3

KENYA SCHOOL OF LAW

ADVOCATES TRAINING PROGRAMME

2011/2012 ACADEMIC YEAR

LEGAL PRACTICE MANAGEMENT (ACCOUNTING)

LECTURER MR. SOLOMON WANYIRI

---

**THE ACCOUNTING EQUATION**

By adding up what the accounting records say belong to the business, and deducting what they say the business owes, you can identify what a business is worth according to those records. Financial accounting is based on this simple idea and this is known as **accounting equation**.

For a business to start trading it will need resources. Thus;

***RESOURCES SUPPLIED BY THE OWNER(S) = RESOURCES IN THE BUSINESS.***

The amount of resources supplied by the owner(s) is called capital. The actual resources in the business are called assets. Thus when the owner has supplied all the resources, the equation becomes,

***CAPITAL= ASSETS.***

However other parties other than the owner supply some of the asset. The amounts owing to these people for the assets they have supplied are called **LIABILITIES**. This accounting equation becomes,

***CAPITAL=ASSETS – LIABILITIES.***

It can be seen the two sides of the equation will be equal i.e. have same totals. This is because we are dealing with the same thing from two view points, i.e. from the value of owners investment in the business and the value of what is used by the owners. To see at a glance what a value is represented in the business, we present the equation as; ASSETS = CAPITAL + LIABILITIES

***Resources: (what they are) = Resources (who supplied them)***

***ASSETS*** ***CAPITAL + LIABILITIES***

No matter how you present the accounting equation, the totals will always be equal no matter how many transactions there may be. The actual assets, capital and liabilities may change but **assets** will always be equal to **capital + liabilities**.

Assets include; buildings, machinery, inventories (stock0, motor vehicles, debts owed by customers and amount of money in the organization's bank account.

Liabilities include amounts owed by the business for goods and services supplied to the business and expenses incurred by the business and not yet paid. Capital is often called owners equity or net worth. It includes funds invested in the business by the owner plus any profits retained for use in the business less any share of profits paid out of the business to the owner(s).

**THE BALANCE SHEET AND THE EFFECTS OF BUSINESS TRANSACTION**

The accounting equation is expressed in financial statement called the balance sheet. The balance shows the financial position of an organization at a particular point in time. In other words it presents a snapshot of the organization at the date for which it was prepared.

**Examples of transactions that affect a balance sheet:**

1. **Introduction of capital**
   On 1st May 2009 J. King started in business and deposited Ksh.600,000 into a bank account opened specially for the business. The balance sheet would show

**J. KING**
**BALANCE SHEET AS AT 1ST MAY 2009**

| | sh |
|---|---|
| *Assets:* cash at bank | 600,000 |
| *Capital* | 600,000 |

Note that the two parts of the balance sheet have balanced.

2. **Purchase of an asset by cheque**

On 3rd may j. kings buys a small shop for kshs.320,00 paying by cheque. Cash in the bank decreases but a new asset is added.

**J. KING**
**BALANCE SHEET AS AT 3 MAY 2009**

| | sh |
|---|---|
| *Assets* | |
| | 320 000 |
| shops | 280 000 |
| | 600,000 |
| *Capital* | 600,000 |

### 3. Purchase of an asset and incurring liability

On 6th may 2009, king buys some goods for ksh. 70,000 from D. Smith and agrees to pay for them sometime within the next two weeks. The effect of this is that a new asset inventory is acquired and a liability for the goods is created. A person to whom money is owed for goods is known as creditor and is described in the balance sheet as account payable. The balance sheet becomes

**J. KING**

**BALANCE SHEET AS AT 6 MAY 2009**

| *Assets* | sh |
|---|---|
| *Shop* | 320,000 |
| Inventory | 70,000 |
| Cash | 280,000 |
| | 670,000 |
| less: account payable | (70,000) |
| | 600,000 |
| *Capital* | 600,000 |

The liability is shown as a deduction from the assets.

### 4. Sale on an asset on credit

On 10 may 2009 goods which cost sh. 6,000 were sold to j. ~~brown~~ king for the same amount , the money to be paid later. The effect of this is reduction of stock for goods and creation of a new asset. A person who owes the business money is called a **debtor** and is described in the balance sheet as **account receivable.**

The balance sheet is shown as

**J. KING**

**BALANCE SHEET AS AT 10 MAY 2009**

| *Assets* | sh |
|---|---|
| shop | 320,000 |
| Inventory | 64,000 |
| Account receivable | 6,000 |
| Cash at bank | 280,000 |
| | 670,000 |
| Less: account payable | (70,000) |
| | 600,000 |
| *Capital* | 600,000 |

**5. Sale of an asset for immediate cash**

On 13 may 2009 goods which cost sh. 4,000 were sold to D. Daley for the same amount. Daley paid for them immediately by cheque. Here are asset; inventory is reduced but another asset, cash at bank is increased.The balance sheet becomes:

**J. KINGS**

**BALANCE SHEET AS AT 13$^{TH}$ MAY 2009.**

| Assets | sh |
|---|---|
| Shop | 320,000 |
| Inventory | 60,000 |
| Accounts receivable | 6,000 |
| Cash at bank | 284,000 |
| | 670,000 |
| Less : account payable | (70,000) |
| | 600,000 |
| Capital | 600,000 |

**6. Payment of a liability**

On 15th may 2009, kings pays a cheque for sh.30,000 to D. smith in part payment of the amount owing. The asset of cash at bank is therefore reduced and the liability to the creditor is also reduced. The balance sheet is now presented as follows:

**J. KINGS**

**BALANCE SHEET AS AT 15 MAY 2009**

| assets | sh |
|---|---|
| Shop | 320,000 |
| Inventory | 60,000 |
| Accounts receivable | 6,000 |
| Cash at bank | 254,000 |
| | 640,000 |
| Less: account payable | (40,000) |
| | 600,000 |
| Capital | 600,000 |

**7. Collection of an asset**

j. Brown who owed sh. 6,000 makes a part payment by cheque of sh. 2,000 on 31st may 2009. The effect is to reduce one asset, cash receivable and increase another asset, cash at bank. The balance sheet becomes

**J. KINGS**

**BALANCE SHEET AS AT 31 MAY 2009**

| assets | sh |
|---|---|
| Shop | 320,000 |
| Inventory | 60,000 |
| Accounts receivable | 4,000 |
| Cash at Bank | 256,000 |
| | 640,000 |
| Less: Account payable | ( 40,000) |
| | 600,000 |
| Capital | 600,000 |

More detailed presentation of balance sheet

**J. KINGS**

**BALANCE SHEET AS AT 31 MAY 2009**

| | | |
|---|---|---|
| **Non currents assets (fixed assets)** | sh | sh |
| Shop | | 320,000 |
| **Current assets** | | |
| Inventory | 60,000 | |
| Accounts receivable | 4,000 | |
| Cash at bank | 256,000 | 320,000 |
| Total assets | | 640,000 |
| *Less: current liabilities* | | |
| Account payable | | (40,000) |
| NET ASSETS | | 600,000 |
| Capital | | 600,000 |

F.A. are assets with a long life bought with the intention to use them in the business and not resale e.g buildings, machinery, fixtures, motor vehicle.

C.A. are assets consisting of goods for resale or items having a short life (ie no more than a year remaining on the date of balance sheet)

C.L. liabilities to be paid within no more than a year from the date of the balance sheet eg. Accounts payable for goods purchased.

**ILLUSTRATION**

J. Hill has the following assets and liabilities as on 30th Nov 2010. Accounts payable sh. 28,000, equipment sh.62,000, car sh 730,000, inventory sh.810,000, accounts receivable sh.405,000, cahs at bank sh.910,000, cash in hand sh.195,000.

During the first week if Dec 2010

a) Hill bought extra equipment on credit for sh. 11,000
b) Hill bought extra inventory by cheque for sh. 380,000
c) Hill paid creditors by cheque sh. 115,000
d) Debtors paid hill sh.150,000 into business, sh 13,000 by cheque and sh. 20,000 cash.

Required; draw up the balance sheet as at 7th December after the transactions have been compiled.