central Processing Unit. Central Processing Unit is to computer as the brain is to human body. This is used to store program, photos, graphics, and data and obey the instructions in program. It is divided into three subunits:

(a) Control Unit
(b) Memory Unit
(c) Arithmetic Logic Unit (ALU)

3) Control Unit

Control unit controls and co-ordinates the activities of all the components of the computer. This unit accepts input data and converts it into computer binary system.

4) Memory Unit

This unit stores data before being actually processed. The data so stored is accessed and processed according to instructions which are also stored in the memory section of computer well before such data is transmitted to the memory from input devices.

5) Arithmetic and Logic Unit

It is responsible for performing all the arithmetical calculations and computations such as addition, subtraction, division, and multiplication. It also performs logical functions involving comparisons among variable and data items.

6) Output unit

After processing the data, it ensures the convertibility of output into human readable form that is understandable by the user. The commonly used output devices include like monitor also called Visual Display Unit, printer etc.

9.4 Challenges of a computerized accounting system

1) Cost of Installation

Computer hardware and software needs to be updated from time to time with availability of new versions. As a result heavy cost is incurred to purchase a new hardware and software from time to time.

2) Cost of Training

To ensure efficient use of computer in accounting, new versions of hardware and software are introduced. This requires training and cost is incurred to train the staff personnel.

3) Self Decision Making

The computer cannot make a decision like human beings. It is to be guided by the user.

4) Maintenance

Computer requires to be maintained properly to help maintain its efficiency.

It requires a neat, clean and controlled temperature to work efficiently.

5) Dangers for Health

Extensive use of computer may lead to many health problems such as muscular pain, eyestrain, and backache, etc. This affects adversely the working efficiency and increasing medical expenditure.

Discuss the current trends in computerised accounting software both nationally and internationally.

9.5 Current trends

We are now in the information age which dictates that growth is parallel to sufficient, relevant and timely information

This has facilitated increased interaction between people globally in turn leading to the growth of international trade which impacts directly on how we account in our businesses. To fulfill the requirements of Generally Accepted Accounting Principles (GAAP), software companies have been forced to develop new systems that would meet the challenges of modern accounting.

The national trends in regard to computerised accounting software shows a gradual movement from manual to computerised systems. This is witnessed by observing a gradual increase in the number of companies/corporations who are purchasing the accounting software.

In Kenya, the computerized accounting software 2006 was the T24 microfinance software which was developed by Temos of Switzerland. It was upgraded to T24 R08 in 2008. It has been standardized by the central Bank therefore used in most financial institutions.

Despite the proliferation of the computerized accounting software, the implementation of these systems remains a significant issue. Most Kenyan organizations have failed to effectively deal with the accounting software's implementation and its related challenges. Some of the major challenges faced nationally is the cost, lack of user skill and awareness by the staff members, resistance to change and benign neglect.

Hackney, R and Little, S. (1999) observed that, lack of implementation of the accounting systems in parastatals is significantly influenced by cultural, political and power behavioral situations within parastatals.

International trends in computerized software are several steps ahead of the Kenyan situation especially in the developed economies.

International trends show most countries have embraced online accounting and mobile computing.

Economies developments of many nations can be attributed to the technological innovations that have been realized in such nations, that is, China has developed and adopted the current computerised software that are applicable in accounting.

This can be attributed to the fact that knowledge economy requires the development of computerised accounting. In the knowledge economy, there are tendencies that high speed information transmission and information science and technology will be further developed. More standards units are a must to provide timely and relevant information in order to facilitate investors' decisions making process under the knowledge based economy. The popularity of computerised accounting is well established; clearly only the knowledge economy can meet the need for accounting information.

The developed and fast developing economies have largely adopted computerised accounting to accelerate their growth and also attract foreign investors.

In his article Computerised Accounting "Not a trend but a necessity" Accountant Jason Tsang quoted" Computerised accounting nowadays is necessary to cope with the bust and hectic schedules and reduce manpower. The choice of having one kind of the software over another depends upon the specific needs of businesses. Small business and medium enterprises has the option to know the typical versions of computerised accounting system that suits their preferences. Accounting software providers make sure to create the latest trend in presenting computerised accounting in a simple manner with terms specifically designed to make it more understandable to non- accountants".

The global trends according to Alan Salmon and Randy Jackson have brought in significant changes. Previously accounting software focused on the basic accounting need that is general ledger, sales ledger, purchases ledger among others. Today, the same focuses on simplification and customization: the software is more user friendly and expectation satisfying.

Notably, the elements of uniformity and security are a major concern, unveiling the felt need to provide a systematic and uniform software that caters for all business transactions and a proper secure storage as well as encryption method immune to a majority of viral attacks if not all.

Summary of Critical Accounting Concepts for Lawyers

Below is a summary of the critical accounting concepts for lawyers and their implications to lawyers:

1. Along with the accompanying notes, the balance sheet, the income statement, the statement of changes in owners ' equity, and the statement of cash flows constitute a complete set of financial Statements.

Accountants use these four different financial statements and the accompanying notes to describe an enterprise's financial condition and the results of its operations. The balance sheet presents an enterprise's financial assets and liabilities, and owners' equity, for a specified period, and it reflects the fundamental accounting equation:

Assets – Liabilities = Owners' Equity

The income statement shows the extent to which the enterprise's operations and other changes in assets and liabilities from peripheral activities affected the amount of owners' equity, or net assets, over a period of time. The statement of owners' equity more fully reconciles the income statement with the net changes in owners' equity during the period by describing investments by, and distributions to, owners. In addition, most enterprises currently use the statement of owners' equity to report comprehensive income, an amount that summarizes all increases and decreases in net assets during a period, except those changes resulting from investments by, and distributions to, owners. Finally, the statement of cash flows explains the change in the enterprise's cash and cash equivalents during a given period.

2. Financial statements currently use a "mixed-attribute model," which increasingly requires enterprises to report certain financial assets and liabilities at fair value.

Until recently, financial accounting primarily used historical costs, rather than current values, to record financial transactions. Financial statements, therefore, have historically presented, at best, a retrospective picture of an enterprise's financial condition and the results of its operations. Increasingly, financial accounting requires enterprises to use fair value or current market value, rather than historical cost, to report certain financial assets and liabilities in an effort to provide more contemporary or prospective information. At the same time, however, financial statements do not reflect many important "assets" and "liabilities."

For example, the value of an outstanding management team, good morale among the enterprise's employees, loyal and satisfied customers do not appear on the financial statements; nor do the financial statements list weak management, labor problems, unsatisfied customers, or a poor reputation in the community as "liabilities."

3. Poor accounting can violate the law.

An enterprise's financial statements represent the "ends" in a process that accountants refer to as "double-entry bookkeeping." As the "means" in this bookkeeping process, business enterprises use journals, ledgers, accounts, debits, credits, trial balances, and worksheets to prepare financial statements.

4. When reading financial statements, pay careful attention to the accompanying notes and, if applicable, Management's Discussion and Analysis.

Accounting is an art, rather than a science. Accountants, like lawyers, constantly exercise judgment. Accounting often involves estimates and does not always provide precise rules. Generally accepted accounting principles typically provide alternative choices or may not address a particular situation because business transactions evolve more rapidly than accounting principles. Like lawyers, accountants must examine and interpret Statutes, regulations, administrative cases, and official pronouncements of accounting bodies for answers to accounting and auditing questions.

Lawyers should know where and how to find and apply this body of authorities. As a general rule, an enterprise's management selects the accounting principles that the enterprise will use from among the acceptable alternatives. The notes to the financial statements address and explain these choices and judgments. Management's Discussion and Analysis gives readers an opportunity to view the business "through the eyes of management" and may provide important information about the business and significant trends, commitments, or risks.

5. Generally accepted accounting principles are dynamic.

Lawyers should specifically consider this possibility when drafting contracts and legal documents involving accounting terminology. In particular, lawyers in the information age should pay attention to the emergence of international accounting principles and their use and acceptance in Kenya.

6. An audit does not guarantee the accuracy of financial statements.

Even an unqualified audit report provides only "reasonable assurance" that the financial statements fairly present, in all material respects, the enterprise's financial condition, results of operations and cash flows. In addition to auditing financial statements, accountants also often render review and compilation services. Reviews offer only limited assurance, and compilations provide no assurance that the financial statements provide fair representations.

7. A shilling today is worth more than a shilling tomorrow.

Remember the time value of money. Check consideration

8. Different sets of accounting rules can apply for different purposes.

An enterprise may use one set of rules for preparing financial statements for creditors and investors, another set for reporting to a regulatory agency, and still others for tax purposes. Different rules or accounting measurements may also apply for specific contracts or for trust accounting, or to determine the legality of distributions to owners, such as a dividend to corporate shareholders. As a result, enterprises may keep different sets of accounting records to maintain information necessary for the various sets of rules or accounting measurements that may be applied..

9. Be aware of the legal issues involving contingent liabilities.

Be careful when responding to an auditor's requests for information about pending or threatened litigation, claims, or assessments. You probably waive the Advocate-client privilege as to any information that you provide to the auditor.

Wherever possible, seek information about a litigation opponent's reserve for a contingent liability during discovery, by examining the opponent's financial statements and public filings, books and records, and tax returns, or by requesting such information from the other party's auditor.

10. Various lawful and unlawful motivations can influence the discretionary, and often difficult, cost allocation issues that underlie financial statements.

Small businesses and their owners generally prefer accounting principles that reduce income in order to reduce income taxes. In contrast, a publicly traded enterprise may select accounting treatments that increase earnings so that management can report higher earnings to investors. All businesses incur costs that they must classify as either assets or expenses. Enterprises expect assets such as inventories, fixed assets, and intangibles, which appear on the balance sheet, to produce future revenues or other benefits.

Expenses like selling commissions, repairs, depreciation, depletion, and amortization, in contrast, offset current revenues on the income statement. Many smaller businesses use the "cash method" of accounting for tax purposes, which requires the taxpayer to report income when actually or constructively received and allows the taxpayer to deduct expenses when actually paid.

The cash method, however, does not match expenses with the revenues that they produce. Financial accounting requires the "accrual method," under which a business recognizes revenue when it has completed, or has at least substantially completed the earnings process and matches the expenses necessary to generate those revenues.

The past decade has witnessed corporate and accounting fraud lead to the sudden collapse in late 2001 of Enron, America's fifth largest company in terms of revenue, Arthur Andersen LLP's conviction for obstructing justice the following year, and the Supreme Court's subsequent reversal of that conviction in 2005. In May 2006, the guilty verdicts against former Enron chairman Kenneth Lay and former chief executive officer and president Jeffrey Skilling ended another chapter in Enron's demise.

The additional scandals at WorldCom, which caused the largest bankruptcy in U.S. history, plus similar debacles at other publicly traded companies, quickly led to the landmark Sarbanes-Oxley Act of 2002 ("Sox"), the most significant piece of accounting-related legislation since the 1930s. Even now, however, stories about accounting fraud and the resulting criminal trials, administrative proceedings, and civil suits continue to appear in the financial and general press almost daily not only in America but also in Kenya e.g. the CMC Motors scandal.

Case Study

1. Enron Corporation

Enron Corporation is an energy trading, natural gas, and electric utilities company based in Houston, Texas that employed around 21,000 people by mid-2001, before it went bankrupt.

It was listed as the seventh largest company in the United States, and it was expected to dominate the trading it had actually invented in communications, power, and weather securities.

However, due to its fraudulent accounting techniques it became the largest corporate scandal in history; a reference of a well-planned corporate fraud.

Interestingly, Enron stage managed the electricity crisis of 2000 and 2001 in California.

Using tape recordings of Enron traders on the phone with California power plants, the film chillingly overhears them asking plant managers to "get a little creative" in shutting down plants for "repairs." It clearly dawns on thousands that in fact there was never a shortage of power in California.

Between 30 percent and 50 percent of California's energy industry was shut down by Enron a great deal of the time, and up to 76 percent at one point, as the company drove the price of electricity nine times higher.

Its European operations filed for bankruptcy on 30 November 2001, and it sought Chapter 11 protection in the U.S. on December 2.

Enron's global reputation was undermined, by persistent rumors of bribery and political pressure to secure contracts in Central and South America, in Africa, and in the Philippines.

Especially controversial was its US $30 billion contract with the Maharashtra State Electricity Board in India, where it is alleged that Enron officials used political connections within the Clinton and

Bush administrations to exert pressure on the board. On 9 January 2002, the United States Department of Justice announced it was going to pursue a criminal investigation of the Enron scandal and Congressional hearings began on 24 January.

After a series of scandals involving irregular accounting procedures bordering on fraud involving Enron and its accounting firm Arthur Andersen, it stood at the verge of undergoing the largest bankruptcy in history by mid-November 2001 notwithstanding that a white knight(Dynegy)attempted to rescue it.

During 2001, Enron shares fell from US$85 to US$0.30. As Enron was considered a blue chip stock, this was an unprecedented and disastrous event in the financial world. Enron's plunge occurred after it was revealed that most of its profits and revenue were the result of deals with special purpose entities.

The result of this accounting scandal was that many of the losses that Enron encountered were not reported in its financial statements. Initially, Skilling and other executives responded to questions by insulting reporters and lying to employees. When pressure mounted, Skilling sold his Enron shares at a massive profit and resigned; Lay stayed on. In 2001, the Enron scandal came to light, resulting in massive stockholder defections. In December of that year, the company declared bankruptcy, its formerly golden stock now worthless. Because of its silent complicity in the Enron scandal, the Arthur Andersen Company was also forced to close its doors.

The fallout. In the end, 90,000 people lost their jobs; Enron employees, who had been encouraged to invest their retirement plans in company stock, lost $2 billion into the bargain. Stockholders lost another $70 billion in the Enron scandal, and the state of California sued for $6 billion in energy losses. Chief executive Ken Lay escaped justice, dying of a heart attack before he could be sentenced. Skilling, Fastow and another dozen executives went to prison. Skilling appealed his 24-year sentence to the U.S. Supreme Court; Fastow's release was scheduled for December 2011.

Following the 2001 bankruptcy filing, Enron has been attempting to restructure in order to compensate as many creditors as possible.

Enron's innovative core energy trading business was sold early in the bankruptcy proceedings to Merrill Lynch and Company. A last-ditch survival attempt was made in 2002 through a planned merger with arch-rival Dynegy Corporation. Dynegy backed out during merger talks, acquiring control of Enron's original, predecessor company- Northern Natural Gas- in the process.

Enron is currently pursuing legal action against Dynegy over the takeover of Northern Natural Gas, which has since been sold by Dynegy to MidAmerican Energy Holdings Company.

Enron's final bankruptcy plan provides for the creation of three new businesses to be spun off from Enron as independent, debt-free companies. Due to the actions of the Enron executives, the Enron Company went bankrupt. The loss sustained by investors exceeded $70 billion. Furthermore, these actions cost both trustees and employees upwards of $2 billion; this total is considered to be a result of misappropriated investments, pension funds, stock options, and savings plans – as a result of the government regulation and the limited liability status of the Enron Corporation, only a small amount of the money lost was ever returned.

Lessons for lawyers to learn from Enron:

1. Key Issues;

A complete set of financial statements includes an income statement, a balance sheet, a statement of cash flows, a statement of changes in owners' equity, and the accompanying notes.

The Enron crisis accelerated when the company's 2001 third quarter earnings press release on 16 October 2001, provided only an income statement, and not a balance sheet, statement of cash flows, or statement of changes in shareholders' equity. (Remarkably, Enron failed to provide the other financial statements in its earnings releases beginning in 1996.) In response to questions from analysts, Enron's management later disclosed that Enron recorded a $1.2 billion reduction in shareholders' equity. Because the income statement does not reflect this item, without a balance sheet or statement of changes in shareholders' equity, investors could not see a complete and accurate picture of Enron's financial condition and operating results.

In addition, the cash flow statement, possibly the lawyer's best friend in such situations, also would have alerted a careful reader to problems, including the business's declining profitability. As Enron's collapse demonstrates, a missing financial statement may indicate that the enterprise seeks to hide disappointing results. Enron's eventual issuance of its missing balance sheet, and the large write-down of shareholders' equity in that financial statement, triggered a loss of investor confidence, which caused Enron's share price to fall, accelerated debt repayment obligations, and ultimately led to Enron's bankruptcy. The Enron scandal illustrates that each financial statement offers important information necessary to maintain investor and creditor confidence. A lawyer should ask probing questions any time an enterprise does not provide a complete set of financial statements, plus accompanying notes.

2. Old dogs, new tricks.

Generally accepted accounting principles (GAAP) often offer choices in financial accounting treatments. Although the "consistency principle" generally requires enterprises to use the same accounting principles to treat the same transactions similarly from year-to-year, this consistency requirement does not apply to new business activities.

The business community refers to the "rules "governing the compilation of accounting data into financial statements and the accompanying notes as "GAAP." However, GAAP typically allows users to apply permissible alternatives and almost always requires estimates and assumptions that affect the amounts shown in the financial statements, including the reported amounts of assets, liabilities, revenues and expenses.

In today's world, business transactions and practices evolve more rapidly exceeding the rule-makers capability to draft accounting rules. For several reasons, therefore, GAAP does not provide a set of black-and-white rules that a lawyer can apply natural law to verify. Commonly referred to as "earnings management," corporate managers can often use GAAP's flexibility to show operating results in line with projections and expectations. Especially when an enterprise's business changes (witness Enron's evolution from a regional natural gas company to a global energy and commodities trader), lawyers should pay particular attention to the accounting principles an enterprise uses to account for transactions arising from the new business activities.

3. Looks aren't everything.

Pro forma reporting can distort an enterprise's financial appearance.

In its 2001 third quarter earnings release, Enron reported "recurring" net income of $393 million. Such "pro forma" reporting, which provides numbers "as if" certain assumptions apply, does not follow GAAP. Even a simple analysis of the earnings release reveals that Enron actually suffered a $618 million net loss under GAAP. By labeling $1.01 billion as "one-time" or "non-recurring" charges, mostly related to investment and asset write-downs and restructuring charges, the company turned its $618 million net loss, purportedly using GAAP, into $393 million in net income.

Such write-downs and charges, however, would seem to represent normal business expenses and losses. In an effort to focus investors on results from "normal" business operations, an enterprise may, knowingly or innocently, mislead investors. Initially, pro forma reporting can hide troubling financial results. For instance, in its 2000 fourth quarter earnings release, Enron boasted a 25 percent increase in earnings per share ("EPS") for the full year 2000 over 1999 and a 32 percent increase in earnings per share for the 2000 fourth quarter over the Year 1999 fourth quarter. Buried in the last section of its earnings release, however, the company told a very different story. Enron disclosed that EPS for Year 2000, including non-recurring charges, increased only from $1.10 per share in 1999 to $1.12 per share in Year 2000. These amounts translated to an increase of only 1.8 percent, compared to the 25 percent increase Enron reported at the beginning of its earnings release. Next, Enron disclosed that

Year 2000 fourth quarter EPS, after non-recurring charges, totaled \$0.05, a decrease of 83.8 percent from the Year 1999 fourth quarter, in contrast to the 32 percent increase it reported at the beginning of the release.

Interestingly, earlier in the quarter, Enron predicted that it would post fourth quarter EPS of \$0.35. Excluding what it called non-recurring items allowed Enron to exceed those expectations. If Enron had included the non-recurring items, its results would have fallen below that prediction.

Second, an enterprise can use pro forma reporting to manage earnings. Earnings management typically tries to increase net income /or reduce the net loss, relative to what the business would otherwise report under GAAP. Enterprises, however, sometimes exclude non-recurring gains in an effort to report lower net income, which translates to smaller profit-sharing payments to employees (or reduced income tax obligations). Lawyers drafting agreements that rely on earnings to set prices or trigger payments, for Example, should distinguish pro forma earnings from net income calculated in compliance with GAAP. Without distinguishing between the two benchmarks, parties to such an agreement can manipulate earnings by labeling some items as one-time or non-recurring.

4. Sometimes, looks are everything.

Auditor independence matters—both in appearance and in fact.

During the late 1990s in the United States of America, the largest public accounting firms increasingly provided non-audit services, such as consulting, internal audits, and tax advising, often for the very enterprises they audited. During 2000, Enron paid \$52 million to Arthur Andersen—\$25 million for auditing services, and an additional \$27 million for non-auditing services—and ranked as Andersen's second largest client. In addition, an internal Andersen memo regarding the retention of Enron as an audit client refers to \$100 million a year in potential revenues from Enron.

Unlike lawyers who must zealously represent their clients, auditors' real responsibilities flow to the investing public, not the enterprise that hires them. By evaluating an enterprise's financial statements and expressing an opinion as to whether those statements are a fair presentation, in all material respects, the enterprise's financial position and operating results, an auditor seeks to help maintain investor and creditor confidence. To satisfy generally accepted auditing standards, an auditor must remain independent from any enterprises it audits—both in fact and in appearance. When non-audit fees comprise a substantial piece of an auditor's income from the audit client, those fees might tempt an auditor to overlook an enterprise's "aggressive" accounting simply to retain the client's non-audit business.

At a minimum, substantial fees paid to auditors for non-audit related services distorts the independence perception providing a fertile base for questions. Even if the auditor continues, in fact, to exercise objective judgment, such relationships distorts the perception of independence. As the recent malaise that has afflicted the stock markets in the United States ably demonstrates, even the perception of a lack of independence can shake investor confidence in the quality of financial statements. Because investors view a lack of independence, whether in appearance or in fact, with a critical eye, lawyers should scrutinize financial statements, disclosures, and transactions that involve an auditor who may have compromised independence, whether in fact or in appearance and also encourage clients to preserve their independence.

5. With friends like these, ...

Related-party transactions, especially those involving a special purpose entity ("SPE"), can distort an enterprise's apparent financial condition and operating results.

Although related-party transactions may increase efficiency in transacting business, they may also allow an enterprise to manipulate its earnings by the way the enterprise sets prices or allocates expenses. Similarly, an enterprise may use SPEs for legitimate purposes, such as to limit exposure to risk in certain investments, including credit card receivables or residential mortgages. An enterprise, the "sponsor," generally forms an SPE to transfer risks from such investments to outside investors.

Enron's transactions with its SPEs, including the so-called Chewco and LJM partnerships, highlight the dangers that can arise from related-party transactions. As a small, but relatively simple example, Enron sold an interest in a Polish company to LJM2 for $30 million on 21 December 1999. While Enron intended to sell the interest to an unrelated party, the company could not find a buyer before the end of the year.

The sale allowed Enron to record a gain of $16 million on a transaction that Enron could not close with a third party. Remarkably, Enron later bought back LJM2's interest for $31.9 million after it failed to find an outside buyer. Another deal allowed Enron to report a $111 million gain on the transfer of an agreement with Blockbuster Video to deliver movies on demand, even after Enron realized that no real profits would ever flow from the underlying agreement. The related-party transactions with SPEs, often occurring at the end of a fiscal period, allowed Enron to manipulate its reported earnings, to close deals at desired amounts quickly, to hide debt, and to conceal poorly performing assets. Such transactions, which frequently closed at the end of a quarter or year, allowed Enron to meet its earnings expectations and to sustain its stock price. In fact, Enron sometimes even backdated such transactions to the previous period, in an effort to "manufacture" income for that period. Because Enron entered into those transactions with "friendly" related parties, the company could quickly and easily negotiate terms that allowed its earnings to appear on target. In addition, Enron used its earliest SPEs to obtain financing, without showing the related liability on its balance sheet. Finally, Enron used SPEs to move poorly performing assets off of its balance sheet. By transferring such assets to SPEs, Enron could hide later declines in the value of those assets.

GAAP requires an enterprise to disclose information about material related-party transactions in the notes to the financial statements. In particular, an enterprise must disclose: the nature of any relationships involved; a description of the transactions for each period for which the financial statements present an income statement, including any information necessary to understand the transactions' effects on the financial statements; the dollar amounts of the transactions and the effects of any changes in the method used to establish terms when compared to those followed in the preceding period; and amounts due from or to related parties on each balance sheet date and the related terms governing those amounts. The disclosures should not imply that the transactions contained terms equivalent to those that would have prevailed in an arm's-length transaction unless management can substantiate that claim.

Enron did disclose various related-party transactions in the notes to its financial statements, but not in any detail. Lawyers who assist in related-party transactions should carefully examine the transactions and their client's securities disclosures in an effort to assure that those disclosures accurately describe the transactions' true nature and effects on the financial statements. Likewise, lawyers negotiating other transactions or pursuing other claims, especially when future or past earnings determine legal rights and obligations, should keep in mind that an enterprise can use related-party transactions to manipulate earnings.

6. Details, details, details.

Corporations should develop and adhere to internal controls (both administrative and accounting). Administrative controls generally refer to an enterprise's plan of organization, procedures, and records that lead up to management's approval of transactions. Accounting controls, by comparison, describe the plans, procedures, and records that an enterprise uses to safeguard assets and produce reliable financial information. Enron's administrative controls included policies designed to minimize conflicts of interest and to ensure that transactions fairly benefitted the company. Not only did recent events prove Enron's administrative controls inadequate, but those events also showed that Enron failed to follow the controls that it had put in place. For example, when Enron's board approved a policy that allowed the company to enter into transactions with certain entities owned by Enron officers, the implementing procedures explicitly required management to use a "Deal Approval

Sheet." By requiring certain disclosures and the approval of Enron's chief executive officer, the Deal Approval Sheets sought to ensure that the contractual provisions in such transactions would closely resemble the terms that would have materialized in an arms'-length transaction.

The fact that the chief executive officer's signature does not appear on the sheets for several specific transactions confirms the laxity in which controls were viewed. Moreover, the current absence of sheets for other transactions suggests that Enron did not complete any such document in those transactions. As another example, Andrew Fastow, Enron's former chief financial officer and, for a time, the general partner of the several partnerships that entered into transactions with Enron, reportedly earned more than $30 million from his investments in those enterprises. Even though the board seemed to recognize the conflict of interest inherent in such related-party transactions, the board failed to require that Mr. Fastow report his profits from the partnerships to the company. Such disclosures almost certainly would have alerted the board to the possibility that the underlying transactions unfairly benefitted the related parties, to the detriment of Enron and its shareholders. Other items in this list document that Enron failed to implement adequate accounting controls.

Although top management bears the initial responsibility to develop, implement, and, when necessary, revise adequate internal controls, the overall oversight falls to the board of directors, who often rely on lawyers for advice. Internal controls work effectively only when those who bear responsibility for developing, implementing, and overseeing those controls stress the need to adhere to all policies and procedures and lead by adhering to those rules themselves. In recent years, the SEC has brought administrative actions and imposed so-called "tone-at-the-top liability" under the Foreign Corrupt Practices Act, which applies to all SEC registrants, including enterprises that engage only in domestic operations. Strong internal controls enhance the likelihood that the enterprise will engage in sound, beneficial transactions and reduce the chances that an enterprise will incur the enormous losses that can result from internal control failures.

7. If it walks like a duck, ...

In recognizing revenue (and accounting generally), substance prevails over form.

Under GAAP, an enterprise cannot recognize revenue until the business has substantially completed performance in a bona fide exchange transaction. If a transaction does not unconditionally transfer the risks that typically accompany a "sale," the enterprise may not recognize revenue.

Enron's announcement regarding a $544 million after-tax charge to earnings in October 2001 revealed a serious flaw in its prior financial statements: Enron had improperly recognized revenue from transactions with its SPEs. In short, Enron recorded revenue after transferring certain assets to those SPEs, even though credit guarantees, promises to protect the purchasers from any loss from decline in value, or buyback agreements caused the company to retain the risks of ownership even after the transfers.

As a result, Enron had not truly "earned" the revenue it reported. Enron's "sham" transactions resemble schemes that ultimately led to the demise of Drexel Burnham and the imprisonment of Michael Milken, that appeared so frequently during the savings and loan crisis, and that accompany most financial accounting frauds today. Milken ultimately pled guilty to charges involving "parking," whereby Drexel Burnham purchased securities from third parties with the understanding that the investment banking firm would quickly resell the securities back to the third parties at a fixed price. Similarly, the Federal Home Loan Bank Board (FHLBB) took control of Lincoln Savings & Loan Association in 1989 after discovering, among other things, that Lincoln or its affiliates had recognized income on sales of real estate even though the funds for the down payments had emanated from Lincoln itself. In substance, Lincoln or its affiliates had retained the risks of ownership and could not recognize revenue from the sales.

The issue of substance over form applies not only to managers and accountants, but to advocates as well. The litigation that follows financial frauds can impose enormous financial costs. In addition, a lawyer who fails to investigate, or perhaps spot, a "red flag," such as a side agreement or guarantee, can face staggering personal liability for negligence. Whether drafting, negotiating, or interpreting contractual provisions that refer to "net income" or "earnings," performing "due diligence" to determine whether a particular transaction will further a client's best interests, or rendering a "true sale" opinion regarding whether a transferor that retains some involvement with the transferred asset (or the transferee) has surrendered economic control over the asset to justify treating the transaction as a sale for financial accounting purposes, substance over form requires an advocate to look beyond the form of a transaction and to try to identify any arrangements that may affect the transaction's economic realities. In particular, understanding the motivations for a transaction offers an important clue to the transaction's substance. Enron often transferred assets to SPEs to hide losses or to remove liabilities from its balance sheet. Although most clients or adversaries will not expressly state such desires, such effects should also alert advocates to issues of substance over form appreciating it as a canon of equity.

8. Promises, promises.

Any time an enterprise guarantees the indebtedness of another in material amounts, the enterprise must disclose the nature and amount of the guarantees in the notes to the financial statements.

When Enron's SPEs sought credit, the lenders often required that Enron guarantee the debt. On several occasions, Enron guaranteed amounts that various SPEs borrowed by promising to pay cash or to issue additional common shares to repay the debt, if the market price of Enron's common shares dropped under a set amount or if Enron's bond rating fell below investment grade. While the notes to Enron's financial statements disclosed guarantees of the indebtedness of others, Enron did not mention that its potential liability on those guarantees, which shared common debt repayment triggers, which totaled $4 billion. When material, GAAP specifically requires an enterprise to disclose the nature and amount of guarantees of the indebtedness of others. Again, inadequate disclosure can subject enterprises to liability and lawyers to negligence claims.

9. If it sounds too good to be true, ...

An enterprise cannot recognize income from issuing its own shares and generally should not record a net increase in shareholders' equity when it issues stock in exchange for a note receivable.

At the risk of oversimplifying, Enron used related-party SPEs to hedge, or to protect itself from declines in the market value of, certain investments that Enron used current market prices to value on its books. In these arrangements, Enron transferred its own stock to an SPE in exchange for a note or cash. In addition, Enron guaranteed, directly or indirectly, the SPE's value. The SPEs in turn hedged the underlying investments, using the transferred Enron stock as the principal source of payment for the hedges.

The value of the underlying investments decreased, but the hedges allowed Enron to recognize a corresponding increase, resulting in a wash. The SPEs, however, could reimburse Enron for any decline in value of the investments only as long as the market price of Enron's common shares remained stable or increased. When the value of Enron's common shares fell, Enron had to issue additional shares pursuant to its agreements with the SPEs and the related guarantees. These additional shares reduced Enron's stock value, which triggered additional guarantees. In the interim, Enron recognized about $500 million in revenues from the hedges, which had really arisen from the issuance of the company's own shares. GAAP, however, does not allow an enterprise to record gains from the increase in the value of its capital stock on its income statement.

As previously mentioned in the first item, Enron announced on 16 October 2001, that it had recorded a $1.2 billion reduction in shareholders' equity, arising, in large part, from an accounting error. When Enron issued its common shares to several SPEs in exchange for notes receivable, Enron recorded the notes receivable as assets, thereby overstating shareholders' equity by $1 billion. Although

GAAP usually allows an enterprise to record notes receivable as assets, a different rule applies when an enterprise issues stock in exchange for the notes. GAAP states that an enterprise should treat any notes received in payment for the enterprise's stock as an offset to shareholders' equity. Only when the obligor pays the note can the enterprise record an increase in shareholders' equity for the amount actually paid.

Many credit agreements allow the lender to accelerate the repayment of the debt if the borrower's debt-to-shareholders' equity ratio exceeds a certain level or if the borrower fails to maintain a certain credit rating. Although Enron's $1.2 billion reduction in shareholders' equity did not itself trigger any debt repayment obligations, investment ratings companies immediately placed Enron on review for downgrade. Soon after, the ratings companies downgraded Enron's credit rating to below investment grade. Because provisions in many of Enron's credit agreements required the company to maintain an investment grade credit rating, the downgrades triggered debt repayment obligations, which accelerated Enron's bankruptcy.

10. When the going gets tough. . . . .

Lawyers' duties to their clients include an obligation to object when a client proposes or uses questionable accounting policies or practices.

In his well-publicized opinion in the Lincoln Savings and Loan case, Judge Sporkin asked where the lawyers were when Lincoln discharged various improper transactions, wondering why they did not attempt to prevent those transactions or disassociate themselves from them. Now, more than ten years later, we hear similar questions directed to Enron's lawyers. While Enron's lawyers, both in-house and outside counsel, did question some practices, Enron officers and employees often either ignored the lawyers' advice, or changed the transactions just enough to get around the lawyers' particular concerns. In some cases, Enron's lawyers apparently helped to complete the very transactions they questioned.

The advocate-client privilege prevents lawyers from disclosing client confidences. That privilege, however, does not prevent lawyers from discussing concerns with their clients, attempting to persuade their clients to choose another course of action, going up the "corporate ladder," or even withdrawing from representing their clients if a client declines to follow the lawyer's advice. When Enron's lawyers questioned Enron's practices, they voiced their concerns to Enron's in-house lawyers and its management, but not to the board of directors or the audit committee. Blind deference to accountants and auditors seems unwise and dangerous. We'll never know, but without hearing the concerns of Enron's lawyers, the board of directors or the audit committee arguably could not see an objective picture of those transactions and Enron's financial accounting practices. Standing up takes courage. Let's hope that the well-publicized scandals at Enron, WorldCom's bankruptcy, and the Sarbanes-Oxley Act of 2002 encourage more lawyers to watch for accounting "red flags" and to respond courageously when they see them.

2. Kenyan Pyramid Schemes

In 2006, the Kenyan economy growing at more than 5 percent annually with the construction, information technology and transportation industries experiencing phenomenal growth, the Central Bank of Kenya posted a warning about "excessive liquidity" in the Kenyan economy. This meant that there was too much money floating around.

It was this booming economy that gave Kenyans surplus funds that were invested in pyramid schemes.

It was as a result of the above discussed increased economic activity, Kenyans were earning more than they did a few years earlier. The Nairobi Stock Exchange was posting lucrative returns that turned ordinary people into millionaires. The global economy was booming as exporters made impressive returns. Meanwhile, Kenyans in the diaspora were sending billions of shillings in remittances to relatives back in Kenya.

With reduction in interest rates that began in 2003, bank loans were affordable to practically anyone who wanted. Banks were literally hawking loans on the streets. There were loans for housing, school fees and motor vehicles. At some point, banks were offering loans for people to buy household effects – furniture and televisions.

Essentially, the Kenya of 2006 was one where people had access to a lot of money. Which is just as well. Kenyans were looking for ways of ploughing the money into ventures that could generate even more money. Unfortunately, there was little knowledge of savings and investment opportunities. Most of the youth were experiencing this phenomenon for their first time, unlike the older generation who had gone through the 1970s coffee boom.

Ignorance on investing money largely contributed to the rise of pyramid schemes.

A pyramid scheme is one that promises investors very high rewards in exchange for recruiting new members. Everybody who joins a pyramid scheme brings some money that will be refunded with interest. For every member that you bring into the scheme, you get a commission on what that member has invested. For this reason, pyramid schemes tend to be very profitable for the initial investors. However, the people joining much later find it difficult to get recruits and therefore their returns are low. Eventually, the pyramid collapses because there are no new members bringing fresh cash.

The people who formed pyramid schemes in 2006 made billions of shillings by the time the organizations collapsed in 2007. The biggest pyramid scheme was called DECI and was founded by one George Donde and his sister, Mary Odinga. George Donde is brother to former Gem legislator, Joe Donde of the "Donde Bill."

Other pyramid schemes were run by former legislators Andrew Ligale and Njeru Ndwiga. Another former legislator, Stanley Murage, was also implicated in pyramid schemes by a parliamentary taskforce headed by former Kitui legislator Francis Nyenze.

In total, Kenyans lost over KShs34 billion (US$435,897,000) within two years to at least 160 pyramid schemes. The Francis Nyenze Taskforce found that many families broke up as a result of losing their savings. At least 20 people are known to have committed suicide due to the losses. A DECI manager in Nairobi was tossed out the window of Union Towers on Moi Avenue by irate investors who wanted their money back. The manager died.

Majority of the schemes were run by politicians and their allies. For this reason, there are hardly any criminal cases facing the perpetrators of the massive rip-off.

The Central Bank of Kenya has absolved itself from blame, saying that pyramid schemes are not banks and therefore fall outside its regulatory structure. The pyramid fraudsters were shrewd enough to register their organizations as co-operative societies under the Ministry of Co-operative Development. They knew only too well that the Ministry of Co-operatives lacks the capacity to monitor massive financial transactions involving millions of accounts.

To be fair to the Central Bank, it did issue warnings through the press discouraging Kenyans from investing outside the banking system. The pyramid schemes dismissed the warnings as "jealousy by mainstream banks" and urged Kenyans to ignore the Central Bank. Because of inadequate knowledge on banking and finance systems, people preferred believing the pyramids.

The Central Bank and the financial sector in general should work hard to increase awareness on the many investment options available to Kenyans. This will ensure that the public does not fall prey to fraudsters taking advantage of the human need to increase personal wealth.

Glossary of Terms

Accelerated depreciation allocates a greater portion of the cost of a tangible asset to the earliest years of the asset's useful life, which typically offers the most predictable, functionality.

See also *depreciation, straight-line method, sum-of-the-years'-digits method.*

Account records changes in or transactions involving an individual asset or liability, component of equity, or revenue or expense.

See also *T-account.*

Accounting periods artificially divide an firm's life into regular intervals so that the firm can assess its operating results and financial condition.

See also *periodicity assumption.*

Accounting equation. See fundamental accounting equation.

Accounts payable, a current liability, shows the unpaid amount for the entity's purchases on credit.

See also *current liabilities.*

Accounts receivable, a current asset, records uncollected revenue owed to an firm for sales on credit.

Accrual refers to the process whereby an firm recognizes a revenue earned or expense incurred, even though no payment actually occurred, during the current accounting period.

Accrual accounting seeks to portray an entity's operating results within a given period by allocating revenues and expenses to the period earned or incurred rather than when actually collected or paid.

See also *cash method.*

Accrued liabilities refer to amounts owed for services already performed.

See also *current liabilities.*

Accumulated depreciation cumulates all depreciation expenses related to a particular asset or group of assets in a contra-asset account.

Acquisition costs reflect the portion of the depletion cost base devoted to obtaining the right to search

Active investments enable the investor to exert significant influence over the investee, meaning that the investor typically owns twenty percent or more of the investee's voting shares.

See also *passive investments.*

Adjusted book value attempts to eliminate bias from the historical cost assumption that generally underlies financial accounting by substituting some other amount, usually fair market value, but perhaps liquidation value or replacement cost, for an asset's book value in valuing the asset or a business.

See also *liquidation value, replacement cost, tangible book value.*

Adjusting entries modify expenses and revenues at the end of an accounting period to reflect that period's activity, accounting for such things as prepaid expenses that span several periods or earned, but uncollected, income.

Adverse opinions, from independent auditors, report very material departures from GAAP, but rarely occur because an firm's management can usually correct the underlying circumstances.

See also *disclaimer of opinion, qualified opinion, and unqualified opinion.*

Aging of accounts receivable assesses the probability that the firm will collect the amount owed, based on experience that shows that as receivables become progressively overdue, the likelihood of non-payment increases dramatically.

Allowance for doubtful accounts offsets gross receivables to determinant receivables. This contra-account allows accounts receivable that become uncollectible in a later period to not affect that period's income. When bad debts arise, the firm can debit the allowance for doubtful accounts and offset to the uncollectible account receivable.

Amortization allocates the cost of an intangible asset to the various accounting periods in its useful life.

See also *depletion, depreciation*.

Analytical procedures compare financial data to corresponding data for prior periods to ascertain whether or not the data appears reasonable.

Annuity describes a sequence of periodic and equal amounts, such as a monthly deposit.

Annuity due requires the investor to make payments at the beginning of period.

See also *ordinary annuity.*

Annuity in advance. See *annuity due.*

Annuity in arrears. See *ordinary annuity.*

Asset means a future economic benefit that a particular firm owns or controls as the result of a past transaction or event.

See also *current assets, long-term investments, fixed assets, intangible assets.*

Audit examines an firm's internal controls and financial records to obtain evidence as to whether the firm's financial statements fairly present its financial condition and operating results in accordance with generally accepted accounting principles.

See also *compilation, review.*

Audit committee, as a subset of the board of directors, oversees the accounting, financial reporting, and disclosure processes and the audits of a firm's financial statements.

Audit inquiry letters request a firm's attorney to list and describe information concerning the firm's potential legal liabilities for its auditor.

See also *management letters.*

Audit reports opine whether financial statements fairly present the firm's financial position, i.e. results of operations, and cash flows in conformity with GAAP.

See also *unqualified opinion, qualified opinion & adverse opinion.*

Audit risk expresses the chance that an auditor may erroneously fail to modify appropriately the audit opinion despite materially misleading financial statements.

Authorized but unissued shares represent additional shares that the articles of in company allow a company to issue.

Available-for-sale securities includes all debt and marketable equity securities that accounting rules do not classify as held-to-maturity debt or trading securities.

See also *held-to-maturity debt securities, trading securities.*

Average cost method, an inventory method, eliminates the need to identify the precise costs to purchase or manufacture items remaining unsold by dividing the total costs to acquire or manufacture goods during an accounting period by the total number available for sale or resale.

See also *fifo- first-in first-out, lifo- last-in first-out, retail method, specific identification, standard costs.*

Bad debts collected, a typical subaccount of allowance for doubtful accounts, allows a firm to record the collection of previously written-off bad debts.

See also *allowance for doubtful accounts.*

Bad debt expense records the likely losses resulting from either credit sales during an accounting period or worsening economic conditions during the period that impair an firm's ability to collect accounts receivable originating in an earlier period.

See also *allowance for doubtful accounts.*

Balance sheet shows a business's assets, liabilities, and equity at particular moment in time.

See also i*ncome statement, statement of cash flows, and statement of changes in owner's equity.*

Balance sheet test weighs assets against liabilities to determine whether a firm is insolvent.

See also e*quity insolvency test.*

Basic earnings per share calculate the amount of earnings for the period attributable to each share of common stock outstanding during the period.

See also *diluted earnings per share.*

Big bath refers to situations when a firm announces a huge write-down or write-off during an accounting period in an effort to lump losses into that period and improve future earnings.

Bookkeeping describes the process of recording and reporting transactions to convey a firm's financial condition and operating results.

Book value. See *net book value.*

Buy-back arrangements. See *right of return.*

Capital accounts record an owner's investment in the business.

Capital assets. See fixed assets.

Capital expenditures describe costs that a firm incurs to acquire or improve a long-lived asset, such as property, plant and equipment.

Capitalized earnings method attempts to value a business by first computing the business's average annual earnings for some number of years, and then capitalizing those average earnings by multiplying them by the reciprocal of the relevant interest or capitalization rate.

Capital leases, for the lessee, essentially transfer substantially all of the benefits and risks that accompany property ownership to the lessee.

See also *direct financing leases, operating leases, sales-type leases.*

Capital stock account, usually denominated common shares or preferred shares, shows a balance that equals the product of the number of issued shares times the par value per share.

Capital structure conveys the total amount that a firm has borrowed by use of long-term debt or loans, raised by issuing its common or preferred shares, or accumulated as retained earnings.

Capital surplus equals the cumulative amount that shareholders paid for shares in excess of par value under the legal capital system.

Cash includes not only currency, but bank accounts that the firm can access easily.

Cash equivalents include short term, highly-liquid investments that mature 90 days or less after acquisition.

Cash flow from operating activities. See *operating cash flow.*

Cash flow statement. See s*tatement of cash flows*.

Cash method recognizes revenues when the firm actually receives cash or payment for goods or services and records expenses when actually paid. See also accrual accounting.

Charge off. See write-off.

Chart of accounts lists each account and the account number that identifies the account's location in the ledger.

Classified balance sheet arranges the balance sheet into useful categories, generally separately listing current assets, long-term investments, fixed assets, intangible assets, current liabilities, long-term liabilities, and owners' equity.

Closing entries transfer the ending balances in accounts for revenues, gains, expenses, and losses to owners' equity at the end of a period.

Closing process occurs when the bookkeeper transfers the balances in revenue, gain, expense, and loss accounts to owners' equity.

Commitments generally refer to quantifiable transactions that bind a firm in the future.

Common shares represent the residual ownership interest in a company. See also preferred shares.

Common-sized analysis reduces a financial statement, such as the income statement, to a series of percentages of a given base amount, such as net sales. See also trend analysis.

Comparison method extrapolates the value of a closely held business or division of a company from the values that the market has assigned to comparable publicly traded firms based on relevant financial measures.

Comparative financial statements present a firm's financial condition on separate dates and the results of operations for similar periods to convey a broader picture of a firm than a single financial statement.

Compilation, an alternative to an audit, simply reports data that management has supplied with no independent testing or review.

See also audit, review.

Completed project method, a method of revenue recognition for long-term contracts, waits until the firm has fully, or at least substantially, finished its task under the agreement before recognizing any income.

See also *program method*.

Compound journal entries compress multiple entries that credit or debit the same account into one entry to show the combined effect of a series of transactions on the common account.

Compound interest requires the borrower to pay interest on the unpaid interest of past periods as well as on the original principal amount.

See also *simple interest*.

Comprehensive income. See also net income, other comprehensive income.

Conformity requirement requires a firm to use the LIFO method for financial accounting

Conservatism anticipates and records possible losses while ignoring potential income to offset the natural optimism of business owners or managers in reporting the results of a firm's operations or its financial condition.

Consistency principle requires that a firm give economic events the same accounting treatment from period to period.

Consolidated financial statements aggregate financial data for a parent company and its majority and wholly owned subsidiaries as if the parent and subsidiaries constitute a single economic entity.

Contingent liabilities rise when uncertainty exists as to whether the firm will incur an expense or loss.

Contra-asset accounts function as offsets to the balance in the related asset account.

See also *accumulated depreciation*.

Contributed capital shows amounts that owners invested in a firm.

Cost base quantifies the total expended to develop a natural resource for the purpose of calculating depletion. See also acquisition costs, depletion, development costs, and exploration costs.

Cost collection methods establish an asset's depletion base.

See also cost base, full-cost method, successful efforts accounting.

Cost method entails recording an investment at historical cost and then treating any dividends distributed from subsequent earnings as income.

See also e*quity method*.

Cost of goods sold collects the costs attributable to items sold during an accounting period, which the firm previously purchased for resale or manufactured. These costs include direct materials and labor, other direct costs, and an allocable portion of indirect costs, such as factory overhead. These costs do not include office, selling, accounting, or advertising expenses.

Cost recovery method, a method for recognizing revenue with uncertain collectibles, treats payments as equal and offsetting amounts of revenue and expenses until the firm has recovered all its costs. See also installment method.

Credit, often abbreviated as "Cr.," means a right-hand entry in an account.

See also *debit*.

Current assets include cash and other assets that the firm expects to convert into cash or use within one year.

See also *long-term investments, fixed assets, and intangible assets.*

Current liabilities require payment or economic performance in one year or less.

See also *accounts payable, accrued liabilities, notes payable, unearned revenues.*

Current replacement cost. See *replacement cost*.

Debit, often abbreviated as "Dr.," means a left-hand entry; in an account. See also *credit*.

A declining-balance method calculates accelerated depreciation by using a multiple of the straight-line depreciation rate. See also accelerated depreciation.

Default premium reflects the risk that the borrower will default on a loan and that the lender will lose the loan principal and any accrued interest.

See also i*lliquidity premium, inflation premium, maturity premium, pure rate of interest*.

Deferred costs delay treating cash expenditures as expenses until the accounting period when the firm enjoys the benefit of the expenditure.

See also *deferred income*.

Deferred income reflects received but unearned revenue, such as customer deposits, and appears as a current liability on a firm's balance sheet.

See also *deferred costs.*

Depletion allocates the costs to acquire natural resources among the accounting periods in which a firm consumes those wasting assets.

See also a*mortization, cost base, depreciation*.

Depreciation systematically spreads the cost to acquire a tangible asset over the accounting periods that benefit from the assets expected useful life.

See also *accelerated depreciation, amortization, depletion, straight-line method, units-of-activity method, sum-of-the-years'-digits method, useful life.*

Depreciation base equals a tangible asset's original cost minus any salvage value.

Depreciation expense equals the portion of a tangible asset's cost that a firm has allocated as an offset to revenues in a particular accounting period.

Derivatives base their value on the performance of some underlying asset, such as bonds or foreign currency.

Development costs reflect the portion of the depletion cost base devoted to extraction of discovered reserves and preparation of facilities necessary for that process.

See also *acquisition costs, cost base, exploration costs.*

Diluted earnings per share shows the amount of net income for the period attributable to each share of common stock outstanding during the period and certain potential common shares arising from options, warrants, and convertible securities. See also basic earnings per share.

Direct cost, an inventory costing method, allocates only direct costs and variable overhead costs to inventory.

See also f*actory overhead costs, full absorption, prime cost*.

Direct financing leases describe capital leases that involve no dealer or manufacturer profit or loss for the lessor while essentially transferring ownership of the property to the lessee.

See also *capital leases, operating leases, sales-type leases.*

Disclaimer of opinion, from an independent auditor, does not express an opinion as to whether the financial statements fairly present a firm's financial condition and operating results in accordance with generally accepted accounting principles.

See also a*dverse opinion, qualified opinion, unqualified opinion*.

Discontinued operations refer to a distinct business or other operational segment that a firm has decided to sell or eliminate.

Dividend-payout ratio shows the percentage of a company's net income that the firm paid out in dividends during a fiscal period.

Dividends an entitlement for each shareholder to receive corporate earnings, typically paid in cash, on a *pro rata* basis.

See also *redemptions.*

Dividend yield equals a company's per share dividend payout over the last twelve months divided by the share's market price.

Double-entry bookkeeping records each transaction's effect on assets, liabilities, and owners' equity so that the two sides of the fundamental accounting equation remain in balance.

See also *single-entry bookkeeping.*

Drawings track an owner's total withdrawals from a firm during an accounting period.

Earned capital includes all of a firm's undistributed net earnings.

Earned surplus equals a firm's undistributed earnings that remain invested in the firm under the legal capital system.

Earnings. See net income.

Earnings management describes managerial actions that increase or decrease a business's current reported earnings without changing the unit's long-term economic prospects.

Earnings per share. See *basic earnings per share, diluted earnings per share.*

Effective interest method uses a constant interest rate to recognize interest income or expense.

Equity refers to the difference between a firm's assets and liabilities.

Equity insolvency test evaluates whether a firm can pay its debts as they come due in the usual course of business for purposes of determining the lawfulness of a distribution to the firm's owners.

See also *balance sheet test.*

Equity method initially records an investment in another firm at cost and adjusts the investment's carrying amount to recognize the investor's share of the investee's earnings or losses after the acquisition date.

See also *cost method*.

Excess earnings method estimates a value for goodwill even though no actual transaction has taken place by comparing average earnings to a fair return on the underlying identifiable assets.

See also *goodwill.*

Expectation gap reflects the difference between investor expectations and auditor's ability to detect misstatements and fraud in financial statements.

Expense accounts record decreases in owners' equity arising from a firm's regular activities.

See also *income accounts.*

Expenses represent decreases in assets, increases in liabilities, or both, resulting from using goods or services to produce revenue.

See also l*osses, revenues.*

Explanatory language, added to an unqualified opinion, allows the auditor to clarify the audit report. See also unqualified opinion.

Exploration costs reflect the portion of the depletion cost base devoted to finding natural resources, such as geological surveys, testing, and exploratory wells.

See also *acquisition costs, cost base, development costs.*

Extraordinary items describe events or transactions that qualify as both unusual in nature and infrequent in occurrence and appear as a separate category on the income statement.

See also *nonrecurring items*.

Factory overhead costs include the normal expenses of operating a factory, such as light, heat, depreciation, insurance, and property taxes.

See also *direct cost, fixed costs, variable costs.*

Fair value means the price at which knowledgeable, unrelated parties would buy or sell an asset or settle a liability in a current, voluntary transaction.

Fair value model represents a new trend in financial accounting that records market values, rather than historical costs, in financial statements.

Financial statements record and report financial information. See balance sheet, income statement, statement of cash flows, statement of changes in owner's equity.

Financing activities include the issuance and retirement of short- and long-term debt from creditors and also reflect additional investments by, and distributions to, owners.

See also *statement of cash flows.*

Financing cash flows. See *financing activities.*

Financing leases. See *direct financing leases.*

Fiscal year, an accounting period of twelve months or fifty-two or fifty-three weeks, which often differs from the calendar year.

First-In, First-Out, or FIFO, accounting method, matches a business's oldest inventory costs with current revenues.

See also *average cost method, last-in first-out, retail method, specific identification, standard costs.*

Fixed assets include tangible resources such as land, buildings, plant, equipment, machinery, furniture, and fixtures that a firm acquires for long-term use in the business.

See also *current assets, long-term investments, intangible assets.*

Fixed costs, a portion of overhead costs, do not change within a specified production range.

See also *factory overhead costs, variable costs.*

Forensic accounting combines accounting, auditing, and investigative skills, usually to detect fraud during audits, to prevent it in developing and assessing internal controls, or to support litigation.

Free cash flow presents cash flow from operating activities minus several types of investments and dividend requirements, and has recently become an important figure for analyzing operating cash flows.

Full absorption method allocates both direct and indirect production costs to all goods that a firm produced during an accounting period, including those items that remain in inventory at the close of the period.

Full-costing accounting, a cost collection method, capitalizes all acquisition, exploration, and development costs, whether or not associated with the development of productive natural resources. See also cost collection methods, successful efforts accounting.

Full disclosure principle generally requires an accounting entity to set forth in the financial statements or related notes any fact important enough to influence an informed reader's judgment.

Fundamental accounting equation states that asset equals the sum of a firm's equity and liabilities.

Future value equals the sum that an amount or an annuity will grow to by a certain time when invested at a particular compound interest rate.

Gain accounts. See *income accounts.*

Gain contingencies represent existing conditions, situations, or sets of circumstances involving uncertainty as to possible gains.

See also *loss contingencies.*

Gains increase assets or decrease liabilities from transactions peripheral or incidental to major or central operations.

See also *losses, revenues*.

General journal, record of original entry, lists transactions chronologically and begins the bookkeeping process.

See also *journal*.

General ledger contains all asset, liability, revenue, expense, and other equity accounts for a business.

Generally accepted accounting principles, or GAAP, reflect what the accounting profession and financial community consider legitimate accounting practices.

Generally accepted auditing standards, or GAAS, express the standards and procedures that accountants must follow and perform during an audit.

Goodwill describes the intangible asset equal to the price paid for a business above the sum of its identifiable assets, indicating a sum greater than its parts.

See also *excess earnings method, residual method*.

Going concern assumption presumes that an accounting entity will continue normal operations into the future.

Going concern value, an unidentifiable intangible asset like goodwill, refers to the additional value that attaches to properties that comprise an ongoing business.

Gross profit appears as a separate line in a multiple-step income statement and shows the difference between net sales and the cost of goods sold.

Gross profit percentage reflects the business's profitability from selling its products, ignoring operating expenses, such as general, selling, and administrative expenses.

Group method treats a number of individual items together as a group and applies a single depreciation rate to the total cost of the assets in the group, less the total estimated salvage value.

Historical cost equals the purchase price of an asset at acquisition.

Historical cost principle indicates that the carrying value of an asset remains fixed at original cost or derived from that amount as long as the firm owns the asset.

Illiquidity premium compensates a lender for the price concession that the lender may have to grant if unexpected circumstances force the lender to sell the debt instrument without a readily available market.

See also *default premium, inflation premium, maturity premium, pure rate of interest.*

Income. See *net income, other comprehensive income.*

Income accounts record increases in equity. See also expense accounts.

Income smoothing. See *earnings management.*

Income statement compares a firm's revenues to its expenses, showing how operations affected owners' equity.

See also *balance sheet, statement of cash flows, and statement of changes in owner's equity.*

Indirect costs. See *factory overhead costs.*

Inflation premium compensates the lender for the inflation that the lender expects over the loan's term.

See also *default premium, illiquidity premium, maturity premium, pure rate of interest.*

Inflation risk refers to the general loss in purchasing power that rising prices cause.

Insolvency tests appear in corporate and creditors' rights statutes to determine whether a firm can lawfully distribute assets to an owner.

See *balance sheet test, equity insolvency test.*

Installment method, a method of recognizing revenue when the circumstances do not reasonably assure that the seller will collect the sales price, requires the seller to allocate all cash received from the buyer between cost recovery and profit. See also *cost recovery method.*

Intangible assets include intellectual property, goodwill, and other nonphysical resources. See also *current assets, fixed assets, long-term investments.*

Interest represents a charge for the use of money. See also compound interest, simple interest.

Interim reports present monthly or quarterly financial information.

Internal controls refer to those systems, procedures, and policies that an firm uses to help assure that an appropriate individual properly authorizes transactions and that the firm then appropriately executes and records the transaction.

Inventory comprises goods held for sale or resale in the ordinary course of business.

Inventory turnover measures how often a firm sells and replaces goods held for sale in a fiscal period by dividing average inventory into cost of goods sold.

Investing activities include this acquisition and disposition of long-term investments and long-lived assets. See also *statement of cash flows.*

Investing cash flows summarize the movement of cash from the acquisition and disposition of long-term investments and long-lived assets. See also *financing cash flows, operating cash flows.*

Issued shares include those shares that the company has sold or otherwise transferred to shareholders. See also *shares.*

Journal records transactions chronologically, showing debits and credits to appropriate accounts. See also *general journal.*

Junk bonds fall into the below "investment grade" risk category because the borrower has a greater than average chance of default. See also *bonds.*

Last-In, First-Out, or **LIFO**, accounting method assumes that a business sells the most recently acquired goods first. See also *average cost method, first-in first-out, retail method, specific identification, standard costs.*

Ledger collects in one place all accounts that a business maintains and all information about changes in specific account balances.

Legal capital reflects the cumulative par value of all issued shares.

Leverage conveys the amount of debt, relative to equity or total assets, that a company carries.

Leveraged buyouts occur when a purchaser primarily uses borrowed money to acquire a firm.

Liquidation value typically represents the minimum value of an asset or business, being the amount a buyer would pay for scrap or in a "going-out-of business" sale. See also *adjusted book value, tangible book value.*

Liquidity refers to the ability to convert an asset into cash.

Long-lived assets benefit several accounting periods, and include fixed assets.

Long-term investments include assets that a firm would not normally expect to convert into cash or use within one year. See also *current assets, fixed assets, intangible assets.*

Loss accounts. See *expense accounts.*

Loss contingencies represent existing conditions, situations, or sets of circumstances involving uncertainty as to possible losses. See also *gain contingencies.*

Losses decrease assets or increase liabilities from transactions peripheral or incidental to major or central operations. See also *gains, expenses.*

Lower of cost or market sets the value of inventory at the closing of a period to market value if that amount falls below the actual cost of that inventory, and uses conservatism to create an exception to the historical cost principle in accounting for inventories. See also *net realizable value, replacement cost*.

Management letters, from a firm's management, furnish the auditor information regarding the firm's financial condition and operating results, especially asserted and unasserted legal claims against the firm. See also *audit inquiry letters.*

Management's discussion and analysis, or **MD&A**, requires a registrant to discuss and analyze the firm's financial condition and results of operations and gives investors the opportunity to see the company through the eyes of management.

Market capitalization multiplies the number of outstanding shares by the market price per share.

Market discount reflects the difference between the face value of a bond and its market value given the prevailing interest rate and occurs when the bond's market value falls below its face value. See also *market premium*.

Market premium describes the difference between the face value of a bond and its market value given the prevailing interest rate, when a decline in market interest rates causes the fair value of the bond to exceed its face value. See also *market discount*.

Marketable security refers to a current asset, such as a stock or bond that the owner can easily sell.

Matching principle dictates that firms should record expenses in the same accounting period as the revenues they generate, when feasible.

Materiality permits the accountant to disregard otherwise applicable accounting principles and rules as to small and unimportant items.

Maturity premium offsets the risks associated with committing funds for longer periods. See also *default premium, illiquidity premium, inflation premium, pure rate of interest.*

Minority interests, in a consolidated financial statement, reflect the shares of a subsidiary that the parent company or other related subsidiaries do not own.

Monetary unit assumption asserts that the monetary unit best communicates economic information regarding exchanges of goods and services, as well as changes in owners' equity, and assists in rational, economic decision-making.

Multiple-step, or multi-step, income statements show gross profit as an intermediate figure in computing net income or loss. See also *single-step income statements.*

Net book value refers to the difference between a firm's assets and liabilities or the difference between an asset and a related contra-asset. The term can also refer to the amount of equity per outstanding ownership interest.

Net income shows the difference between a firm's revenues and its cost of sales, operating expenses, and taxes during a particular time period. See also *comprehensive income, other comprehensive income.*

Net profit margin, sometimes referred to as return on sales, shows how much net income a company earns compared to its revenue.

Net sales show the numerical difference between the 'Sales' and 'Sales Returns and Allowances' accounts.

Net realizable value subtracts the costs of sale from estimated selling price.

See also *lower of cost or market.*

Net worth. See equity.

a distribution.

Nonrecurring items unusually affect the income statement in one period but most likely not subsequent periods. See also *extraordinary items.*

Normal profit reflects the anticipated gain upon the sale of inventory, normally equaling expected retail price minus costs.

Notes payable express a liability arising from a promissory note.

Objectivity principle seeks to assure that different qualified persons would reach essentially similar measures and conclusions upon examining the same data. See *also verifiability principle.*

Operating activities involve selling or providing the firm's products and services. See also *statement of cash flows.*

Operating cash flows, a residual category on the statement of cash flows, generally reflects the movement of cash from selling and providing the firm's products and services. See also *investing cash flows, financing cash flows.*

Operating leases describe leases that do not essentially transfer ownership of the leased property. See also *capital leases, direct financing leases, sales type leases.*

Operating profit margin shows how much operating income, often before income taxes, interest, and other items, a company earns compared to its operating revenue.

Ordinary annuity requires the underlying payments at the end of each period. See also *annuity due.*

Other comprehensive income comprises the part of comprehensive income that includes unrealized gains or losses from holding certain investments in debt and equity securities, including related reclassification adjustments, foreign currency translation adjustments, and minimum pension liability adjustments. See also comprehensive income, net income.

Outstanding shares refer to those shares that shareholders continue to own. See also shares.

Overhead costs. See *factory overhead costs.*

Owner' equity. See *equity.*

Par value historically refers to a nominal value assigned to each share in the company's charter. Absent coincidence, this amount bears little or no relation to the share's market price or current value.

Passive investments do not convey significant influence over the investee, generally defined to be twenty percent of voting stock. See also *active investments.*

Percentage of completion method allows a firm to recognize a portion of the estimated profit on a long-term contract even though the firm has not substantially completed the project.

Periods. See *accounting periods.*

Period costs refer to those costs that both merchandisers and manufacturers incur, such as administrative salaries that will generate revenues only in the current accounting period. See also *product costs.*

Periodicity assumption attributes a firm's activities to distinct accounting periods. See also *accounting periods.*

Periodic inventory method computes the cost of goods sold by subtracting ending inventory from the sum of beginning inventory and net purchases. See also p*erpetual inventory method*.

Perpetual inventory method continuously shows the quantity and cost of the goods that the business holds as inventory at any time on the accounting records. See also *periodic inventory method*.

Posting records amounts reflected in journal entries in the appropriate accounts in the ledger.

Preferred shares give the shareholder priorities as to dividends or amounts at liquidation. See also *common shares.*

Prepaid expenses, better described as prepaid costs, appear as current assets and connote the fact that a future benefit has been paid in advance.

Prime cost. See *direct cost*.

Product costs include all expenditures directly or indirectly incurred in bringing inventory to its existing condition and location. See also *period costs.*

Profit and loss account serves as the consolidating account for all revenues, expenses, gains, and losses during an accounting period.

Program method, an accounting method for revenue recognition most often used in the aerospace-defense industry, averages the net profit of current and anticipated future contracts. See also *completed project method*.

Property, plant and equipment. See *fixed assets.*

Proprietorship accounts represent residual ownership in a sole proprietorship.

Pure rate of interest describes the rate a lender would charge a borrower for the use of money if the risks represented by the default, illiquidity, inflation, and maturity premiums did not exist. See also *default premium, illiquidity premium, inflation premium, maturity premium*.

Qualified opinions convey the independent auditor's belief that the financial statements do not fairly present the firm's financial position, operating results, and cash flows in conformity with generally accepted accounting principles. See also *adverse opinions, disqualified opinion, unqualified opinions.*

Quick assets generally include only cash, cash equivalents, marketable securities that the firm plans to sell in the near future, and accounts receivable, but the precise definition varies.

Rate base includes those assets viewed as devoted to providing utility services, and historically provides the starting point for determining the prices a utility can lawfully charge its customers.

Reasonable assurance describes the level of comfort that an unqualified opinion conveys, which falls well below a guarantee because the auditor only reviews a sample of a firm's total transactions.

Redemptions repurchase a company's own shares, which then become treasury shares or authorized but unissued shares. See also *dividends.*

Related party transactions involve dealings between parties who enjoy some close relationship to each other. Such transactions, if material, require disclosure in the financial statements.

Replacement cost estimates the amount a firm would pay to acquire a new asset as equally useful or productive as an asset that the firm currently has. See also *adjusted book value, lower of cost or market.*

Reserve refers to anticipated liabilities when uncertainty exists about the amount or timing of the transfer of the economic benefits that the obligation's payment or satisfaction will entail. When estimating a reserve, a firm treats the estimated amount necessary to resolve the matter as an expense or loss and records a liability or increases a contra-asset account to reflect the amount owed or the asset's impairment.

Reserve for bad debts. See *allowance for doubtful accounts.*

Residual method values goodwill at the difference between the purchase price to acquire an on-going business and the business's identifiable assets.

See also *goodwill.*

Restatements amend previously issued financial statements to correct errors arising from mathematical mistakes, misapplying accounting principles, or overlooking or misapplying facts that existed when the firm prepared the original statements.

Restrictive covenants contractually protect lenders from default by prohibiting the borrower from taking certain actions, such as paying dividends, or requiring the borrower to do certain things, such as providing financial statements to the lender or maintaining certain financial ratios.

Retail method allows a merchandiser to estimate the business's inventory based on a ratio of inventory costs to their retail prices without counting and pricing individual items. See also *average cost method, first-in first-out, last-infirst-out, specific identification, standard costs.*

Retained earnings account tracks all undistributed profits that remain invested in the firm.

Revaluation surplus may arise when a company's directors revalue assets to determine whether the board can lawfully distribute assets to shareholders.

Revenues consist of increases in assets, decreases in liabilities, or both, resulting from delivering goods, rendering services, or engaging in ongoing major or central operations. See also *expenses, gains.*

Revenue recognition principle delays recording revenue, with some exceptions, until an exchange transaction has occurred and when the firm has completed, or virtually completed, the earnings process.

Reverse stock splits combine a number of outstanding shares to form one new share.

Review, as an alternative to a full audit, offers only limited assurance that the financial statements fairly present the firm's financial position, operating results, and cash flows in conformity with generally accepted accounting principles. See also *compilation*.

Right of return implies that the selling firm has not entirely transferred all risks of ownership, and therefore should not immediately record the transaction as a sale.

Sales-type leases describe capital leases that involve either a dealer or manufacturer profit or loss for the lessor while essentially transferring ownership of the property. See also *capital leases, operating leases, direct financing leases.*

Salvage value is the expected market value of an asset at the end of its useful life.

Shares comprise the residual ownership of a company. See also *outstanding shares, treasury shares.*

Simple interest requires the borrower to pay interest on the original principal amount only, regardless of any unpaid interest attributable to past periods. See also *compound interest*.

Single-entry bookkeeping records each transaction affecting a particular asset, but does not track any other assets or liabilities. See also *double-entry bookkeeping.*

Single-step income statements classify all items into two categories: revenues, which include both operating revenues and gains; and expenses, which include cost of goods sold, operating expenses, losses, and taxes. See also *multiple-step income statements.*

Six-column worksheet, actually containing seven columns, lists accounts and credits and debits to each of the trial balance, income statement and balance sheet. See also *trial balance, worksheet*.

Specific identification, an inventory method, matches the precise cost to acquire or manufacture an item against its selling price to determine gross profit. Similarly, the costs of acquire or manufacture unsold items determine the ending inventory. This method offers the most accurate way to calculate gross profit and net income, but the time and expense necessary to record and track each item can overwhelm most firms. See also *average cost method, first-in first-out, last-in first-out, retail method, standard costs.*

Standard costs, an inventory method, assigns predetermined unit costs to materials, labor, and overhead, and then records variances when actual costs differ from the expected amount. See also a*verage cost method, first-in first out, last-in first-out, retail method, specific identification*.

Stated value conveys an amount that the board of directors arbitrarily assigns to shares before issuing them under the legal capital system. See *par value.*

Statement of cash flows reports and explains the changes in a firm's cash and cash equivalents during an accounting period. See also *balance sheet, income statement, statement of changes in owner's equity.*

Statement of changes in owner's equity fully reconciles the changes in net worth between balance sheet dates, including increases arising from owner investments and decreases from withdrawals. See also *balance sheet, income statement, statement of cash flows.*

Statement of earnings. See *income statement.*

Statement of operations. See *income statement.*

Statement of financial condition. See *balance sheet.*

Statement of financial position. See *balance sheet.*

Statement of retained earnings. See *statement of changes in owner's equity.*

Straight-line method allocates an item, such as depreciation or interest income, equally between any accounting periods involved. For depreciation, this method divides the asset's useful life into the depreciable basis to determine the depreciation for each period in the useful life.

See also *depreciation.*

Successful efforts accounting, a cost collection method, capitalizes only those acquisitions, exploration, and development costs directly associated with fruitful projects.

See also *cost collection methods, full-costing accounting.*

Sum-of-the-years'-digits method produces a decreasing depreciation charge as a function of a decreasing fraction of the depreciation base.

See also *accelerated depreciation, depreciation.*

Surplus, in a legal capital system, represents equity in excess of stated capital.

See also *capital surplus, earned surplus.*

T-account records changes in a given asset, liability, or component of equity.

See also *account.*

Tangible book value modifies net book value by subtracting any recorded intangible assets from a firm's net assets.

See also *net book value.*

Tone-at-the-top refers to the environment established by upper management that influences financial accounting practices.

Tracing, an auditing technique, follows a particular item of data through the accounting and bookkeeping process to determine whether the business has properly recorded and accounted for it.

See also *vouching.*

Trading securities imply the intent to sell the debt or marketable equity securities in the near term.

See also *available-for-sale securities, held-to maturity debt securities.*

Treasury shares describe shares repurchased by the company. The modern trend treats such shares as authorized but unissued.

See also *authorized but unissued shares, shares.*

Trend analysis involves comparing financial statements for a firm over several periods.

See also *ratio analysis.*

Trial balance lists all accounts and their temporary balances.

Unearned revenues require the entity to refund the unearned amount if it does not perform certain services.

See also current liabilities.

Unexpired assets. See *capital expenditures.*

Units-of-activity method bases an asset's depreciation on the estimated quantity of output or expected number of hours of productive capacity.

See also *depreciation*.

Unqualified opinions, from independent auditors, reflect that the financial statements fairly present the firm's financial position, operating results, and cash flows in conformity with generally accepted accounting principles.

See also *adverse opinions, disclaimer of opinion, explanatory language, qualified opinions.*

Useful life estimates the duration of the expected future benefits of a long lived asset.

See also *depreciation*.

Variable costs, such as raw materials and direct labor, change depending on production levels.

See also *factory overhead costs, fixed costs.*

Verifiability principle prefers accounting treatments that available and reliable evidence can support. See also objectivity principle.

Vertical analysis. See *common-sized analysis.*

Vouching, an auditing technique, selects a transaction recorded in a business's books to determine whether underlying data supports the recorded entry.

See also *tracing.*

Wasting assets. See *depletion*.

Work-in-process inventory describes unfinished, not-yet-marketable goods that a firm holds for completion.

Working capital measures the difference between current assets and current liabilities.

Working papers document the various procedures and findings in an audit.

Working trial balance. See *six-column worksheet*.

Work papers. See *working papers.*

Worksheet separates the revenue, gain, expense, and loss accounts in the trial balance that flow into the income statement and the asset, liability, and equity accounts that appear on the balance sheet.

See also *trial balance, six-column worksheet*.

Write-down transfers a portion of the balance in an asset account to an expense account, which reduces net income in the current period, reflecting a decrease in the asset's value. See also *write-offs.*

Write-offs eliminate assets that have become worthless from the balance sheet.

See also *write-downs.*

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